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BY EMAIL AND BY FEDERAL EXPRESS

Ms. Rebecca H. Ewing
Executive Secretary
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

**Re: September 27, 2012 Letter to Members of the Financial Stability Oversight Council
from Chairman Timothy F. Geithner ("Recommendation Letter")**

Dear Ms. Ewing:

On behalf of clients of this Firm that may be impacted by actions of the Financial Stability Oversight Council ("FSOC"), we are writing to request clarification of, and to comment upon, the Recommendation Letter (a copy of which is attached), which Secretary of the Treasury Timothy F. Geithner (the "Secretary") sent to his fellow members of the FSOC in his capacity as Chairman of the FSOC and released to the public.

In the Recommendation Letter, the Secretary proposed an agenda for the FSOC in light of the announcement, in August, by the Chairman of the Securities and Exchange Commission ("SEC") that she would not ask the other SEC Commissioners to vote on an SEC staff proposal for structural reforms of money market funds ("MMFs") at that time. Among the actions that the Secretary proposed to his fellow FSOC members, he asked them to consider for the first time issuing a recommendation to a primary financial regulatory agency under section 120 of the Dodd-Frank Act ("DFA"), by which the FSOC would recommend that such agency (here, the SEC) fundamentally change the MMF regulatory regime.

The Recommendation Letter raises significant legal and regulatory issues of first impression for the FSOC regarding how it will, and must, conduct its business in a manner consistent with the law. Because this is a novel action by a nascent agency and because the potential consequences for the U.S. economy are so serious, the FSOC must establish processes that follow not only the statutory requirements but also administrative best practices that ensure the accountability and transparency that a recent Government Accountability Office ("GAO") report calls on the FSOC to provide.¹

¹ U.S. Government Accountability Office, Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of the Their Decisions, GAO-12-886 (Sept. 2012) ("GAO Report").

1. Conclusions

There are no clear rules of engagement to guarantee transparency, fairness and accountability in this unprecedented action that the Secretary requests the FSOC to take under section 120 of the DFA. He has asked the FSOC to rush, by any standard of regulatory action, to endorse significant changes in the MMF industry, without first establishing the appropriate process to analyze transparently the purported need for and benefits of regulatory changes and the enormous impact such changes may have on the industry, financial system and U.S. economy. The Recommendation Letter does not call for the FSOC to establish internal agency rules that would serve as a template to ensure fair, appropriate and consistent evaluation of potential section 120 recommendations, nor has the FSOC established any internal agency rules or procedures to implement the express statutory requirements of section 120. On the contrary, the Recommendation Letter implies that the predicates for a section 120 recommendation regarding MMFs have already been satisfied. For the reasons set forth in this letter, we do not believe that is the case.

Although the Secretary chairs the FSOC, each member is individually responsible to ensure that the agency follows sound procedures for the exercise of its authority, in order that the FSOC acts in a fair, legal and justifiable manner. To discharge this responsibility, each member must evaluate whether and to what extent the Recommendation Letter inappropriately prejudges the outcome of what is required to be an objective and transparent regulatory process that seeks to balance important public policy objectives. FSOC members cannot satisfy those requirements by merely reiterating preconceptions and prejudgments contained in the Recommendation Letter. In that regard, the FSOC must act in a logical order and put the regulatory horse before its cart if the FSOC is to meet statutory requirements and administrative best practices, and avoid being found to have acted arbitrarily, capriciously and contrary to law.

In the context of considering action under section 120, the FSOC must, at a minimum, first address the following issues:

- **FSOC Internal Agency Rules** – What internal agency rules will define the exercise of the FSOC’s section 120 authority, to ensure the appropriateness of the process, the avoidance of conflicts of interest, the absence of bias and predisposition of relevant issues and the creation of the administrative record?
- **The Authority Question** – How can the FSOC conclude that MMFs come within its statutory purview over “nonbank financial companies” when the Board of Governors of the Federal Reserve System (“FRB”) has not yet completed the necessary regulatory action under the DFA to define that term? Has the FSOC determined that MMFs are engaged in “financial activities” that pose the financial stability threat required under section 120?

- **The Transparency Question** – How will the FSOC conduct itself and what standards will it adopt prior to taking up the Recommendation Letter to address the concerns already raised by GAO with regard to the lack of accountability and transparency in its decision-making?
- **The Consultation Requirement** – How will the FSOC consult with the SEC commissioners and key SEC staff who are most knowledgeable about how MMFs work and are regulated? What will the rules of engagement be for such consultations? Will such consultations be on the record and available to the public for comment? How will the FSOC ensure that the process is free of undue influence and conflicts of interest?
- **The Cost Benefit Analysis** – What will be the parameters of the required comprehensive analysis of the costs to long-term economic growth associated with each proposed recommendation under section 120(b)(2)(A) (“Cost Benefit Analysis”)? How will the Cost Benefit Analysis be performed, who will perform it, and how will it be reviewed? How and when will the FSOC disclose the metrics of its analysis to public review and comment? How will the Cost Benefit Analysis be reconciled with similar work that may have been undertaken by the SEC?
- **The Administrative Record: Notice and Comment** – How will the FSOC’s notice and request for public comment on the proposed recommendations address the requirements of the law, including the need for public comment on the Cost Benefit Analysis, and will the public be provided a reasonable period of time for public comment?
- **Final Recommendations; Response to Public Comments** – How and on what terms will the FSOC transmit any final recommendations to the SEC? How will the FSOC inform the public of its responses to comments that it receives and of the basis for any final recommendations it may make to the SEC? Will the FSOC provide more robust and detailed responses to comments than it has done in the past, such as in its responses to comments on its rulemaking under section 113 of the DFA?

The Recommendation Letter also suggests that the FSOC should take other steps beyond those permissible under section 120 in the event that the SEC does not propose MMF reforms in what the Secretary considers a timely and effective manner. Before proceeding, the FSOC must address significant questions and legal issues related to those suggestions as well:

- **SIFI Designation** – The Recommendation Letter suggests that the FSOC consider designating MMFs or their sponsors or investment advisers as systemically important financial institutions (“SIFIs”) subject to supervision by the FRB, but it does not address how the statutory prerequisites for a SIFI designation—*e.g.*, a company must qualify as a nonbank financial company—may be satisfied before

the FRB adopts the final regulations required for such a determination.² Nor does it address why such a designation would not be premature, since the Office of Financial Research has not completed, or published for comment, its study of the asset management industry.³ The Recommendation Letter's suggestion of a selective, targeted focus on a particular group of entities also appears to be at odds with the evenhanded approach to SIFI designation contemplated by the FSOC's interpretive guidance on the subject.⁴ Its suggestion regarding the potential designation of sponsors or investment advisers of MMFs raises even more questions, since the FSOC has indicated that it may issue additional guidance regarding the treatment of asset managers but has not published any proposed metrics or thresholds specific to asset management for public comment.⁵ Indeed, it is not clear how a SIFI designation of an MMF or an MMF-related firm would achieve the reform objectives set forth in the Recommendation Letter.⁶ As many commenters have observed, the characteristics of the asset management industry are incompatible with the bank-type regulations that the FRB has proposed to impose on designated companies.⁷ Any attempt to "reform" a segment of the

² See section 2.2.1. below.

³ See letter to FSOC Chairman Geithner from eleven members of Congress, June 15, 2012.

⁴ 77 Fed. Reg. 21637 (April 11, 2012).

⁵ *Id.* at 21645. See letter to Rep. Nan Hayworth from Alastair M. Fitzpayne, Assistant Secretary of the Treasury, August 6, 2012. The letter states that if the FSOC decides as a result of its analysis of asset management companies to supplement existing metrics and thresholds with metrics and thresholds that are specific to asset managers, it intends to provide the public with an opportunity to review and comment on such metrics and thresholds.

⁶ A company that is designated as a SIFI will be subject to enhanced prudential standards adopted by the FRB, but the FRB has conceded that its proposed standards were "largely developed with large, complex bank holding companies in mind" and that it expects to tailor their application individually to each designated company. 77 Fed. Reg. 594, 597 (Jan. 5, 2012). However, the FRB has provided little guidance as to what its approach to tailoring the standards for nonbank SIFIs would be, which raises serious issues regarding the outcome and efficacy of the designation of an MMF-related company as a SIFI. See letter to the FSOC from the Investment Company Institute ("ICI"), Feb. 25, 2011 ("ICI FSOC Letter"), at 6 ("[T]he FSOC should have a reasonable expectation that the 'remedies' that would flow from SIFI designation are necessary and will be effective to address the specific risk(s) that the FSOC seeks to minimize."). The ICI stated that the prudential standards under section 165 are either unnecessary or inappropriate for MMFs. It commented that several of the prudential standards are largely addressed in the current MMF regulatory regime, citing leverage, liquidity buffers and enhanced disclosure, and that other concepts, such as risk-based capital, reflect banking concepts that do not work for MMFs.

⁷ See letter to the FRB from the ICI, April 30, 2012, at 2 (stating that applying a bank-oriented regulatory framework to all covered companies disregards Congressional recognition that for purposes of prescribing enhanced prudential standards one size does not fit all). See also letter to the FRB from The Financial Services Roundtable and the Securities Industry and Financial Markets Association, April 30, 2012, at 2. (stating that the fundamental differences in the capital structures, risk profiles and activities of nonbank financial companies as compared to bank holding companies, as well as the diversity among nonbank financial companies themselves, make the FRB's one-size-fits-all approach ill-conceived, unworkable and

asset management industry by selectively applying bank-type regulations to a subset of companies in that segment is likely to be ineffective and counterproductive for many reasons, including that it is likely to cause designated firms or funds to shrink dramatically or liquidate, with no assurance that the repositioning of investors' funds would result in reduced financial stability risk.

- **Title VIII** – The Recommendation Letter suggests that the FSOC's authority to designate systemically important payment, clearing or settlement activities under Title VIII of the DFA could enable the application of heightened risk-management standards to MMFs on an industry-wide basis. However, the statutory language of Title VIII does not support such a targeted application.

2. The FSOC Should Comply with the Requirements of Applicable Law and Administrative Best Practices if It Makes a Section 120 Recommendation

2.1. Introduction

The FSOC should first establish clear processes that follow not only the statutory requirements of section 120, but also adhere to long-standing, well established best practices to ensure the sort of accountability and transparency that the GAO Report called on the FSOC to provide. The Secretary expressed strong opinions in the Recommendation Letter regarding the actions that he believes the FSOC should take, and urged his fellow members of the FSOC to act quickly, which would strain even a robust, well established process. Without such a process in place here, the proposed timeline and apparent predisposition present additional issues of fairness.⁸

Even well-intentioned proposals can have a destabilizing impact on financial markets and, accordingly, must comply with statutory restrictions and the safeguards of sound

ineffective). FRB Governor Daniel K. Tarullo has expressed similar doubts regarding the attempt to regulate MMFs through SIFI designation, stating that "prudential standards designed for regulation of bank affiliated firms may not be as useful in mitigating risks posed by different forms of financial institutions. Continuing with the money market fund example, the options for reform identified by the President's Working Group on Financial Markets show that these standards may not be the optimal form of regulation." Speech at 2011 Credit Markets Symposium, March 31, 2011. It is also noteworthy, as the ICI observed in its letter to the FSOC, that nowhere does the Report of the President's Working Group on Financial Markets on Money Market Reform Options ("PWG Report") even suggest that the FSOC consider taking a "fund-by-fund, complex-by-complex, or adviser-by-adviser approach under section 113." ICI FSOC Letter at 9.

⁸ The Secretary's call for the FSOC to act in an accelerated manner on MMF reform is in sharp contrast to the deliberate manner in which the FSOC has acted with respect to the exercise of other aspects of its authority. The FSOC sought public comment and adopted procedural rules and interpretive guidance before it began the process of considering potential SIFI designations. The FSOC likewise sought public comment and adopted regulations before it acted to designate systemically important financial market utilities under Title VIII.

administrative process.⁹ Given the role of MMFs in the U.S. economy, any actions that could prompt significant redemptions from MMFs could undermine growth in the U.S. economy and, depending on where those funds go, create or exacerbate threats to the stability of the U.S. financial system. In order to fulfill its mandate, the FSOC must carefully analyze these risks before issuing any MMF reform proposal. This also requires that the FSOC implement a transparent process that provides, among other things, a meaningful opportunity for the public to comment on all aspects of any reform proposal and allows the public and Congress to hold the FSOC accountable for its actions.

FRB Governor Tarullo recently identified several reasons for the FSOC to proceed cautiously in regard to any MMF reform actions. In a speech on October 10, 2012, he observed that the SEC already has ample regulatory authority and is best positioned to address the systemic risk problems that MMFs may present. It should also be noted that the SEC's status as the primary and most appropriate regulator of MMFs has not changed simply because Chairman Schapiro could not persuade a bipartisan majority of her fellow Commissioners to support her proposed reform options, on her preferred timeline, without the benefit of the additional analysis that they requested.

Regarding the SEC's primary role, Governor Tarullo also noted that Congress considered and rejected giving the FSOC the power to override agency action or inaction regarding systemic financial stability. In his opinion, the actions that Congress authorized the FSOC to take, including making recommendations under section 120, are a "decidedly second-best alternative" to action by the SEC. He observed that "[t]he protective tools available to the Council do not fit the problem precisely and thus will not regulate at the least cost to the [MMFs] while still mitigating financial risk." Governor Tarullo also noted in his speech that there is little academic, administrative, legislative, or judicial analysis of how financial stability is defined, not to mention threatened, and no official consensus on the subject.

2.2. The FSOC must comply with all legal requirements for FSOC action

Section 120 imposes several statutory requirements for a recommendation to the appropriate financial regulatory agency—in this case, the SEC. These requirements were put in place by Congress to ensure that such highly significant public policy-making is properly done. The FSOC is also subject to other applicable law in regard to any section 120 recommendation, including the Administrative Procedure Act ("APA").

⁹ See, e.g., Statement Regarding Money Market Funds by SEC Commissioner Luis A. Aguilar, August 23, 2012, in which he described "larger macro questions and concerns about the cash management industry as a whole that must be considered before a specific slice of that industry—money market funds—is fundamentally altered." He stated that "[t]o move forward without this foundation is to risk serious and damaging consequences in contravention of the Commission's mission."

2.2.1. Legal status of MMFs as nonbank financial companies

One fundamental limitation on any recommendation under section 120 is that it can only apply to a financial activity or practice conducted by “bank holding companies or nonbank financial companies.” In the Recommendation Letter, the Secretary suggested that the FSOC’s recommendation would apply to MMFs, but it has *not* been established that MMFs are nonbank financial companies under the provisions of the DFA.¹⁰

Section 102(b) of the DFA requires the FRB to issue regulations to establish how to determine whether a company meets the requirements to be deemed a “nonbank financial company.” While the FRB has issued a proposed rule and a supplemental proposed rule, it has not promulgated a final rule for this purpose.¹¹ Serious issues have been raised in comment letters to the FRB as to whether an MMF would qualify as a nonbank financial company under the statute. In any event, until the FRB adopts a final rule, there is no basis for the FSOC or its members to conclude that MMFs are nonbank financial companies for purposes of section 120. Therefore, the FSOC cannot at this time make a recommendation to the SEC with respect to MMF activities or practices in compliance with section 120(a) of the DFA.

2.2.2. Factual basis for a section 120 recommendation

In order to make a section 120 recommendation, the FSOC must make four determinations. It must find, for (i) “a financial activity or practice” conducted by bank holding companies or nonbank financial companies, that (ii) “the conduct, scope, nature, size, concentration, or interconnectedness” of the financial activity or practice (iii) “could create or increase the risk of significant liquidity, credit, or other problems” (iv) that would spread among “bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or under-served communities.”

Based on the foregoing, in order for the FSOC to make a valid recommendation for MMF reform, it must specify the financial activity or practice that it seeks to address. Furthermore, the FSOC must describe the specific characteristics—*i.e.*, the conduct, scope, nature, size, concentration, or interconnectedness—of the identified financial activity or practice as conducted by MMFs that it believes require reform. Finally, the FSOC must identify the significant

¹⁰ Under sections 102(a)(4)(A)(ii) and (B)(ii) of the DFA, a “nonbank financial company” is defined as a company that is “predominantly engaged in financial activities.” To be “predominantly” engaged in financial activities, a company generally must receive 85% or more of its consolidated gross revenues from, or 85% or more of its consolidated assets must be related to, a group of financial activities as defined in section 102(a)(6) of the DFA. “Financial activities” in section 102(a)(6) are those activities that are “financial in nature” under section 4(k) of the Bank Holding Company Act.

¹¹ 76 Fed. Reg. 7731 (Feb. 11, 2011); 77 Fed. Reg. 21494 (April 10, 2012).

problems that the identified financial activity or practice as conducted could cause or exacerbate and the persons or communities that are threatened.¹²

The FSOC must determine that there is a clear causal relationship between a financial activity or practice as conducted by MMFs and a significant credit, liquidity or other problem. Establishing this relationship requires more than a conclusory statement in a recommendation that a financial activity or practice had such an effect in the past. It would not be sufficient, for example, for the FSOC simply to rely on the fact that SEC staff developed an unpublished draft proposal for MMF reform based on the presumed existence of such a relationship, or to rely on analyses of the need for reform that do not adequately address the need for, or presume the efficacy and likely impact of, a proposed reform.

For example, as noted by SEC Commissioners Daniel M. Gallagher and Troy A. Paredes in their statement on August 28, 2012 regarding the SEC staff draft proposal, further study is required of the “runs” on MMFs that occurred during the financial crisis in view of the large amounts of funds that were transferred from prime MMFs to government MMFs. These transfers raise questions regarding the extent to which the structure of MMFs—*i.e.*, their stable net asset value accounting, which both prime MMFs and government MMFs share—actually contributed to a larger “flight to quality.”¹³ Also relevant is the record of the performance of MMFs after the SEC’s 2010 MMF reforms took effect and during subsequent threats to the value and liquidity of the assets they held, such as the downgrade of the U.S. credit rating and the economic crisis in certain Eurozone countries.¹⁴ To paraphrase an observation by FRB Governor

¹² In addition to these findings, any rulemaking by the SEC to implement a final recommendation from the FSOC must comply with the Investment Company Act, as amended (“ICA”), the APA, other law applicable to SEC rulemaking, applicable Executive Orders and the organic rulemaking requirements that the SEC has adopted. Section 120 does not authorize the FSOC to direct a primary financial regulatory agency to take any action that is outside the lawful scope of its authority. Thus, the SEC does not appear to have any authority to implement a recommendation for MMF reform by any means that is in conflict with applicable legal requirements. For example, under section 2(c) of the ICA, the SEC is required to consider whether any proposed rule would promote efficiency, competition, and capital formation; a recommendation by the FSOC does not override that requirement.

¹³ The contribution of MMFs to the “flight to quality” is also brought into question by a preliminary study of repurchase and reverse repurchase (“repo”) financing from the second quarter of 2007 to the first quarter of 2009. The study combines data for “tri-party repo,” which is dominated by regulated institutions and where most research on repos has focused, and “bilateral repo,” which is less well documented and understood. The study suggests that a “run” on repo of approximately \$1 trillion occurred during the heart of the financial crisis, but that MMFs did not participate in it and actually increased their repo assets during this period. See Gary Gorton and Andrew Metrick, *Who Ran on Repo?*, National Bureau of Economic Research Working Paper Series (Oct. 4, 2012).

¹⁴ SEC Commissioner Aguilar noted the lack of such empirical analysis in his August 23, 2012 statement, discussed at footnote 9 above, setting forth his objections to the SEC staff draft proposal. One such study has recently been released. See David W. Blackwell, Kenneth R. Troske and Drew B. Winters, *Money Market Funds Since the 2010 Regulatory Reforms: More Transparency, Increased Liquidity, and Lower Credit Risk* (U.S. Chamber of Commerce Center for Capital Markets Competitiveness, Fall 2012). In the study, the authors analyzed MMF industry data on liquidity, credit risk, redemption patterns and net cash flows since the 2010 reforms and documented the stability of the MMF industry during that period. In light

Tarullo in a speech on March 31, 2011, it is essential to understand the type of systemic risk being faced and the dynamics of that particular type of systemic risk in order to prescribe appropriate reforms for that risk.

In addition to being an administrative best practice, it is also a statutory requirement that such an “understanding” be reached transparently by publishing the regulatory rationale and that it be tested through a public comment process. Furthermore, the FSOC must rigorously analyze the costs and benefits when considering the appropriateness of any proposed reforms, as discussed further below, and the public should have a full opportunity to evaluate the FSOC’s analysis. Only in this way can it be established that the FSOC has a sound basis for proceeding and can the FSOC be held accountable as the public measures the actual impacts of any reforms against the impacts that the FSOC predicts.

2.2.3. Cost benefit analysis

MMFs constitute a significant part of the U.S. economy.¹⁵ They are widely held by consumers and businesses, are a substantial source of funding for U.S. businesses and state and local governments, and constitute a significant portion of liquid assets in the U.S. Without extensive analysis and study, it is not possible to predict what the specific effects of MMF reform may be, but they are likely to be felt throughout the economy.¹⁶ In that regard, the Recommendation Letter appears to prejudge the results of such a study, thereby potentially rendering the SEC consultation process and the public notice and comment process meaningless.

Congress mandated in section 120(b)(2) that any recommendations by the FSOC must properly take into account costs to long-term economic growth. This Cost Benefit Analysis must be published for public comment. The Cost Benefit Analysis mandate recognizes that the impact of any section 120 recommendation is likely to extend well beyond those companies that are affected directly to affect the financial services sector more broadly and the U.S. economy. The Cost Benefit Analysis and the opportunity for public comment on the Cost Benefit Analysis

thereof, they questioned the efficacy of commonly proposed MMF reforms and called for more study before any reforms were implemented. The FSOC’s Cost Benefit Analysis should consider this study and other empirical evidence that is relevant to the justification for any proposed recommendation or to the evaluation of a recommendation’s effect on long-term economic growth.

¹⁵ As of December 31, 2011, 632 MMFs held approximately \$2.7 trillion of assets in the aggregate. Source: Investment Company Institute, 2012 Investment Company Fact Book.

¹⁶ As pointed out in the PWG Report, MMF reform could cause a massive shift of funds. If, as a result of MMF reforms, MMF investors redeem shares, hundreds of billions of dollars could be shifted from MMFs to insured depositories or to other, possibly more attractive investment vehicles that operate outside of a regulated environment. PWG Report at 21. That could increase the concentration of funds in the largest banking organizations, grow the holdings of relatively unregulated investment vehicles, or both, which could increase threats to the stability of the U.S. financial system. In addition, U.S. businesses and state and local governments that rely on MMFs for short-term financing could be required to turn increasingly to alternative funding sources, which may be more expensive and more difficult to obtain, or to hoard capital, which would tend to slow economic activity.

serve as an essential check on the exercise of regulatory authority that may be unduly risk averse or based on deficient information, analysis, or presumptions about the benefits of regulatory action. Thus, in order that the FSOC fulfill its obligations under the statutory scheme, it must engage in a rigorous, comprehensive and impartial analysis of the costs and benefits that any recommendation for MMF reform may have for the long-term prospects for U.S. economic growth.

This analysis is particularly challenging given the reliance that U.S. investors, businesses and state and local governments have placed on MMFs as an investment and as a source of financing. A disruption of these relationships would raise many questions about what alternatives would be available to investors, businesses and governments and whether and how a shift of assets away from MMFs could directly and indirectly stifle long-term economic growth. The potential implications of MMF reform recommendations require the FSOC to undertake a comprehensive and impartial Cost Benefit Analysis. To that end, the FSOC should consider hiring one or more impartial third parties to conduct it.

Congress expressly decided to make a Cost Benefit Analysis a statutory requirement for a recommendation under section 120. In the event that a recommendation were to be subject to judicial review, a reviewing court could strike down a section 120 recommendation that is not supported by an adequate Cost Benefit Analysis on the grounds that the recommendation is arbitrary, capricious or contrary to law. Courts in recent years have repeatedly invalidated regulatory actions based on inadequate cost benefit analyses.¹⁷ Recent Executive Orders and a report by the GAO further highlight the importance of comprehensive cost benefit analysis by the federal agencies.¹⁸

The preparation and publication of a thorough Cost Benefit Analysis in the public notice of any proposed recommendations for MMF reform is essential to allow the wide range of potentially affected constituencies, individual and institutional MMFs investors, and U.S. businesses and state and local governments that obtain financing from MMFs a meaningful opportunity to provide their perspectives on the likely impact of particular reform options.

2.2.4. SEC consultation

Section 120(b)(1) requires that the FSOC consult with the primary financial regulatory agencies to which a proposed recommendation is to be directed. In this case, each SEC Commissioner has an equal vote to authorize actions by the SEC, and a majority of the SEC Commissioners must agree for the SEC to take any action in response to the receipt of a recommendation from the FSOC. It also is clear from statements by the SEC Commissioners

¹⁷ See *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *American Equity Life Insurance Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010); *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005).

¹⁸ E.O. 13563, 76 Fed. Reg. 3821 (Jan. 18, 2011); E.O. 13579, 76 Fed. Reg. 41587 (July 14, 2011); U.S. Government Accountability Office, *Dodd-Frank Act Regulations: Implementation Could Benefit from Additional Analyses and Coordination*, GAO-12-151 (Nov. 2011).

that there are significant differences of opinion among them regarding the need for, and the appropriateness of, specific MMF reforms. In this situation, in order to fulfill the letter and the spirit of the section 120(b)(1) consultation requirement, the FSOC should consult individually with each SEC Commissioner. Furthermore, to the extent possible, and in accordance with the Government in the Sunshine Act, the FSOC's Transparency Policy and the GAO recommendations for greater FSOC transparency, the FSOC should make its consultation with the SEC Commissioners, and all other contacts that the FSOC may have with the SEC regarding MMF reforms, part of the public record of any proposed recommendation and available for public comment. Most importantly, the FSOC must determine how it will deal with any conflicting consultative advice that it may receive and how it will weigh it.

2.2.5. Public notice and comment

Under section 120(b)(1), the FSOC is required to provide notice to the public and the opportunity for the public to comment on any proposed FSOC recommendations. This requires publication in the Federal Register of a notice explaining the statutory basis and justification for any proposed recommendation, a description of the proposed recommendation, the text of the proposed recommendation, a Cost Benefit Analysis of the proposed recommendation, an analysis of the impact of the proposed recommendation on small entities consistent with the Regulatory Flexibility Act and a request for public comment on the proposed recommendation, including the Cost Benefit Analysis. The FSOC must give meaningful consideration to the public comments received and discuss them publicly if it releases a final recommendation.

In this regard, it should be noted that the FSOC is specifically required to consider the risks that a financial activity or practice may pose to low-income, minority or under-served communities. The direct effects of MMF reforms in these communities may be limited in comparison to other constituencies, but the effects of MMF reforms on state and local governments may have significant follow-on effects in these communities. Public notice in the Federal Register may be inadequate to bring forth meaningful comment from these and similar communities on the potential indirect effects that the proposed MMF reforms may have on account of the magnitude of the role MMFs play in the U.S. economy. Public hearings held in several areas of the country or some other mechanism may be required in order to explore these issues fully.

2.3. FSOC Transparency and Accountability Considerations

Statutory law, regulations, case law and best practices require administrative procedures to be open, to be transparent and to ensure accountability. These requirements help ensure that agencies act judiciously and do not produce regulations that unduly restrict or redirect economic activity. Adherence to these requirements is essential for any agency that hopes to prove that its actions are not arbitrary, capricious or contrary to law. Agencies that do not embrace standards of openness, transparency and accountability are on notice that their actions may be challenged on these grounds. The FSOC is in that situation.

The GAO recently criticized the FSOC for a lack of accountability and transparency in its decision-making.¹⁹ The GAO specifically criticized the FSOC for its failure to make adequate public disclosures regarding its activities and deliberations and noted that “transparency is a key feature of accountability.”²⁰ The GAO concluded that “[s]uccessfully implementing their mandates will require FSOC members to actively work together *and with external stakeholders*.”²¹ In order to do this, the FSOC will need to be more transparent. The GAO Report and comments made in response to FSOC rulemaking proposals highlight the importance of developing sound agency processes for making any recommendations to a primary financial regulatory agency under section 120 and for fulfilling the FSOC’s mandate more broadly.

3. Conclusion

How the FSOC as a body and its individual members respond to the Recommendation Letter and the administrative record that they create to support any recommendation under section 120 will establish important precedents for how the FSOC exercises its authority over a wide range of issues going forward. The large role that MMFs play in the U.S. economy only raises the stakes and adds a further imperative for the FSOC to consider carefully the need to act and the effects of its actions. A failure by the FSOC and its members to adhere to appropriate legal, administrative and substantive standards of decision-making could expose the recommendation process to numerous potential challenges, which would only confuse the marketplace and delay the implementation of appropriate policies.

We appreciate your and the FSOC’s consideration of the points contained in this letter as the FSOC evaluates potential actions with respect to MMF reform. Please feel free to contact us if you would like to discuss any of the issues that we have raised.

Sincerely,



Thomas P. Vartanian

Attachment

¹⁹ In its report, the GAO observed that “[a]ppropriate accountability and transparency mechanisms also need to be established to determine whether FSOC and OFR are effective and to ensure that the public and Congress have sufficient information to hold them accountable,” GAO Report at 50-51; *see also* GAO Report at 11.

²⁰ *Id.* at 26-30, 52.

²¹ *Id.* at 50 (emphasis supplied).



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

September 27, 2012

Members of the Financial Stability Oversight Council,

Last month, the Securities and Exchange Commission (SEC) announced that it would not proceed with a vote to solicit public comment on potential structural reforms of money market funds (MMFs). This comes after a long and concerted effort by the SEC to develop reform options.

Further reforms to the MMF industry are essential for financial stability. MMFs are a significant source of short-term funding for businesses, financial institutions, and governments. The funds provide an important cash-management vehicle for both institutional and retail investors. However, the financial crisis of 2007–2008 demonstrated that MMFs are susceptible to runs and can be a source of financial instability with serious implications for broader financial markets and the economy. In the days after Lehman Brothers failed and the Reserve Primary Fund, a \$62 billion prime MMF, “broke the buck,” investors redeemed more than \$300 billion from prime MMFs. Commercial paper markets shut down for even the highest quality issuers. Only Treasury’s guarantee of more than \$3 trillion of MMF shares, a series of liquidity programs by the Federal Reserve, and support from many fund sponsors stopped the run and helped MMFs meet their shareholders’ redemption requests in a timely manner.

The SEC took important steps in 2010 to improve the resilience of MMFs by amending Investment Company Act Rule 2a-7 to strengthen the liquidity, credit-quality, maturity, and disclosure requirements of MMFs. But the effort toward reform should not stop there. The 2010 reforms did not attempt to address two core characteristics of MMFs that leave them susceptible to destabilizing runs: (1) the lack of explicit loss-absorption capacity in the event of a drop in the value of a portfolio security and (2) the “first-mover advantage” that provides an incentive for investors to redeem their shares at the first indication of any perceived threat to the fund’s value or liquidity.

Both the President’s Working Group on Financial Markets and the Financial Stability Oversight Council (Council) have consistently called for the SEC to pursue additional reforms to address structural vulnerabilities in MMFs, including unanimous recommendations in the Council’s 2011 and 2012 annual reports. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) gives the Council both the responsibility and the authority to take action to address risks to financial stability if an agency fails to do so. Accordingly, I would like the Council to consider taking a series of additional steps to address this challenge.

Path Forward to Protect Investors and the Economy

As its Chairperson, I urge the Council to use its authority under section 120 of the Dodd-Frank Act to recommend that the SEC proceed with MMF reform. To do so, the Council should issue for public comment a set of options for reform to support the recommendations in its annual reports. The Council would consider the comments and provide a final recommendation to the SEC, which, pursuant to the Dodd-Frank Act, would be required to adopt the recommended standards or explain in writing to the Council why it had failed to act. I have asked staff to begin drafting a formal recommendation immediately and am hopeful that the Council will consider that recommendation at its November meeting.

The proposed recommendation should include the two reform alternatives put forward by Chairman Schapiro, request comment on a third option as outlined below, and seek input on other alternatives that might be as effective in addressing MMFs' structural vulnerabilities.

Option one would entail floating the net asset values (NAVs) of MMFs by removing the special exemption that allows them to utilize amortized-cost accounting and rounding to maintain stable NAVs. Instead, MMFs would be required to use mark-to-market valuation to set share prices, like other mutual funds. This would allow the value of investors' shares to track more closely the values of the underlying instruments held by MMFs and eliminate the significance of share price variation in the future.

Option two would require MMFs to hold a capital buffer of adequate size (likely less than 1 percent) to absorb fluctuations in the value of their holdings that are currently addressed by rounding of the NAV. The buffer could be coupled with a "minimum balance at risk" requirement, whereby each shareholder would have a minimum account balance of at least 3 percent of that shareholder's maximum balance over the previous 30 days. Redemptions of the minimum balance would be delayed for 30 days, and amounts held back would be the first to absorb any losses by the fund in excess of its capital buffer. This would complement the capital buffer by adding loss-absorption capacity and directly counteract the first-mover advantage that exacerbates the current structure's vulnerability to runs.

Option three would entail imposing capital and enhanced liquidity standards, potentially coupled with liquidity fees or temporary "gates" on redemptions that may be imposed as an alternative to a minimum balance at risk requirement.

We should also be open to alternative approaches that satisfy the critical objectives of reducing the structural vulnerabilities inherent in MMFs and mitigating the risk of runs. We should use this opportunity to seek informed perspectives on the extent to which any mix of the specific reforms described above or other reforms would achieve the same level of protection for investors and the broader economy. The Council should engage with key stakeholders as part of this overall process.

The proposal should take into account the concern expressed that reform of MMFs may result in outflows from MMFs to less-regulated parts of the cash-management industry. While investors should welcome enhanced protections in MMFs, experience tells us that we cannot ignore the potential for capital, in times of relative stability, to flow to less-regulated sectors with fewer protections. Our objective should be to propose reforms to MMFs that protect the stability of MMFs without creating a competitive advantage for unregulated cash-management products.

Alternative Paths to Reform

The SEC, by virtue of its institutional expertise and statutory authority, is best positioned to implement reforms to address the risks that MMFs present to the economy. However, while we pursue this path, the Council and its members should, in parallel, take active steps in the event the SEC is unwilling to act in a timely and effective manner.

Under Title I of the Dodd-Frank Act, the Council has the authority and the duty to designate any nonbank financial company that could pose a threat to U.S. financial stability. The Council should closely evaluate the MMF industry to identify firms that meet this standard. Designating MMFs or their sponsors or investment advisers would subject those firms to supervision by the Federal Reserve and would give the Federal Reserve broad authority to impose enhanced prudential standards, potentially including the options discussed above. Alternatively, the Council's authority to designate systemically important payment, clearing, or settlement activities under Title VIII of the Dodd-Frank Act could enable the application of heightened risk-management standards on an industry-wide basis.

Other Council member agencies have the authority to take action to address certain of the risks posed by MMFs and similar cash-management products. For example, the bank regulatory agencies should evaluate their authorities to impose capital surcharges on regulated entities that sponsor MMFs, or restrict financial institutions' ability to sponsor, borrow from, invest in, and provide credit to MMFs that do not have structural protections. As currently conducted, such activities can pose risks to financial institutions' safety and soundness in a variety of ways, including the potential for MMFs to curtail funding for financial firms abruptly in times of market stress and the implicit support provided by firms that sponsor MMFs. Additionally, the potentially destabilizing role of MMFs in the tri-party repo market should be carefully assessed as part of the ongoing efforts to improve the safety, soundness, and resiliency of that market.

I urge the members of the Council to accelerate their evaluation of these alternatives. The members of the Council should move ahead to consider how best to give effect to these alternative paths as they consider public comments on reform options for the SEC.

Conclusion

Without further reform of MMFs, our financial system will remain vulnerable to runs and instability, which are harmful for retail and institutional investors, businesses that need a reliable source of funding, the MMF industry, and the financial system as a whole. We will seek broad input from the full range of stakeholders on how best to design further reforms.

Four years after the instability of MMFs contributed to the worst financial crisis since the Great Depression, with the failure of the SEC to act, the Council should now move forward with the tools provided by Congress.

Sincerely,



Timothy F. Geithner