SEC HOLDS ROUNDTABLE ON MONEY MARKET FUNDS AND SYSTEMIC RISK

Last week, the Securities and Exchange Commission ("SEC") held its long-anticipated roundtable on money market funds. The principal topics discussed at the roundtable were systemic risks posed by money funds and potential regulatory changes that could mitigate those risks. Roundtable participants represented a broad cross-section of interested parties including money market industry representatives, institutional investors, academics, representatives of the Financial Stability Oversight Council, and other regulators.

A number of regulatory proposals were discussed at the roundtable that could, if adopted by the SEC, significantly alter the operation of money market funds as we know them, including requiring money market funds to institute market-based net asset value ("NAV") instead of stable NAV, be subject to banking regulations, create an industry-funded private liquidity bank, or maintain liquidity reserve requirements. None of the proposals reflected an idea that has not been discussed before, none garnered anything close to uniform support of the panelists, and it remains to be seen whether the SEC will offer any of the proposals for further public comment. Nonetheless, the roundtable is significant, as it is likely to provide some shape to the future discussion of the regulation of money market funds. Set out below is an overview of the roundtable proceedings.

**Background**

Money market funds came under significant liquidity pressures as a result of, among other things, the failure of Lehman Brothers in 2008, which was a substantial issuer of commercial paper. After the failure of Lehman Brothers, the market for commercial paper and other short-term instruments became very illiquid and one large money market fund ceased to be able to value at $1.00 per share.1 The illiquid commercial paper marketplace, coupled with significant redemptions of money market fund shares by institutional investors, raised concerns about the systemic importance of money market funds to the U.S. economy. In early 2010, the SEC responded by amending rules under the Investment Company Act of 1940 (the “1940 Act”) that govern money market funds to permit amortized cost valuation of fund portfolios, tighten portfolio quality and maturity standards, add liquidity requirements, and impose new oversight obligations on fund boards of directors.

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The money market fund issues were part of a larger credit crisis, which led to Congressional and regulatory reviews of systemic risk in the financial markets. In 2010, Congress adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which created an interagency Financial Stability Oversight Council to provide regulatory oversight of systemic risk, including such risk potentially posed by money market funds and other financial institutions. Later that year, the President’s Working Group on Financial Markets published a report identifying regulatory approaches that could reduce the risk of runs on money market fund assets and, as a result, reduce systemic risk concerns about money market funds. This report discussed, among other things, the possibility of requiring floating NAVs and an industry-supported money market fund liquidity facility, but the report stopped short of recommending any specific regulatory approach.

The recent SEC roundtable provided an opportunity for government regulators, including representatives of the Financial Stability Oversight Council, to discuss these and other issues related to money market fund regulation and systemic risk.2

Themes of the Roundtable

Underlying the roundtable discussion was the issue of dealing with the potential risk of significant sales of money market assets and the systemic risk those sales create in the broader market (including resulting sales of money market fund assets). Institutional investors and representatives of money market funds stressed the importance of the $3 trillion money market fund industry to businesses and the economy, and raised concerns about the absence of an investment alternative to money market funds if regulatory changes addressing relatively infrequent market-wide liquidity problems made money market funds unattractive to investors. Broader questions were also asked by panelists regarding whether money market funds should continue to use stable NAVs or adopt floating NAVs, and whether additional regulation should be considered that might present less systemic risk from money market funds.

2 Regulators participating in the roundtable were the SEC Commissioners, Eileen Rominger, the Director the SEC’s Division of Investment Management, Robert Plaze, an Associate Director of that Division, and representatives of the Financial Stability Oversight Council, including Chairman Gary Gensler of the U.S. Commodity Futures Trading Commission, U.S. Department of Treasury Undersecretary of Domestic Finance Jeffrey Goldstein, Governor Daniel Tarullo of the Board of Governors of the Federal Reserve System, Chairman Sheila Bair of the Federal Deposit Insurance Corporation, Chairman Deborah Matz of the National Credit Union Administration, and Special Advisor Mario Ugoletti of the Federal Housing Finance Agency. Other roundtable participants included Travis Barker of HSBC Global Asset Management, Seth Bernstein of J.P. Morgan Asset Management, Robert Brown of Fidelity Management & Research Company, David Certner of AARP, Carol DeNale of CVS Caremark, John Hawke, Jr. of Arnold & Porter LLP, Kathryn Hewitt of the Government Finance Officers Association, Lance Pan of Capital Advisors Group, Brian Reid of the Investment Company Institute, Professor Erik Sirri of Babson College and formerly a Director of the SEC’s Division of Trading and Markets, Bill Stouten of Thrivent Financial, René Stulz of The Ohio State University, Paul Tucker of the Bank of England, and Paul Volcker, a former Chairman of the Board of Governors of the Federal Reserve System.
Potential Changes to the Regulation of Money Market Funds

Floating NAVs

Roundtable participants discussed whether the use of floating NAVs could prevent future periods of large-scale redemptions of money market fund shares and mitigate systemic risk concerns. In 2010, when amending Rule 2a-7 under the 1940 Act, the SEC discussed the possibility of a future rulemaking requiring floating NAVs for money market funds. At the roundtable no consensus emerged as to the benefits or detriments of requiring money market funds to value their shares using floating NAVs. The banking regulator panelists, not surprisingly, favored the use of floating NAVs in money market funds to decrease the systemic risk posed by these funds. SEC Chairman Mary Schapiro also expressed some interest in instituting floating NAVs, but both institutional investors and the money market industry participants expressed strong opposition to the notion. Some of these participants argued that floating NAVs would not prevent large scale redemptions of money market fund shares and would cause a reduction in assets (and the related funding of corporations). Concerns were raised by investor and industry representatives that many institutional investors have strict investment guidelines that would not be met by floating NAV funds and that abolishing the use of stable NAVs would provide incentives to institutional investors to place their money in private funds not regulated under the 1940 Act that operated to have stable NAVs.

Bank Regulation

Banking regulators—perhaps most importantly, Chairman Sheila Bair of the Federal Deposit Insurance Corporation—advocated that money market funds be treated as special-purpose banks subject to banking oversight and regulation. Participants debated whether money market funds could be viewed as a shadow banking system primarily designed to circumvent banking regulation. Paul Volcker, former Chairman of the Board of Governors of the Federal Reserve System, and Bair, as expected in light of their previously articulated views, agreed with this premise and expressed concerns about a perception by some investors of an implicit government guarantee of the money market. Money market fund industry representatives responded that increased transparency and regulation of money market funds have made these funds far less susceptible to large scale redemptions that result in liquidity crises. The industry representatives also expressed the view that investors look to money market funds to diversify their asset holdings and provide an alternative to bank accounts and other banking products. Institutional investors generally agreed with the industry participants and noted that they did not want to concentrate their risk in the “too-big-to-fail” banks and instead sought the diversification provided by money market funds.
Private Liquidity Bank

The roundtable participants discussed a proposal championed by the mutual fund trade group, the Investment Company Institute, to use a private liquidity bank to mitigate the risk of runs on money market funds.3 Under the proposal, the money market fund industry would create the private bank to provide a central liquidity facility that could be accessed by a money market fund facing liquidity problems. The liquidity facility would purchase illiquid securities from a money market fund, providing the fund with the liquidity needed to meet investor redemptions. The liquidity facility would collect fees from money market funds with the goal of providing the liquidity bank with a buying capacity of approximately $24 billion after ten years. Some roundtable participants questioned the sufficiency of that amount and others voiced concerns about the effectiveness of the proposed liquidity bank in meeting its goal. The banking regulators criticized the private liquidity bank’s proposed access to $30 billion from the Federal Reserve’s discount window as indirectly providing money market funds access to taxpayer-supported capital.

Mandatory Liquidity Reserves

Roundtable participants discussed proposals by two participants that would require money market funds to establish individual liquidity reserves, up to 3.0% of a fund’s assets, for use during a liquidity crunch. One option would be to have investors fund the liquidity reserve until the reserve reaches the required level. Some participants believed that a liquidity fee paid by investors would discourage investment in money market funds, whereas others believed that investors would be more willing to invest knowing a liquidity backstop existed in case of an emergency. Panelists noted that these proposals would effectively accomplish many of the goals of banking regulation by providing money market funds with adequate capital to meet substantial redemptions.

Regulatory Timeline

The roundtable was convened to discuss potential changes to money market fund regulation rather than to generate specific regulatory proposals. Regulatory proposals would require notice-and-comment rulemaking before being adopted.

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If you have any questions concerning the matters described in this memorandum, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Benjamin J. Haskin (202-303-1124, bhaskin@willkie.com) or the Willkie attorney with whom you regularly work.

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