

## MONEY MARKET FUND REFORM: SEC RULEMAKING IN THE FSOC ERA

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*For more than four years, our law firm represented a large asset manager and adviser to money market mutual funds in the debate over proposals to impose new regulations on these funds. These proposals were developed in response to the heavy redemptions from prime money market funds during 2008 in the depths of the financial crisis. In this Article we share our observations about the dynamics of the debate and the forces that led to the Securities and Exchange Commission’s (“SEC”) action in 2014 to adopt amendments to its money market fund rules, which will be fully implemented on October 14, 2016. We begin with an overview of the SEC’s action, followed by a review of money market fund regulation, a recounting of relevant events in the 2007–2009 financial crisis, a discussion of the SEC’s initial efforts on money market fund reform, and a discussion of the impact of the new Financial Stability Oversight Council (“FSOC”) on the debate. We end with our comments regarding the SEC’s new money market fund rules and some concluding observations.*

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*While the purpose of this Article is to provide a narrative of events that led to the SEC's ultimate decision on new money market funds rules, we observe that the FSOC's intervention into the SEC's rulemaking, accompanied by threats of further FSOC action against SEC-regulated entities if the SEC failed to act on new rules, raises serious concerns and questions yet to be addressed about the role of the FSOC and the independence of the SEC as the primary capital markets regulator. The FSOC's actions, if left unchecked, could portend a shift of power toward bank-like regulation of the capital markets.*

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## I. INTRODUCTION

Money market funds are widely popular cash management products used by millions of investors—individuals, businesses, and governments—who have relied upon them for liquidity, stability, efficiency, and returns. Their popularity in significant part has been based upon their ability to offer investors a stable net asset value (“NAV”) per share—generally a price of \$1.00 per share,

which is available to a money market fund *only* if it abides by the very strict risk-limiting requirements imposed by the Securities and Exchange Commission’s (“SEC”) rules and the fund board continuously monitors any deviation between that price and the “market-based” estimated value of the fund’s underlying portfolio instruments.<sup>1</sup> Money market funds are viewed, even by bank regulators, as safer than bank deposits in amounts above the Federal Deposit Insurance Corporation (“FDIC”) insurance limits.<sup>2</sup> They are significant participants in the markets for short-term debt, at various times accounting for investments in almost forty percent of outstanding commercial paper, approximately two-thirds of short-term state and local government debt, and a significant amount of outstanding short-term Treasury and federal agency securities.<sup>3</sup>

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<sup>1</sup> These pricing and risk-limiting requirements are found generally in the SEC’s Rule 2a-7 under the Investment Company Act of 1940. Money Market Funds, 17 C.F.R. § 270.2a-7 (2015). Rule 2a-7’s pricing provisions are found in 17 C.F.R. § 270.2a-7(c). As discussed in this Article, these provisions were amended by the SEC to provide that only “retail” and “government” money market funds will be permitted to use the amortized cost method and penny rounding method to achieve a stable price per share. Money Market Fund Reform; Amendments to Form PF; Final Rule, 79 Fed. Reg. 47,736, 47,782 n.529 (Aug. 14, 2014) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274, 279) [hereinafter Adopting Release]. The new pricing provisions and other major amendments to Rule 2a-7 became effective October 14, 2014, but money market funds are not required to comply with the new provisions until October 14, 2016. *Id.*, at 47,736, 47,932.

<sup>2</sup> PATRICK E. MCCABE ET AL., FED. RESERVE BANK OF N.Y., THE MINIMUM BALANCE AT RISK: A PROPOSAL TO MITIGATE THE SYSTEMIC RISKS POSED BY MONEY MARKET FUNDS 52 (2012), [http://www.newyorkfed.org/research/staff\\_reports/sr564.pdf](http://www.newyorkfed.org/research/staff_reports/sr564.pdf) [<http://perma.cc/8FRW-P8QH>] (“Even bank deposits have safety disadvantages for large institutional investors whose cash holdings typically exceed by orders of magnitude the caps on deposit insurance coverage . . . . MMF shares—which represent claims on diversified, transparent, tightly regulated portfolios—would continue to offer safety advantages relative to bank deposits.”).

<sup>3</sup> President’s Working Group Report on Money Market Fund Reform, 75 Fed. Reg. 68,636, 68,641 (Nov. 8, 2010) [hereinafter PWG Report] (citing 2010 figures). Proposals to impose new regulations on these funds,

In the early 1980s, money market funds' stable NAV per share and their popularity provoked fierce attacks from banking regulators, particularly the Board of Governors of the Federal Reserve System ("Federal Reserve" or "Fed") and its then-Chairman Paul Volcker, who viewed money market funds as competitors to banks and sought to impose requirements on funds that would raise their costs and undermine their efficiency.<sup>4</sup> The SEC at that time, however, strongly defended money market funds, making the case that the funds were good for investors and that the SEC's regulation was sound.<sup>5</sup> The SEC prevailed, and, as a result,

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developed in response to heavy redemptions from prime money market funds during 2008 in the depths of the financial crisis, included a report by the President's Working Group on Financial Markets ("PWG"), proposed recommendations by the FSOC under section 120 of the Dodd-Frank Act, and a notice of proposed rulemaking issued by the SEC. *Id.* at 68,636; Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69,455 (proposed Nov. 19, 2012) [hereinafter FSOC Release]; Money Market Fund Reform; Amendments to Form PF; Proposed Rule, 78 Fed. Reg. 36,834 (proposed June 19, 2013) (to be codified at 17 C.F.R. pts. 210, 230, 239, 270, 274, 279) [hereinafter Proposing Release].

<sup>4</sup> See Karen W. Arenson, *Volcker Proposes Money Funds Be Subject to Rules on Reserves*, N.Y. TIMES, June 26, 1981, at D3 (noting that former Federal Reserve Chairman Paul A. Volcker testified before a congressional subcommittee that money market funds should be subject to regulations that would make them more competitive with banking institutions and less attractive to investors; noting that Volcker also testified that reserve requirements were a key part of monetary policy, and because they could not be removed from banking institutions, they should also be applied to other investment vehicles); Beatson Wallace, *Money Funds Aren't Banks*, BOSTON GLOBE, May 21, 1981, at 61 (noting that "[m]oney market funds continue to be the whipping boy of the banking industry and the delight of the small sum investor").

<sup>5</sup> See, e.g., *Competition and Conditions in the Financial System: Hearings Before the S. Comm. on Banking, Hous., & Urban Affairs*, 97th Cong. 939, 945 (1981) (statement of former SEC Commissioner John R. Evans, who testified, "[W]e are very concerned with suggestions that legislation should be enacted which would impose bank-type regulation on money market funds to the detriment of [public] investors. . . . [M]any depository institutions are having difficulty attracting savings during a period when money market funds are experiencing dramatic growth. . . . We can understand why certain depository institutions might like their

investors significantly benefited. By one estimate, money market funds returned to investors an estimated \$450 billion above comparable returns from money market deposit accounts over the period from 1985 to 2008.<sup>6</sup> Investors also have benefited from the enviable safety record of money market funds over the years. During their forty-year history, only two money market funds returned investors less than \$1.00 per share.<sup>7</sup> Businesses that fund their short-term borrowing through commercial paper issuance have benefited from the participation of money market funds in these markets, which has helped lower funding costs for these issuers.<sup>8</sup>

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competitors to be restricted. We believe, however, that any consideration of legislation to impose bank-type regulatory burdens and limitations on money market funds should include an evaluation of the existing regulation of such funds, the present protection provided to investors, and the negative impact that such proposals would have on the millions of people who invest in money market funds. . . . It is also the Commission's view that the harm to small investors, and the inconvenience to large investors, which could result from the imposition of bank-type regulations on money market funds may not be significantly offset by any benefit to banks and thrift institutions.”).

<sup>6</sup> This estimate was compiled by Federated Investors, Inc. (“Federated”) using data from the Investment Company Institute (“ICI”), iMoneyNet, and the Bank Rate Monitor. See Federated, Comment Letter Providing Briefing Book on Money Market Fund Reform (May 17, 2013), <http://www.sec.gov/comments/mms-response/mmsresponse-49.pdf> [<http://perma.cc/W6UD-PJ2C>] [hereinafter Federated Letter (May 17, 2013)].

<sup>7</sup> See *infra* text accompanying notes 60–62. Note that while the number of money market funds during this period fluctuated, it peaked between 1997–2001 at over 1000 funds. INVESTMENT COMPANY INST., 2014 INVESTMENT COMPANY FACT BOOK 197 tbl.38 (2014). There were more than 800 funds in operation as of year-end 2007 prior to the worst part of the financial crisis. *Id.*

<sup>8</sup> The built-in cost inefficiencies of banks add over 300 basis points to the cost of borrowing as compared to borrowing in the commercial paper markets. Arnold & Porter LLP, Comment Letter on Money Market Fund Reform; Amendments to Form PF; Proposed Rule (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-225.pdf> [<https://perma.cc/8R4B-RB6E>] [hereinafter Arnold & Porter Letter (Sept. 17, 2013)]. The disparity in rates between banks and commercial paper has grown even larger since our September 2013 analysis. As of November 9, 2015, the prime-banking rate of 3.25 percent compares with nonfinancial

But on July 23, 2014, the SEC, by a vote of 3–2, adopted new money market fund rules that will completely eliminate two categories of funds: stable value institutional prime money market funds and stable value institutional tax-exempt money market funds.<sup>9</sup> Beginning on the compliance date of October 14, 2016, these types of funds may be offered only with a floating NAV, a price based upon estimates of the market-based valuations of a fund’s underlying portfolio securities.<sup>10</sup> These changes to the SEC’s money market fund rules were adopted in addition to provisions in the same rulemaking that address the potential risk of large-scale redemptions or “runs” by giving fund boards the ability to temporarily suspend redemptions and/or impose a liquidity fee under certain circumstances.<sup>11</sup>

Institutional prime and tax-exempt money market funds together represented well over a trillion dollars of the overall \$3.0 trillion in money market funds assets around the time of the SEC’s rulemaking.<sup>12</sup> Because the floating NAV pricing

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commercial paper rates as low as 0.08 basis points, according to Federal Reserve data. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FED. RESERVE STATISTICAL RELEASE H.15: SELECTED INTEREST RATES (Nov. 9, 2015), <http://www.federalreserve.gov/releases/h15/current/h15.pdf> [<http://perma.cc/ZAQ9-S62B>].

<sup>9</sup> Adopting Release, *supra* note 1, at 47,983; *see also infra* notes 311–317 and accompanying text.

<sup>10</sup> Money Market Funds, 17 C.F.R. § 270.2a-7(c)(1)(ii) (2015); Adopting Release, *supra* note 1, at 47,960–61.

<sup>11</sup> 17 C.F.R. § 270.2a-7(c)(2)(i) (2015); Adopting Release, *supra* note 1, at 47,961.

<sup>12</sup> The SEC’s Adopting Release tallies the combined assets of institutional prime and tax-exempt money market funds at \$1.269 trillion of overall \$3.0 trillion in money market fund assets, using data as of February 28, 2014. Adopting Release, *supra* note 1, at 47,900. Other sources report slightly lower numbers. *See, e.g.*, Michael S. Piwowar, Comm’r, SEC, Dissenting Statement at Open Meeting Regarding Money Market Fund Reform (July 23, 2014), <http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542553721#.VFqY9TTF-uM> [<http://perma.cc/7ULE-VJVB>] (citing an analysis by Crane Data as of July 3, 2014, showing institutional prime money market funds held more than \$800 billion in assets, constituting 33% of all money market fund assets, and tax-exempt money market funds held \$254.5 billion in assets).

requirement eliminates one of the most important features of affected money market funds, hundreds of billions in assets currently in these funds will flow to less transparent, less regulated alternative cash management vehicles that offer a stable value to systemically important banks or to government money market funds providing lower returns for investors; other assets will be recharacterized as “retail” money market funds, which are authorized to continue offering shares at a stable value.<sup>13</sup> While we have no doubt that asset managers, working with their investors, will be able to address investor cash management needs through these and other vehicles (although at higher cost and/or lower efficiency), the interesting question for SEC watchers is, “*Why would the SEC want to risk destroying such a large and important segment of an industry which, under the SEC’s close regulation for decades, has served investors and the capital markets so well?*” The answer requires additional questions.

***Was the SEC statutorily mandated to act?*** Agencies take rulemaking action for any number of different reasons. In some instances, agencies may be subject to statutory mandates, often with prescribed time periods within which to propose and adopt final rules. Indeed, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”),<sup>14</sup> Congress’ response to the financial crisis, directed or authorized the SEC to adopt nearly 100 specific rules on a wide range of subjects affecting thousands of broker-dealers, private funds, investment advisers,

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<sup>13</sup> These consequences are discussed in the SEC’s Proposing and Adopting Releases for its new rules, as well as in letters filed by numerous commenters. See Proposing Release, *supra* note 3, at 36,914–20; Adopting Release, *supra* note 1, at 47,900–06; see also Arnold & Porter LLP on behalf of Federated, Comment Letter on Money Market Fund Reform; Amendments to Form PF; Proposed Rule (Nov. 21, 2013), <http://www.sec.gov/comments/s7-03-13/s70313-282.pdf> [<http://perma.cc/4GNR-4FTB>] [hereinafter Arnold & Porter Letter (Nov. 21, 2013)] (citing commenter views on likely asset flows under the SEC’s proposed rule).

<sup>14</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.) (“Dodd-Frank Act”).

derivatives dealers, and others, in many cases with strict deadlines that the SEC inevitably missed because of the volume and complex nature of the rulemakings and the SEC's limited resources.<sup>15</sup> Notably, the 849-page Dodd-Frank Act contains nary a word about the regulation of money market funds.<sup>16</sup> Congress gave no mandate to the SEC to act in this area.

***Was the SEC under public pressure to act?*** Agencies also act in response to public pressure to address areas of perceived failures in regulation. Here, there was no public pressure on the SEC to further restrict money market funds; indeed, there was overwhelming public pressure to preserve them and, specifically, to preserve the essential characteristic of money market funds—stable NAV pricing. Individual investors and investor groups ranging from the AARP to the National Association of Corporate Treasurers urged the SEC *not* to impose a floating NAV on money market funds.<sup>17</sup> Moreover, investors had, and still have, a

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<sup>15</sup> CURTIS W. COPELAND, CONG. RESEARCH SERV., RULEMAKING REQUIREMENTS AND AUTHORITIES IN THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 7 (2010) [hereinafter CRS REPORT]; DAVIS POLK & WARDWELL LLP, DODD-FRANK PROGRESS REPORT: JANUARY 2013 6 (2013), [http://www.davispolk.com/files/uploads/FIG/Jan2013\\_Dodd.Frank.Progress.Report.pdf](http://www.davispolk.com/files/uploads/FIG/Jan2013_Dodd.Frank.Progress.Report.pdf) [<http://perma.cc/9QVP-E4FJ>] (showing that the SEC had missed forty-nine rule deadlines).

<sup>16</sup> References to “money market instruments” or money market mutual funds appear only in provisions addressing rating agency requirements, Federal Reserve facilities to be audited by the Government Accountability Office, and the definition of “account” for purposes of consumer access provisions of Title XII. Dodd-Frank Act §§ 932, 938, 939A, 1109, 1203, 15 U.S.C. §§ 78o-7, 78o-8, 12 U.S.C. § 5622 (2012).

<sup>17</sup> By our count, 1397 of the 1417 comments in the recent rulemaking that addressed the issue opposed or raised serious concerns with respect to the SEC's floating NAV proposal. (This tally counts Arnold & Porter's and its client's advocacy letters as only one; a record of our count is on file with the *Columbia Business Law Review* (“CBLR”).) See *Comments on Proposed Rule: Money Market Fund Reform; Amendments to Form PF*, SEC, <https://www.sec.gov/comments/s7-03-13/s70313.shtml> [<https://perma.cc/E6FC-PPPG>] (last modified July 23, 2014) [hereinafter Proposing Release Docket] (providing comments). The overwhelming majority of commenters on the SEC's request for comments on the PWG Report expressed similar opposition to the floating NAV option. See *President's Working Group*



high level of confidence in money market funds, as evidenced by the strong flow of investor funds into prime money market funds with no insurance protection within weeks after the initial chaos-inspired redemptions in September 2008.<sup>18</sup> Money market funds remain a popular product with investors today.<sup>19</sup>

***Did the SEC on its own identify a need to take the specific action it took?*** Of course, agencies independently and routinely identify the need for regulation under their existing authority. The SEC, for example, has broad regulatory authority under various statutes to promulgate rules “in the public interest or for the protection of investors.”<sup>20</sup> The SEC in 2009 to 2010 engaged in a lengthy rulemaking to make money market funds more resilient to shareholder redemptions—a rulemaking in which the SEC adopted new liquidity, portfolio duration, credit quality, and

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*Report on Money Market Fund Reform (Request for Comment)*, SEC, <https://www.sec.gov/comments/4-619/4-619.shtml> [<http://perma.cc/M5Y3-ZE2E>] (last modified May 29, 2013) [hereinafter PWG Docket] (providing comments).

<sup>18</sup> A Treasury insurance program instituted during the crisis guaranteed money market fund investments only as of September 19, 2008; investors poured a net \$170 billion in *uninsured* funds back into prime money market funds over the following weeks. TREASURY STRATEGIES, INC., *DISSECTING THE FINANCIAL COLLAPSE OF 2007–2008: A TWO-YEAR FLIGHT TO QUALITY 3* (2012), [http://www.treasurystrategies.com/sites/default/files/TSI\\_DissectingFinancialCollapse\\_0.pdf](http://www.treasurystrategies.com/sites/default/files/TSI_DissectingFinancialCollapse_0.pdf) [<http://perma.cc/M7WM-J373>].

<sup>19</sup> According to the Investment Company Institute (“ICI”), as of October 21, 2015, money market fund assets totaled \$2.7 trillion. *Money Market Fund Assets*, ICI (Oct. 22, 2015), [https://www.ici.org/research/stats/mmf/mm\\_10\\_22\\_15](https://www.ici.org/research/stats/mmf/mm_10_22_15) [<https://perma.cc/AC8W-4FSD>]. Investors continue to view money market funds as a safe haven during periods of market turmoil. See *Money Fund Inflows Accelerate as Stocks Fall; MMFs Retake 3.0 Tril.*, CRANE DATA (Aug. 26, 2015), <http://cranedata.com/archives/all-articles/5730/> [<http://perma.cc/6U7X-QSTD>].

<sup>20</sup> 15 U.S.C. § 78l (2012) (authority to prescribe by rule certain registration requirements for publicly traded securities); § 78q-1 (authority to prescribe rules and issue orders or exemptions regarding the clearance and settlement of securities); § 80b-4 (authority to require reports of registered investment advisors by rule).

other requirements for money market funds but deferred on proposals to require money market funds to price at a floating NAV.<sup>21</sup> It is therefore questionable whether the SEC just a few years later would have acted on its own, despite the widespread objections of investors and users of money market funds, to impose a floating NAV requirement on any large segment of money market funds.

Moreover, to the extent the SEC believed more should be done to address potential money market fund run risk and the potential for shareholder dilution by “first movers” in a fund that experiences extraordinarily heavy redemptions, the SEC in its recent rulemaking had an alternative proposal under consideration. The “gates and fees” requirement (which the SEC ultimately adopted as part of the recent rulemaking) enables fund boards to suspend redemptions to “ensure that a run is stopped in its tracks”<sup>22</sup> and to assess a fee on redemptions to replenish a money market fund.<sup>23</sup> The SEC also had ample authority (which it also used in the recent rulemaking) to require daily disclosure of money market fund market-based valuations and other disclosures to assure that shareholders fully understand the risks of investing.<sup>24</sup> In sorting through the tortured reasoning in the SEC’s 2014 adopting release in support of the floating NAV provisions, one can only conclude that the floating NAV rule adopted by the SEC for institutional prime and tax-exempt funds, layered upon the

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<sup>21</sup> Money Market Fund Reform, 74 Fed. Reg. 32,688 (proposed July 8, 2009) (to be codified at 17 C.F.R. pts. 270 & 274) [hereinafter 2010 Proposing Release] (proposing risk-limiting conditions to Rule 2a-7); Money Market Fund Reform; Final Rule, 75 Fed. Reg. 10,060 (Mar. 4, 2010) (to be codified at 17 C.F.R. pts. 270 & 274) [hereinafter 2010 Adopting Release] (adopting the proposed risk-limiting conditions with certain modifications).

<sup>22</sup> Daniel M. Gallagher, Comm’r, SEC *Statement at SEC Open Meeting – Proposed Rules Regarding Money Market Funds* (June 5, 2013), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370542566722> [<http://perma.cc/A5V4-DY3S>].

<sup>23</sup> Money Market Funds, 17 C.F.R. § 270.2a-7(c)(2) (2015).

<sup>24</sup> See 17 C.F.R. § 270.2a-7(h)(10)(iii) (2015).

gates and fees requirement, is completely gratuitous, albeit somewhat creatively justified.

***What was the SEC thinking?*** Like the Wizard Behind the Curtain, the forces behind an agency rulemaking may be powerful and secretive. An agency action that appears irrational on its face may be completely rational, when viewed in the context of other agendas.

Consider the following: money market funds have long been an anathema to the Federal Reserve Board. In the view of many Fed officials, money market funds should have never been created, should not serve a role that is better performed by banks, and should have never been permitted to grow to their current size and importance in the market.<sup>25</sup> Their stable value, low risk, and historically higher returns over banks provide an attractive alternative to bank deposits. They supply money the Fed cannot control. They withdraw it from the markets at will to meet redemptions or otherwise when it is in the best interests of their shareholders. As fiduciaries for their shareholders, these

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<sup>25</sup> See Arenson, *supra* note 4 (describing testimony of Chairman Paul A. Volcker); *Unofficial Transcript: Roundtable on Money Market Funds and Systemic Risk*, SEC (May 10, 2011), <https://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm> [<https://perma.cc/9WE8-7P28>] (statement of Paul A. Volcker) (suggesting that the 650 money market funds could become banks: “This country could use 650 more banks. We just lost about 1,000 during the crisis.”); *Federal Reserve’s First Monetary Policy Report for 2012: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 30 (2012) (testimony of Ben Bernanke) (Senator Schumer: “Do you think money market funds play a useful role, though, in the economy and we should try to keep them going?” Mr. Bernanke: “Well, generally speaking, they do, and they are a useful source of short-run money. And, again, please do not overread this, but Europe does not have any, and they have a financial system . . . .”); THOMAS M. HOENIG & CHARLES S. MORRIS, FED. RESERVE BANK OF KANSAS CITY, *RESTRUCTURING THE BANKING SYSTEM TO IMPROVE SAFETY AND SOUNDNESS* 27 (2012), <https://www.fdic.gov/about/learn/board/Restructuring-the-Banking-System-05-24-11.pdf> [<https://perma.cc/KBA9-EVRX>] (dismissing the adverse consequences of a floating NAV by arguing that even if a fluctuating NAV limits use of money market funds as a cash management option for large corporations, these corporations can turn to banks).

funds are under no obligation to continue rolling over the commercial paper of issuers of uncertain strength; in fact, they are under an obligation to invest prudently and to hold securities that are sufficiently liquid to meet shareholder redemptions.<sup>26</sup> They are regulated (or have been until recently) by an agency fully independent of the Fed and other banking regulators. Therefore, the Fed for years has wanted to impose on money market funds costly regulations that could have the effect of wiping them off the face of the financial markets.<sup>27</sup>

Moreover, the heavy redemptions that hit money market funds during the worst week of the financial crisis in 2008 provided the Fed and its supporters with the opportunity to write and control a new narrative for money market funds. Much has been written about the Fed's attempt to place money market mutual funds at the heart of the financial crisis when, in fact, as discussed below, they were victims—the last institutions to be hit by the crisis and the first to recover.<sup>28</sup> However, the Fed, together with the new Financial Stability Oversight Council (“FSOC”) created by the Dodd-Frank Act, managed to capture the narrative about the role of money market funds in the crisis, and the Fed's narrative found its way into the rationale used by the SEC to justify its rulemaking. Unlike the 1980s battle over money market funds between the Fed and the SEC, when the SEC made clear that the regulation of money market funds was sound and that their regulation was, and should remain, subject to the SEC's jurisdiction only, the SEC this time offered no effective counter-narrative.

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<sup>26</sup> See 17 C.F.R. § 270.2a-7(d)(4) (2015). The Fed has characterized the activity of money market funds during the financial crisis in meeting shareholder redemptions and refusing to roll over the commercial paper of issuers of uncertain strength as “hoarding liquidity.” Chairman Ben S. Bernanke, *Causes of the Recent Financial and Economic Crisis, Statement Before the Fin. Crisis Inquiry Comm'n*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Sept. 2, 2010), [http://www.federalreserve.gov/news\\_events/testimony/bernanke20100902a.htm](http://www.federalreserve.gov/news_events/testimony/bernanke20100902a.htm) [<http://perma.cc/7B7W-BS7L>].

<sup>27</sup> See, e.g., Arenson, *supra* note 4 (reporting 1981 testimony of Federal Reserve Chairman Volcker).

<sup>28</sup> See discussion in Part III, *infra*.

The financial crisis also gave the Fed the means to work its will through the FSOC, which is dominated by the Fed and other banking regulators and which, during the first two-and-one-half years of its existence, was led by then-Treasury Secretary Timothy Geithner, formerly the President of the Federal Reserve Bank of New York (“FRBNY”).

The FSOC has two important statutory authorities under the Dodd-Frank Act that are particularly relevant to the dynamics of the money market fund reform debate. The first such authority is the FSOC’s authority under Section 120 to issue “recommendations” to a primary financial regulator to apply new or heightened standards and safeguards.<sup>29</sup> This authority was brought to bear on the SEC when the FSOC in 2012 initiated a proceeding under Section 120 aimed at pressuring the SEC to adopt new money market fund rules.<sup>30</sup> Under the statute, a primary regulator like the SEC may reject a Section 120 recommendation and explain its reasons, seemingly without consequence, other than being named in an FSOC report to Congress regarding the regulator’s failure to act. But, while the FSOC could not force the SEC to act and, in this case, only initiated a proceeding to determine *whether* to make specified recommendations to the SEC, the SEC clearly felt pressured to demonstrate that it could and would act on its own to address any remaining concerns on money market funds.

The second is the FSOC’s authority under Section 113 to designate a “systemically important financial institution” (“SIFI”) for prudential regulation by the Federal Reserve.<sup>31</sup> While a potential designee may appeal a proposed designation to the FSOC and, ultimately, to the courts, most large nonbank financial institutions view the FSOC’s

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<sup>29</sup> Dodd-Frank Act § 120, 12 U.S.C. § 5330 (2012).

<sup>30</sup> Timothy F. Geithner, Secretary of the Treasury, Letter to the FSOC (Sept. 27, 2012), <http://www.treasury.gov/connect/blog/Documents/Sec.Geithner.Letter.To.FSOC.pdf> [<http://perma.cc/FKW2-DVBC>].

<sup>31</sup> Dodd-Frank Act § 113, 12 U.S.C. § 5323 (2012).

exercise of this authority with great concern.<sup>32</sup> Indeed, the FSOC has exercised this authority in designating as SIFIs large insurance companies, over their objections and over the dissents of the insurance experts sitting on the FSOC.<sup>33</sup> The FSOC's potential exercise of this authority has been a looming threat to major asset managers, some of whom sponsor money market funds.<sup>34</sup> This threat and, to a lesser

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<sup>32</sup> Victoria McGrane & Leslie Scism, *MetLife Is Closer to 'Systemically Important' Tag After Vote*, WALL ST. J. (Sept. 4, 2014, 6:48 PM), <http://www.wsj.com/articles/fsoc-proposes-naming-metlife-systemically-important-1409862057> [<http://perma.cc/DE7U-B7KL>] (noting criticism from "Republican lawmakers, a few Democrats and industry trade associations" that the SIFI designation process "is too opaque and doesn't give firms enough chance to challenge regulators along the way").

<sup>33</sup> Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc. (Dec. 18, 2014), <http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf> [<http://perma.cc/X2B7-PYRU>]; Views of the Council's Independent Member Having Insurance Expertise (Dec. 18, 2014), <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf> [<http://perma.cc/HP7C-9G69>] (dissent from designation of MetLife); Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc. (Sept. 19, 2013), <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf> [<http://perma.cc/H9BN-3DN8>]; Dissents of Voting and Nonvoting Members of the Council (Sept. 19, 2013), <http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf> [<http://perma.cc/RK5L-UCAS>] (dissents from designation of Prudential).

<sup>34</sup> Andrew Ackerman & Ryan Tracy, *Fund Firms' Subsidiaries Helped Trigger Regulatory Review*, WALL ST. J. (Apr. 23, 2014, 5:40 PM), <http://www.wsj.com/articles/SB10001424052702304788404579520020389734550> [<http://perma.cc/H5UD-63KN>] (reporting that Blackrock and Fidelity were under review for potential SIFI designation). Articles subsequently reported that the FSOC may have shifted its focus on asset managers as entities to a focus on particular products. See Andrew Ackerman & Ryan Tracy, *Asset Managers Notch an 'Important' Win*, WALL ST. J. (July 31, 2014, 7:39 PM), <http://www.wsj.com/articles/asset-managers-may-avoid-more-oversight-by-fsoc-1406828103> [<http://perma.cc/MZ5D-3GYF>]; Ian Katz & Robert Schmidt, *Panel Steps Up Review of Threats Posed by Asset Managers*, BLOOMBERG BUSINESS (Nov. 6, 2014, 12:40 PM), <http://www.bloomberg.com/news/articles/2014-11-06/panel-steps-up-review-of-threats-posed-by-asset-managers> [<http://perma.cc/29ZN-JNAM>]. On December 18, 2014, the FSOC voted to issue a notice

extent, the initiation of the FSOC's Section 120 proceeding, altered the dynamics at the SEC in 2013–2014 as it considered money market fund reform and contributed to the view that the SEC and the fund industry needed to appease the FSOC by, at minimum, imposing a floating NAV requirement on institutional prime money market funds. By doing so, SEC officials and some large asset managers reasoned that they had a chance to preserve other categories of stable value money market funds and at the same time stave off the FSOC from designating large asset managers as SIFIs under Section 113. They could make the argument that the SEC's actions on money market funds addressed the FSOC's major concerns over investment funds.

Thus, the Fed and the FSOC had the motive, the opportunity, and what appeared to be at least the partial means to kill off money market funds. But, despite adopting a costly, disruptive and ineffective floating NAV rule, which its adopting release completely failed to justify, the SEC's actions may not have been wholly irrational. Indeed, it could be argued that the SEC's action was a pragmatic response to the pressure it faced—an effort to preserve what it could of its independence and the entities and products it regulates. By imposing a floating NAV on institutional prime money market funds while exempting other funds, the agency reached a solution that, although unsupported by the record and, in our view, clearly not in the best interests of investors and issuers, offered the opportunity to throw a bone (institutional prime money market funds) to the beast (the

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seeking public comment regarding potential risks to U.S. financial stability from asset management products and activities. Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488, 77,495 (Dec. 24, 2014). Although the Financial Stability Board, a global body of financial regulators that makes recommendations about the global financial system (and in which several member agencies of the FSOC participate), has announced that it will suspend its work on designating asset managers, the FSOC has not announced any similar intent. See Evan Weinberger, *Regulators Back Down on Asset Manager SIFI Designations*, LAW360 (July 30, 2015, 5:23 PM), <http://www.law360.com/articles/685424/regulators-back-down-on-asset-manager-sifi-designations> [<http://perma.cc/F99T-ANUS>].

Fed and the FSOC), yet still make the argument that the SEC had preserved for investors as much as possible the benefits of other types of money market funds. Whether the SEC's offering will be sufficient to satiate the Fed's appetite to regulate asset managers (and all other large nonbank financial institutions) remains to be determined, as is the question of whether the SEC's independence has been irreparably compromised. We provide additional background below and share our further observations.

## II. BACKGROUND ON MONEY MARKET FUND HISTORY AND REGULATION

Money market mutual funds, which were first offered in the United States in 1971, are a type of open-end investment company registered with the SEC under the Investment Company Act of 1940.<sup>35</sup> The Investment Company Act is one of the major statutes under the jurisdiction of the SEC, an agency established by Congress in 1934 as an independent five-member commission to regulate the securities markets.<sup>36</sup> The SEC has broad authority to implement and enforce the various statutes under its jurisdiction and has used its authority under the Investment Company Act to establish the regulatory requirements for money market funds.

Money market funds issue "redeemable securities," allowing an investor in the fund to redeem his or her shares upon request for a proportionate share of the fund's current net assets or cash equivalent.<sup>37</sup> A money market fund pools the funds of investors and invests in a diversified portfolio of high quality "money market" instruments. The composition of a money market fund portfolio varies, depending upon whether it is a *government* money market fund (investing primarily in government securities and/or repurchase agreements that are collateralized by cash or government securities), a *tax-exempt* money market fund (investing in short-term debt of state or local government entities), or a

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<sup>35</sup> 15 U.S.C. § 80a-3 (2012).

<sup>36</sup> *Id.* §§ 78d, 80a-1.

<sup>37</sup> *Id.* § 80a-2(32).



*prime* money market fund (investing in high quality taxable short-term obligations of corporations and banks, such as commercial paper, certificates of deposits, repurchase agreements, and also U.S. Treasury and government agency securities).<sup>38</sup> While assessments of the impact of money market funds on these various markets over the years may vary, there is no question that the presence of money market funds as active participants in the money markets has lowered costs for borrowers. Consider, for example, that money market funds are significant purchasers of commercial paper and that corporate issuers access the commercial paper markets at rates generally 300 basis points below the rates on comparable short-term loans from banks.<sup>39</sup>

Money market funds have provided investors a way to preserve principal while earning a market rate of return. For forty years, they have served as highly efficient cash management and investment products for millions of investors. By one estimate, money market funds have returned approximately \$450 billion to investors over the interest rates available for bank deposits during the period 1985 through 2008.<sup>40</sup> They are used for holding short-term cash balances by corporate treasurers, trustees, state and local governments, and other institutional investors, as well as individual investors. They offer investors liquidity, low risk, and, as a result of the accounting method used to value portfolio instruments, the ability to preserve principal at a stable \$1.00 price per share, plus interest. A corporate treasurer buying \$100,000 of shares in a money market fund to hold cash for a week until meeting payroll will almost always (unless the money market fund experiences a credit loss) be able to redeem those shares for \$100,000 plus interest. But, unlike bank deposits, money market funds are

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<sup>38</sup> The various types of money market funds are described in the Adopting Release, *supra* note 1, at 47,738.

<sup>39</sup> See Arnold & Porter Letter (Sept. 17, 2013), *supra* note 8.

<sup>40</sup> This estimate was compiled by Federated using data from ICI, iMoneyNet, and the Bank Rate Monitor. See Federated Letter (May 17, 2013), *supra* note 6.

an investment product; they are not insured and may lose value, as the SEC for decades has required funds to disclose to investors.<sup>41</sup>

***The stable value “deal.”*** The dollar-in, dollar-out feature of money market funds has been their defining characteristic for decades. It is the result of a 1978 deal between the SEC and various money market fund sponsors to resolve certain pending administrative proceedings and exemptive applications, subsequently codified in 1983 with the SEC’s adoption of Rule 2a-7, the principal rule governing money market funds under the Investment Company Act.<sup>42</sup> Rule 2a-7, which has been strengthened with various revisions over the years,<sup>43</sup> turned out to be a very good deal for investors. A fund that abides by all of the risk-limiting requirements of Rule 2a-7 (including credit quality, portfolio duration, and numerous obligations placed on money market fund boards that go beyond the obligations of other mutual fund boards) may call itself a “money market fund” and may use the “amortized cost method” of valuation and use the

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<sup>41</sup> 17 C.F.R. § 230.482(b)(4) (2015).

<sup>42</sup> The history of the relevant administrative proceedings, subsequent SEC orders and the adoption of Rule 2a-7 is briefly described in materials prepared by Stephen Keen of the law firm Reed Smith on behalf of Federated. See FEDERATED INVESTORS, INC., ASSESSMENT OF THE IMPACT OF PROPOSED STRUCTURAL REFORMS TO MONEY MARKET FUNDS BASED ON A REVIEW OF THEIR OPERATIONS, HISTORY AND REGULATION 27–34 (2013), reprinted in Federated Letter (May 17, 2013), *supra* note 6.

<sup>43</sup> 2010 Adopting Release, *supra* note 21, at 10,060 (requiring funds to maintain a portion of their portfolios in cash equivalents, reducing the maximum weighted average maturity of portfolio holdings, improving the quality of portfolio securities, enhancing certain portfolio reporting requirements, and permitting a fund that has broken the buck (or is at imminent risk of doing so), to suspend redemptions to allow for the orderly liquidation of fund assets); Revisions to Rules Regulating Money Market Funds, 61 Fed. Reg. 13,956 (Mar. 28, 1996) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274) (enhancing Rule 2a-7’s diversification and quality standards); Revisions to Rules Regulating Money Market Funds, 56 Fed. Reg. 8113 (Feb. 27, 1991) (to be codified at 17 C.F.R. pts. 230, 239, 270, 274) (tightening the risk-limiting conditions of Rule 2a-7 and enhancing disclosures of risk to investors).

“penny-rounding method” of pricing.<sup>44</sup> Using the amortized cost method, a fund values instruments held in its portfolio at cost and adjusts for any premium or discount during the life of the instrument. This allows a fund to avoid pricing shares based on minute fluctuations in estimated market values. Penny rounding allows a fund to round its net asset value to the nearest cent. For reasons of efficiency, most money market funds use the amortized cost method of valuation and round to the nearest cent, which allows a well-managed money market fund to offer investors the convenience of transacting in shares at a stable \$1.00 per share.

This pricing method bears further explanation. The stable value offered by money market funds using the amortized cost method is neither “fictitious” nor an “accounting gimmick” as some have suggested,<sup>45</sup> nor is a “floating NAV” a “mark-to-market” price, as former SEC Chairman Mary Schapiro and former Secretary of the Treasury Timothy Geithner said in making their case that money market funds should be required to price shares based on a floating NAV.<sup>46</sup>

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<sup>44</sup> Adopting Release, *supra* note 1, at 47,737. The *amortized cost method* of valuation “means the method of calculating an investment company’s net asset value whereby portfolio securities are valued at the fund’s acquisition cost as adjusted for amortization of premium or accretion of discount rather than at their value based on current market factors.” 17 C.F.R. § 270.2a-7(a)(2) (2015). The *penny-rounding method* of pricing “means the method of computing an investment company’s price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one percent.” *Id.* § 270.2a-7(a)(21).

<sup>45</sup> Editorial, *Republicans Against Reform*, WALL ST. J. (June 12, 2012, 12:01 AM), <http://www.wsj.com/articles/SB10001424052702303753904577452683553649646> [<http://perma.cc/B6QP-6HYQ>]; Eric S. Rosengren, *Flirting with Money-Market Madness*, WALL ST. J. (Nov. 28, 2013, 4:44 PM), <http://www.wsj.com/articles/SB10001424052702304243904579195901233996552> [<http://perma.cc/U5HL-WQR2>] (arguing that money market funds should not use a “fictitious fixed number”).

<sup>46</sup> See, e.g., Press Release, SEC, Statement of SEC Chairman Mary L. Schapiro on Money Market Fund Reform (Aug. 22, 2012), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171484078#.VGOLCDTF-uM> [<http://perma.cc/MD6T-7Y4N>] [hereinafter Schapiro

Amortized cost valuation is an accounting method widely used for valuing debt instruments maturing in fewer than sixty days.<sup>47</sup> It was permitted for money market funds—only those funds that otherwise abide by the stringent risk-limiting requirements of Rule 2a-7—because of the fact that most of the securities and other instruments held by money market funds are not actively traded in the markets; they are high quality short-term instruments generally held to maturity; there are few “mark-to-market” prices available for these securities; and the “market-based” valuations of these instruments, therefore, are based on estimates derived from models and matrix pricing.<sup>48</sup> As the SEC acknowledged in

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Statement on MMF Reform] (stating that money market funds should “float the NAV and use mark-to-market valuation like every other mutual fund”); Geithner, *supra* note 30 (under the FSOC’s proposed recommendations, according to Geithner’s letter, “MMFs would be required to use mark-to-market valuation to set share prices, like other mutual funds”).

<sup>47</sup> Proposing Release, *supra* note 3, at 36,836 n.10 (“The Commission . . . has stated that it would not object if a mutual fund board of directors determines, in good faith, that the value of debt securities with remaining maturities of 60 days or less is their amortized cost, unless the particular circumstances warrant otherwise.”); *see also* Adopting Release, *supra* note 1, at 47,737 n.5.

<sup>48</sup> *See* Jill Fisch & Eric Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy?* 7 (Univ. Pa. Law Sch. Inst. for Law and Econ., Research Paper No. 11-30, 2011) (“Very short-term money market instruments like commercial paper or bank CDs ordinarily lack readily available market prices.”), *reprinted in* Comment Letter on President’s Working Group Report on Money Market Fund Reform (Dec. 2, 2011), <https://www.sec.gov/comments/4-619/4619-110.pdf> [<http://perma.cc/A2G5-RM52>]; Samuel G. Hanson, David S. Scharfstein & Adi Sunderam, Comment Letter on FSOC Proposed Recommendations Regarding Money Market Mutual Fund Reform (Jan. 8, 2013), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0032> [<http://perma.cc/DDA8-NL8R>] (“[S]econdary markets for commercial paper and other private money market assets such as CDs are highly illiquid. Therefore, the asset prices used to calculate the floating NAV would largely be accounting or model-based estimates, rather than prices based on secondary market transactions with sizable volumes.”). *See also* John D. Hawke, Jr., Arnold & Porter LLP, Comment Letter on Proposed Recommendations Regarding Money Market Mutual Fund Reform (Jan. 25, 2013), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0072> [<http://perma.cc/>

both its Proposing and Adopting Releases on new money market fund rules,

[T]he vast majority of money market fund portfolio securities are not valued based on market prices obtained through secondary market trading because the secondary markets for most portfolio securities such as commercial paper, repos, and certificates of deposit are not actively traded. Accordingly, most money market fund portfolio securities are valued largely through “mark-to-model” or “matrix pricing” estimates.<sup>49</sup>

Indeed, pricing services using these models to derive valuations for money market instruments refer to their market-based valuations as “good faith opinions” of the price a particular instrument will fetch in the market under normal conditions.<sup>50</sup> In contrast to the imprecise nature of

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VQ9Q-WRKE] [hereinafter Arnold & Porter Letter on Alternative One] (letter titled “Alternative One: Floating Net Asset Value”); John D. Hawke, Jr., Arnold & Porter LLP, Comment Letter on President’s Working Group Report on Money Market Fund Reform (Nov. 2, 2012), <https://www.sec.gov/comments/4-619/4619-274.pdf> [<http://perma.cc/B99T-5RUG>]; FIN. ACCOUNTING STANDARDS BD., FAIR VALUE MEASUREMENT (TOPIC 820), TOPIC 820-10-55-3C (2011), <https://asc.fasb.org/imageRoot/00/7534500.pdf> [<http://perma.cc/2QQW-WZ39>] (“Matrix pricing is a mathematical technique used principally to value some types of financial instruments, such as debt securities, without relying exclusively on quoted prices for the specific securities, but rather relying on the securities’ relationship to other benchmark quoted securities.”).

<sup>49</sup> Proposing Release, *supra* note 3, at 36,837; *see also* Adopting Release, *supra* note 1, at 47,813. We assume that the SEC’s comments were not intended to encompass the actively traded markets for government securities or to reflect upon the ability of a money market fund to sell such holdings should the fund find it necessary to do so. Moreover, although there is limited secondary market trading in many money market instruments, money market funds are active buyers in these markets on a daily basis. Such purchases are often used by the pricing vendor to establish the curve from which a model price is derived in the absence of a secondary market transaction.

<sup>50</sup> *Pricing and Evaluations*, INTERACTIVE DATA, <http://www.interactivedata.com/products-services/pricing-and-evaluations/> [<http://perma.cc/2828-GJYB>] (“The Company’s independent evaluations represent its good faith opinion as to what a buyer in the marketplace would pay for a

these market-based “opinions,” the amortized cost method of valuation, which is based upon actual costs and actual accruals of discounts and premiums, more accurately accounts for the pricing of high quality, short-term assets held to maturity that mature at par (absent a credit event or the need to liquidate).<sup>51</sup>

However, the use of the amortized cost method of valuation by money market funds has always been *conditional*. In addition to abiding by all of the other conditions of Rule 2a-7, a money market fund board must institute procedures to allow the board to continually monitor any deviation between the price using amortized cost and the price using market-based estimates.<sup>52</sup> A money market fund may price its shares using the amortized cost method only “so long as the board of directors believes that they fairly reflect the market-based net asset value per share.”<sup>53</sup> This has been the essence of the deal in Rule 2a-7 among the SEC, money market fund sponsors and investors.

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security (typically in an institutional round lot position) in a current sale.”). For purposes of “shadow” price comparisons, money market funds typically use independent pricing vendors to obtain market-based valuations for individual instruments held in the funds’ portfolios.

<sup>51</sup> Many comments in the SEC’s rulemaking file made this point. *See, e.g.*, Goldman Sachs Asset Mgmt., Comment Letter on Money Market Fund Reform; Amendments to Form PF; Proposed Rule (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-194.pdf> [<http://perma.cc/PYE6-H58Y>] [hereinafter Goldman Sachs Letter (Sept. 17, 2013)]; Legg Mason & Co., LLC & Western Asset Mgmt. Co., Comment Letter on Money Market Fund Reform; Amendments to Form PF; Proposed Rule (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-166.pdf> [<http://perma.cc/J7AJ-BGMP>]; U.S. Bancorp Asset Mgmt., Inc., Comment Letter on Money Market Fund Reform; Amendments to Form PF; Proposed Rule (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-136.pdf> [<http://perma.cc/WVW9-GAAS>] [hereinafter U.S. Bancorp Letter (Sept. 16, 2013)]; Institutional Cash Distributors, LLC, Comment Letter on Proposed Rule: Money Market Fund Reform; Amendments to Form PF (July 25, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-40.pdf> [<http://perma.cc/XX2T-4P9U>].

<sup>52</sup> 17 C.F.R. § 270.2a-7(g) (2015).

<sup>53</sup> *Id.* § 270.2a-7(c)(1) (these provisions in the amended rule are limited to government and retail money market funds).

Investors get the benefit of transacting at a stable value per share, and that value is constantly benchmarked against market estimates to assure its fairness. If the fund's board believes any deviation from the fund's amortized cost price per share "may result in material dilution or other unfair results to investors or existing shareholders," the board is *required* to cause the money market fund to take action to eliminate or reduce the effect of the dilution or unfair results.<sup>54</sup> Rule 2a-7 provides that in the event that the extent of a money market fund's deviation from the market based NAV exceeds half of one percent ("breaking the buck"), the board must "promptly consider what action, if any, should be initiated."<sup>55</sup> For example, if a material credit event involving one or more of its portfolio securities occurs, the fund would be required to cease using amortized cost for the affected portfolio securities and value its shares based on the market-based NAV. No money market fund is allowed to maintain a "fiction." The stable NAV may be used only for so long as it is fair.

***Performance of money market funds.*** Money market fund boards and advisors over the years have adopted strict procedures designed to fulfill the mandates of Rule 2a-7 and its valuation requirements.<sup>56</sup> Thus, as a 2012 study by the SEC staff pointed out, a money market fund's amortized cost valuation "closely tracks" the fund's market-based price,

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<sup>54</sup> *Id.* § 270.2a-7(g)(8)(ii)(C) (these provisions in the amended rule are limited to government and retail funds); *see also* Fidelity Invs., Comment Letter on FSOC Proposed Recommendations Regarding Money Market Mutual Fund Reform (Feb. 14, 2013), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0105> [<http://perma.cc/5NAT-EGNZ>] (discussing a money market fund board's pricing obligations).

<sup>55</sup> 17 C.F.R. § 270.2a-7(g)(8)(ii)(B) (2015) (these provisions in the amended rule are limited to government and retail money market funds).

<sup>56</sup> John D. Hawke, Jr., Arnold & Porter LLP, Comment Letter on Money Market Fund Reform; Amendments to Form PF; Proposed Rule (Sept. 16, 2013), <http://www.sec.gov/comments/s7-03-13/s70313-147.pdf> [<http://perma.cc/9B4G-R7YT>] (describing requirements under Rule 2a-7 (prior to the 2014 rulemaking) regarding money market fund valuation and the implementation of these requirements by money market funds).

generally, within one one-hundredth of a penny per share.<sup>57</sup> In many cases, the two are identical. Amendments adopted by the SEC in 2010 enhanced the credit quality, liquidity, and transparency of money market funds and thereby considerably decreased the likelihood that any significant deviation, short of a major credit event, will occur. In fact, the SEC's 2012 study found that under the enhanced requirements, the possibility of a money market fund "breaking the buck" due to a change in interest rates is nearly zero.<sup>58</sup> The liquidity requirements adopted in 2010 have been tested. When faced with heavier-than-normal redemptions during the European debt crisis of summer 2011 and the U.S. debt-ceiling impasse, money market funds were able to meet all redemption requests, and market-based valuations continued to track closely the \$1.00 per share price.<sup>59</sup>

As noted earlier, in the almost forty-year existence of money market funds, only two have "broken the buck" and returned shareholders less than 100 cents on the dollar. The first occurred in 1994 with the closure of the Community Bankers U.S. Government Fund, which repaid its investors 96 cents on the dollar.<sup>60</sup> The second occurred in 2008 following the bankruptcy of Lehman Brothers Holdings

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<sup>57</sup> DIV. OF RISK, STRATEGY, & FIN. INNOVATION, SEC, RESPONSE TO QUESTIONS POSED BY COMMISSIONERS AGUILAR, PAREDES, AND GALLAGHER 83 (2012), <https://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf> [<http://perma.cc/9S6J-PRVH>] [hereinafter RSFI REPORT] ("When portfolio durations are limited to a maximum of 60 and 90 days, amortized cost closely tracks the shadow NAV."); *Perspectives on Money Market Mutual Fund Reform: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. 74 (2012) (statement of Paul Schott Stevens, President, ICI).

<sup>58</sup> See RSFI REPORT, *supra* note 57, at 29 tbl.2 (finding that under Rule 2a-7's requirement that money market funds not exceed a weighted average maturity of sixty days the possibility of a money market fund breaking a buck due to a change in interest rates is nearly zero percent).

<sup>59</sup> *Id.* at 34 tbl.3.

<sup>60</sup> The Community Bankers U.S. Government Fund had only institutional investors, so individual investors were not directly harmed. See ICI, MONEY MARKET WORKING GROUP REPORT 39 n.47, 178 (2009), [http://www.ici.org/pdf/ppr\\_09\\_mmwg.pdf](http://www.ici.org/pdf/ppr_09_mmwg.pdf) [<http://perma.cc/Q9FV-QPBR>].



(“Lehman”), when the Reserve Primary Fund was forced to mark its holdings of Lehman debt (about 1.2% of its assets) to zero and soon thereafter suspend redemption requests by investors.<sup>61</sup> The Reserve Primary Fund ultimately returned more than 99 cents per share to investors.<sup>62</sup> No taxpayer funds were used to bail out shareholders.

Investors largely shrugged it off when the Community Bankers fund broke the buck. However, the Reserve Primary Fund’s problems hit during the most turbulent week of the 2007–2008 financial crisis, at the end of a more than year-long period of deteriorating conditions in the subprime mortgage market, failures and forced sales of numerous banks and other financial institutions, credit contraction and worsening confidence in the broader financial markets, culminating in a series of severe shocks in September 2008. As discussed below, the run that ensued gave longstanding critics of money market funds at the Federal Reserve the opportunity to frame a narrative that attempted to place money market funds at the heart of the financial crisis. New SEC Chairman Mary Schapiro, taking office early in 2009 as part of the new administration’s team of financial regulators, offered no counter-narrative and, indeed, adopted the Fed’s narrative as her own.

### III. MONEY MARKET FUNDS IN THE FINANCIAL CRISIS: THE FACTS DO NOT SUPPORT THE FEDERAL RESERVE’S NARRATIVE

The FRBNY, in a 2012 report, referred to the “severity of the damage to financial stability caused by the run in 2008,” stating that outflows from money market funds were “a key

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<sup>61</sup> FIN. CRISIS INQUIRY COMM’N, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 356–57 (2011), <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> [<http://perma.cc/B22S-LRZJ>] [hereinafter FCIC REPORT].

<sup>62</sup> Daisy Maxey, *Reserve Primary Fund Nears End of Its Cash*, WALL ST. J. (July 17, 2010, 12:01 AM), <http://www.wsj.com/articles/SB1001424052748704913304575371003663559266> [<http://perma.cc/MV5D-CS9D>].

factor in the freezing of short-term funding markets and a broader curtailment of credit supply.”<sup>63</sup> The report called for dramatic structural changes to money market funds “[i]n light of the systemic risk stemming from [their] susceptibility to runs.”<sup>64</sup> The FSOC in its 2012 Annual Report stated, “the *structural features* of [money market funds] . . . caused a run on prime [money market funds] and the freezing of the short-term credit markets after the Reserve Primary Fund was unable to maintain a stable net asset value (NAV) in September 2008.”<sup>65</sup>

These statements overlook the fact that the only run in the forty-year history of money market funds occurred during the depths of a financial crisis which, as independent reports of the crisis have observed, was in large part the Fed’s own making. Federally regulated banks and large broker-dealers—virtually all of whom were primary dealers and counterparties of the FRBNY—were at the core of the crisis and turned the collapse of the housing bubble into a full-blown crisis. Reports on the causes of the financial crisis, as well as minutes from the series of the Federal Reserve System’s Federal Open Market Committee (“FOMC”) meetings during 2008, confirm that the Federal Reserve, perhaps more than any other institution, deserves blame for the failures that led to the financial crisis and to the chaos that ensued from the decision to let Lehman fail.<sup>66</sup>

The Financial Crisis Inquiry Commission (“FCIC”), the body established by Congress to examine the causes of the financial crisis, produced a detailed and far-ranging report, which spared no one, including the major financial institutions that took on “too much risk, with too little

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<sup>63</sup> MCCABE ET AL., *supra* note 2, at 1.

<sup>64</sup> *Id.*

<sup>65</sup> FIN. STABILITY OVERSIGHT COUNCIL, 2012 ANNUAL REPORT 11 (2012), <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf> [<http://perma.cc/FW5D-425V>] (emphasis added).

<sup>66</sup> *FOMC: Transcripts and Other Historical Materials, 2008*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., [www.federalreserve.gov/monetarypolicy/fomchistorical2008.htm](http://www.federalreserve.gov/monetarypolicy/fomchistorical2008.htm) [<http://perma.cc/F4FN-JA7V>] (last updated Mar. 21, 2014).

capital, and with too much dependence on short-term funding.”<sup>67</sup> But the FCIC aimed some of its harshest criticism at financial regulators, who were in a position to curb the risky practices but did not: “[I]t was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008.”<sup>68</sup>

The FCIC also noted that

[d]espite the expressed view of many on Wall Street and in Washington that the crisis could not have been foreseen or avoided, there were warning signs . . . . Yet . . . little meaningful action was taken to quell the threats in a timely manner. *The prime example is the Federal Reserve’s pivotal failure to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage-lending standards. The Federal Reserve was the one entity empowered to do so and it did not.*<sup>69</sup>

In the same report, the FCIC further found that

[a]s irresponsible lending, including predatory and fraudulent practices, became more prevalent, the Federal Reserve and other regulators and authorities heard warnings from many quarters. *Yet the Federal Reserve neglected its mission ‘to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers.’* It failed to build the retaining wall before it was too late.<sup>70</sup>

In conclusion, the report stated that

[t]he crisis reached seismic proportions in September 2008 with the failure of Lehman Brothers and the impending collapse of the insurance giant American International Group (AIG). Panic fanned by a lack of

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<sup>67</sup> FCIC REPORT, *supra* note 61, at xviii.

<sup>68</sup> *Id.* at xvi.

<sup>69</sup> *Id.* at xvii (emphasis added).

<sup>70</sup> *Id.* at xxiii (emphasis added).

transparency of the balance sheets of major financial institutions, coupled with a tangle of interconnections among institutions perceived to be ‘too big to fail,’ caused the credit markets to seize up.<sup>71</sup>

***Events leading up to September 2008.*** The financial crisis had been underway for more than a year before it entered a turbulent ten-day period in mid-September 2008 that triggered, among other things, a “run” on prime money market funds, as well as runs on other financial institutions.<sup>72</sup> Thirteen months earlier in August 2007, the Federal Reserve, in recognition of banks’ unwillingness to lend to each other and the deterioration of conditions in the financial markets at that time, began taking extraordinary steps to inject liquidity into the financial markets.<sup>73</sup> As

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<sup>71</sup> *Id.* at xvi.

<sup>72</sup> These events are detailed in the FCIC REPORT, *supra* note 61, at 309–86. *See also Perspectives on Money Market Mutual Fund Reform*, *supra* note 57, at 52–53 (testimony of Paul Schott Stevens, President, ICI) (providing a summary of the causes of the financial crisis); John D. Hawke, Jr., Arnold & Porter LLP, Comment Letter on President’s Working Group Report on Money Market Fund Reform (July 12, 2012), <https://www.sec.gov/comments/4-619/4619-212.pdf> [<http://perma.cc/Z6T3-XVU4>]; Paul Schott Stevens, *Three Gaps in the FSOC’s Account of Money Market Funds in the Financial Crisis*, ICI VIEWPOINTS (July 25, 2012), [http://www.ici.org/viewpoints/view\\_12\\_pss\\_mmfs\\_fsoc](http://www.ici.org/viewpoints/view_12_pss_mmfs_fsoc) [<http://perma.cc/HU92-WRUJ>].

<sup>73</sup> The threats were so severe that Senate Committee on Banking, Housing, and Urban Affairs Chairman Christopher Dodd, in August 2007, took the unusual step of calling a meeting with Fed Chairman Bernanke and Treasury Secretary Henry Paulson to discuss overall market conditions and to push the Federal Reserve to use all available policy tools to ease the growing credit crunch. *See* Emily Kaiser & Mike Peacock, *Fed keeps tools handy and calms Wall Street*, REUTERS (Aug. 21, 2007, 7:52 PM), <http://www.reuters.com/article/2007/08/21/us-economy-credit-correcti-on-idUSHO17757820070821> [<http://perma.cc/396G-REZA>]; *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Aug. 17, 2007), <http://www.federalreserve.gov/newsevents/press/monetary/20070817b.htm> [<http://perma.cc/KKP2-GUNT>] (“Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. . . . The [Federal Open Market] Committee is monitoring the situation and is prepared to

conditions worsened, the Fed in December 2007 launched the Term Auction Facility (“TAF”), the first of over a dozen special liquidity programs.<sup>74</sup> Additional programs were launched in March 2008 to support the funding of primary dealers—the Primary Dealer Credit Facility (“PDCF”) and Term Securities Lending Facility (“TSLF”).<sup>75</sup>

***March 2008: Bear Stearns verges on collapse, but is rescued.*** On March 13, 2008, the Federal Reserve and other regulators were advised by investment bank Bear Stearns “that its liquidity position had significantly deteriorated and that it would have to file for bankruptcy the next day unless alternative sources of funds became available.”<sup>76</sup> A \$12.9 billion loan provided the next day through JPMorgan Chase & Co. from the FRBNY could not stop Bear Stearns’ downward spiral, and on Sunday, March 16, 2008, Bear Stearns’ sale to JPMorgan was announced, with \$29 billion in financing support from the FRBNY.<sup>77</sup>

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act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets.”).

<sup>74</sup> *Term Auction Facility*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/monetarypolicy/taf.htm> [<http://perma.cc/63RK-4G57>] (last updated Sept. 13, 2010). The TAF program provided short-term loans to banks attempting to avoid the perceived stigma of using the discount window. *Id.*

<sup>75</sup> *Credit and Liquidity Programs and the Balance Sheet*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., [http://www.federalreserve.gov/monetarypolicy/bst\\_crisisresponse.htm](http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm) [<http://perma.cc/FH55-T29F>] (last updated Jan. 8, 2014). The PDCF was an overnight loan facility for primary dealers acting as broker-dealers in the tri-party repurchase agreement market to facilitate FRBNY’s open market operations. The TSLF addressed pressures faced by primary dealers in obtaining term funding. In exchange for relatively liquid Treasuries loaned for 28-day terms, primary dealers could offer less liquid (although highly rated) assets such as less liquid Treasuries, municipal securities, agency MBS and CMO, and asset-backed securities as collateral.

<sup>76</sup> *Turmoil in U.S. Credit Markets: Examining the Recent Actions of the Federal Financial Regulators Before the S. Comm. on Banking, Hous., & Urban Affairs*, 110th Cong. 11 (2008) (statement of Federal Reserve Chairman Ben Bernanke).

<sup>77</sup> SEC OFFICE OF THE INSPECTOR GEN., SEC’S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM iv (2008), <http://www.sec.gov/about/oig/audit/2008/446-a.pdf>

***March to June 2008: Regulators believe Lehman will be next.*** Conditions in the financial markets broadly, and within large financial institutions specifically, continued to deteriorate throughout the six months following the rescue of Bear Stearns. As described in the 2010 report of the Lehman Bankruptcy Examiner, Anton Valukas (“Valukas Report”), teams of monitors from both the SEC and FRBNY took up residence at Lehman shortly after Bear’s demise in March 2008, with particular focus on its liquidity.<sup>78</sup> The Valukas Report, citing interviews with Federal Reserve Chairman Ben Bernanke, FRBNY President Timothy Geithner, Treasury Secretary Henry Paulson, and SEC Chairman Christopher Cox, states that “it was widely thought at the highest levels of every relevant Government agency that Lehman could be the next investment bank to fail.”<sup>79</sup>

Transcripts of FOMC meetings from March through June of 2008 reveal mounting concerns among FRBNY President Geithner, Fed Chairman Bernanke, and other Fed officials about the condition of four remaining investment banks (Lehman, Merrill Lynch, Goldman Sachs, and Morgan Stanley), particularly Lehman.<sup>80</sup> The transcripts further

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[<http://perma.cc/4V2D-JEQS>]; Press Release, Fed. Reserve Bank of N.Y., Summary of Terms and Conditions of the JPMorgan Chase Facility (Mar. 24, 2008), <http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html> [<http://perma.cc/VP6C-YQLG>]; *Bear Stearns, JPMorgan Chase, and Maiden Lane LLC*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., [http://www.federalreserve.gov/newsevents/reform\\_bearstearns.htm](http://www.federalreserve.gov/newsevents/reform_bearstearns.htm) [<http://perma.cc/D7UZ-F5NV>] (last updated Dec. 9, 2014).

<sup>78</sup> Report of Anton R. Valukas, Examiner at 8, *In re Lehman Bros. Holdings Inc.*, Bankr. No. 08-13555 (JMP) (Bankr. S.D.N.Y. Mar. 11, 2010), <http://jenner.com/lehman> [<http://perma.cc/X4LK-LB9U>] [hereinafter Valukas Report].

<sup>79</sup> *Id.* at 1491 (citing statements of Federal Reserve Chairman Bernanke, FRBNY President Geithner, Treasury Secretary Paulson, and SEC Chairman Cox).

<sup>80</sup> See, e.g., *Meeting of the Federal Open Market Committee on March 18, 2008*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. 29 (Mar. 18, 2008), <http://www.federalreserve.gov/monetarypolicy/files/FOMC20080318meeting.pdf> [<http://perma.cc/E77J-PDRY>] (quoting Federal Reserve Bank of Boston President Rosengren, discussing Lehman and Washington Mutual,

reveal Fed officials' efforts to keep their concerns about the building crisis from the public.<sup>81</sup> A dominant concern was the liquidity of the investment banks and fears that institutions helping provide that liquidity would pull back, because of concerns about the investment banks' underlying strength. For example, at the April 29–30, 2008 FOMC meeting, one Fed governor expressed concern that “many of the money market mutual funds that hold between \$3 trillion and \$4 trillion will just walk away.”<sup>82</sup>

At the June 24–25 FOMC meeting, Fed staff reported that, based on stress tests conducted on Lehman, Merrill, Goldman, and Morgan Stanley, none of them would have survived a “full-run” Bear Stearns type of scenario.<sup>83</sup> Lehman was understood to be “under the most stress.”<sup>84</sup> Federal Reserve Bank of Boston President Rosengren and Fed Chairman Bernanke pointed to Lehman as the potential source of a “financial shock”<sup>85</sup>—a “systemic event.”<sup>86</sup>

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as stating that “[t]he potential for a further episode of financial market dysfunction and for runs on additional financial firms is significant”).

<sup>81</sup> *Id.* at 69 (quoting Governor Mishkin as stating, “We are in a financial crisis . . . . I will not use ‘financial crisis’ in public. . . . [B]ut I really do think that this is a financial crisis.”); *see also id.* at 75 (quoting Geithner as stating, “I just want to underscore the importance of exceptional care in how we talk about those things, even in private.”).

<sup>82</sup> *Meeting of the Federal Open Market Committee on April 29–30, 2008*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. 83 (Apr. 29, 2008), <http://www.federalreserve.gov/monetarypolicy/files/FOMC20080430meeting.pdf> [<http://perma.cc/RG9V-K95B>] (comments of Randall Kroszner).

<sup>83</sup> *Meeting of the Federal Open Market Committee on June 24–25, 2008*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. 141 (June 25, 2008), <http://www.federalreserve.gov/monetarypolicy/files/FOMC20080625meeting.pdf> [<http://perma.cc/EA6A-QWR9>]. The Valukas Report states that, after Lehman failed the first stress test, the FRBNY developed a new set of assumptions for an additional round of stress tests, which Lehman also failed. Lehman then ran a stress test of its own, which it passed. The Valukas Report states that neither the Fed nor SEC required any action of Lehman in response to the stress tests. Valukas Report, *supra* note 78, at 1488–89.

<sup>84</sup> *See Meeting of the Federal Open Market Committee on June 24–25, 2008*, *supra* note 83, at 4 (comments of William Dudley).

<sup>85</sup> *See* comments of Federal Reserve Bank of Boston President Rosengren, stating that articles on Lehman highlighted “continued

**June 2008: Fed officials privately discuss the “distress scenario” of an investment bank failure causing money market funds to “break the buck”—three months before Lehman’s failure.** Participants at the June 24–25 meeting also discussed the specific scenario in which one of the investment banks could fail, leading one or more money market funds to “break the buck.” Rosengren explained, “[i]n terms of a distress scenario, you have tri-party repos that are very illiquid. The clearing bank does not want to provide the cash. As a result they have to liquidate, and you have companies like Fidelity, Schwab, and Federated having to break the buck . . . .”<sup>87</sup> While acknowledging the risk to money market funds upon the failure of Lehman or another investment bank, Governor Warsh commented, “[i]n the short term, obviously, we want to see some of the money market mutual funds from President Rosengren’s neck of the woods hang in there with these institutions so we don’t have a sort of panic coming.”<sup>88</sup>

**July 2008: The Treasury, Fed and SEC attempt to curb short sellers in Lehman and other financial institutions.** At around this time, a well-known hedge fund manager and short seller, like the proverbial canary in the coal mine, was sounding the alarm. As Andrew Ross Sorkin reports in his book, *Too Big to Fail*, David Einhorn of Greenlight Capital made a presentation May 21, 2008 in which he called upon the SEC, Fed, and Treasury to pay heed to the risk to the financial system that Lehman was

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concerns about investment banks, despite our new liquidity facilities. As a result, I continue to view the downside risk of further financial shocks as being significant.” *Id.* at 50.

<sup>86</sup> Chairman Bernanke referred to concerns about Lehman, stating, “I do not yet rule out the possibility of a systemic event.” *Id.* at 94.

<sup>87</sup> *Id.* at 158.

<sup>88</sup> *Id.* at 184.



creating.<sup>89</sup> The Einhorn presentation sent Lehman's stock price further down.<sup>90</sup>

The SEC historically had supported the role of short sellers as market players who bring pricing efficiencies to the market by, in part, being bearers of bad news.<sup>91</sup> But in July of 2008, the SEC came under "intense pressure" from Treasury Secretary Paulson and Fed Chairman Bernanke to suppress the activity of short sellers in financial stocks.<sup>92</sup> In response, the SEC issued releases on July 13 and 15, 2008, announcing an investigation into short sellers and issuing an emergency order to curb their activities in financial stocks.<sup>93</sup>

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<sup>89</sup> ANDREW ROSS SORKIN, *TOO BIG TO FAIL* 107–08 (2010). Einhorn argued that Lehman was inflating the value of its real estate assets and was unwilling to recognize the true extent of its losses. *Id.*

<sup>90</sup> Valukas Report, *supra* note 78, at 714–15.

<sup>91</sup> *Short-Selling Activity in the Stock Market: The Effects on Small Companies and the Need for Regulation: Hearing Before the Subcomm. on Commerce, Consumer, & Monetary Affairs of the H. Comm. on Gov't Operations*, 101st Cong. 390 (1989) (statement of John H. Sturc, Associate Director, Division of Enforcement, SEC) ("[W]e frequently find that the negative statements which persons holding short positions are alleged to have disseminated to the marketplace are either often true, or may represent legitimate expressions of differing investment opinion by professional securities analysts.").

<sup>92</sup> SEC Chairman Cox later stated in an interview that in taking certain regulatory actions against short sellers, he acted in response to Paulson's and Bernanke's intense pressure; he further stated that it was one of his biggest mistakes. Amit R. Paley & David S. Hilzenrath, *SEC Chair Defends His Restraint During Financial Crisis*, WASH. POST (Dec. 24, 2008), <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/23/AR2008122302765.html?sid=ST2008122302866> [<http://perma.cc/FE8Y-RFWE>].

<sup>93</sup> Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, 73 Fed. Reg. 42,379 (July 21, 2008) [hereinafter July 15 Emergency Order]; Press Release, SEC, SEC Enhances Investor Protections Against Naked Short Selling (July 15, 2008), <http://www.sec.gov/news/press/2008/2008-143.htm> [<http://perma.cc/56QL-8WZ4>]; Press Release, SEC, Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (July 13, 2008), <http://www.sec.gov/news/press/2008/2008-140.htm> [<http://perma.cc/4ZBW-QGNU>]. The July 15 Emergency Order imposed pre-borrow restrictions on

The SEC's July 15th statement said that "false rumors" and short selling could cause the price of securities to "artificially and unnecessarily decline well below the price level that would have resulted from the normal price discovery process. If significant financial institutions are involved, this chain of events can threaten disruption of our markets."<sup>94</sup>

The SEC's short sale emergency order applied only to the limited number of financial firms identified in an appendix to the press release, which included Lehman.<sup>95</sup> The release explained that rumors about Bear Stearns earlier that year had eroded investor confidence in the firm and led to its demise.<sup>96</sup> However, a highly respected former Director of the SEC's Division of Trading and Markets later dismissed the SEC's explanation, commenting that "[t]he losses incurred by Bear Stearns and other large broker-dealers were not caused by 'rumors' or a 'crisis of confidence,' but rather by inadequate net capital and the lack of constraints on the incurring of debt."<sup>97</sup>

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short sales of the stocks of 17 primary dealers as well as Fannie Mae and Freddie Mac. This was the first time the SEC invoked its emergency authority since the terrorist attacks on September 11, 2001. *See The Condition of the Financial Markets: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 107th Cong. 70 (2001) (prepared statement of Harvey L. Pitt, Chairman, SEC, noting that, following September 11th, "the Commission for the first time invoked its emergency powers under Securities Exchange Act Section 12(k) and issued several orders and an interpretive release to ease certain regulatory restrictions temporarily").

<sup>94</sup> July 15 Emergency Order, *supra* note 93, at 42,379.

<sup>95</sup> *Id.* at 42,379–80.

<sup>96</sup> *Id.*

<sup>97</sup> Lee A. Pickard, *SEC's Old Capital Approach Was Tried—and True*, AM. BANKER, Aug. 8, 2008, at 10. Perhaps a more important question than the SEC's motivation for its actions regarding short sellers was the effect of its actions on investors. One might question the message the SEC was sending to investors in July 2008 by suggesting that rumors and short selling might cause the price levels of Lehman and other investment banks to fall "well below the price level that would have resulted from the normal price discovery process." July 15 Emergency Order, *supra* note 93, at 42,379. It certainly is reasonable to ask what price the SEC believed was "normal" for Lehman stock at that time, given what the SEC knew about Lehman's financial condition. One also might question whether

***July 2008: Bernanke defends the Bear Stearns rescue and says he would “do it again”—but then doesn’t.*** Following Bear Stearns’ rescue, Fed Chairman Bernanke publically defended the Fed’s actions. In an April 3, 2008 Senate hearing he explained, “Bear Stearns participated extensively in a range of critical markets. The sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence . . . . [T]he damage . . . could have been severe and extremely difficult to contain.”<sup>98</sup> He said the Federal Reserve, “in close consultation with the Treasury Department,” stepped in “[t]o prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences for market functioning and the broader economy.”<sup>99</sup>

these actions, undertaken as a result of what SEC Chairman Cox said was “intense” pressure from the Fed and Treasury, suppressed the flow of information about financial firms to the markets in order to maintain the flow of funding to Lehman and other financial firms. Rachele Younglai, *SEC chief has regrets over short-selling ban*, REUTERS (Dec. 31, 2008, 11:47 AM), <http://www.reuters.com/article/2008/12/31/us-sec-cox-idUSTRE4BU3GG20081231> [<http://perma.cc/9N47-T6JX>]. The Valukas Report offers additional evidence that regulators, including the Fed and the SEC, the two agencies with unique knowledge of Lehman’s precarious financial condition, stood by while knowing Lehman was issuing reports to public investors that failed accurately to disclose its true condition. In one example, the Valukas Report quotes a FRBNY official who disagreed with Lehman’s decision to include collateral posted with clearing banks as liquid. While the FRBNY discounted the collateral in determining the value of Lehman’s liquidity pool, it declined to take action to force Lehman to alter its liquidity numbers. A FRBNY official explained that “how Lehman reports its liquidity is between Lehman, the SEC, and the world.” Valukas Report, *supra* note 78, at 1472. In another example, the SEC internally discounted from Lehman’s liquidity pool the value of a deposit Lehman was required to post with Citibank but, according to the SEC official interviewed, the SEC was “very comfortable living with a world where the numbers in the public were the ones the firms worked out with their accountants,’ as opposed to the narrower numbers worked out by the SEC.” *Id.* at 1476.

<sup>98</sup> *Turmoil in U.S. Credit Markets*, *supra* note 76, at 11–12 (statement of Chairman Ben Bernanke).

<sup>99</sup> *Id.* at 12.

At a House committee hearing three months later, on July 10, 2008, Chairman Bernanke explained that the size of Bear Stearns, the fact that market infrastructure was not strong enough to deal with its failure, and the fragility of existing financial conditions at the time required that the Fed step in to prevent broader damage to the economy.<sup>100</sup> He said, “*I would do it again. I think it was necessary to protect the financial system.*”<sup>101</sup>

Bernanke never amended these statements. Just two months later, regulators suddenly let Lehman—a firm nearly twice the size of Bear<sup>102</sup>—fail, shocking investors and sending waves of panic through the markets.<sup>103</sup>

***September 2008: The events of Lehman Week.*** Lehman’s failure came just a week after the government seized mortgage giants Fannie Mae and Freddie Mac on September 7, 2008. As conditions in the market deteriorated, the Fed on September 14 expanded programs to make more cash available to investment banks by lowering standards regarding the quality of collateral used for borrowing under the programs. The Fed also allowed financial companies to borrow from their insured depository institutions—measures necessary to address the seizing up of credit.<sup>104</sup> After a week of rumors and uncertainty, on Monday, September 15, Merrill Lynch was forced to sell itself, Lehman Brothers declared bankruptcy, and rumors were circulating about the ability of other large investment banks and financial

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<sup>100</sup> *Systemic Risk and the Financial Markets: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 35 (2008) (statement of Chairman Ben Bernanke).

<sup>101</sup> *Id.* (emphasis added). Bernanke continued, “I don’t want to do it again, and so to avoid doing it again, we want to have things in place that will make it unnecessary, and that includes good supervision and includes strengthening the infrastructure, and it includes other measures to make the financial markets more stable.” *Id.*

<sup>102</sup> See FCIC REPORT, *supra* note 61, at 283 (noting Bear Stearns’ \$400 billion balance sheet); Valukas Report, *supra* note 78, at 3 (noting Lehman Brothers had approximately \$700 billion in assets).

<sup>103</sup> FCIC REPORT, *supra* note 61, at xvi.

<sup>104</sup> *Id.* at 354. The programs were the Primary Dealer Credit Facility and the Term Securities Lending Facility.

institutions to fund themselves.<sup>105</sup> That Monday the cost of protecting Morgan Stanley's debt through credit default swaps nearly doubled from the Friday before,<sup>106</sup> the Dow Jones Industrial Average plunged over 500 points.<sup>107</sup>

Although Bernanke, Geithner, and Paulson later said that they did not have the legal authority to save Lehman, the FCIC Report called these statements “[a]fter the fact” justification.<sup>108</sup> Articles reporting on conversations with Fed staff,<sup>109</sup> as well as statements made by Fed officials and recorded in FOMC minutes the day after Lehman failed (discussed below), also lead to the conclusion that letting Lehman fail was intentional on the part of the Fed, Treasury, and other regulators.

For example, at the FOMC meeting held on September 16, Governor James Bullard said that “[b]y denying funding to Lehman suitors, the Fed has begun to reestablish the idea

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<sup>105</sup> *Id.* at 353–63. A week later, on September 21, 2008, Goldman Sachs and Morgan Stanley announced that they would convert to bank holding companies, giving them access to deposits and the Federal Reserve discount window. Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 21, 2008), <http://www.federalreserve.gov/newsevents/press/bcreg/20080921a.htm> [<http://perma.cc/6TFM-S28B>].

<sup>106</sup> FCIC REPORT, *supra* note 61, at 360.

<sup>107</sup> *Id.* at 356.

<sup>108</sup> *Id.* at 343.

<sup>109</sup> See James B. Stewart & Peter Eavis, *Revisiting the Lehman Brothers Bailout That Never Was*, N.Y. TIMES (Sept. 29, 2014), <http://www.nytimes.com/2014/09/30/business/revisiting-the-lehman-brothers-bailout-that-never-was.html> [<http://perma.cc/7JG3-XP8>]; see also Neil Irwin, *Six Years Later, We're Still Litigating the Bailouts. Here's What We Know.*, N.Y. TIMES (Oct. 3, 2014), <http://www.nytimes.com/2014/10/05/upshot/six-years-later-were-still-litigating-the-bailouts-heres-what-we-know.html> [<http://perma.cc/G3F8-9ZZS>] (“Mr. Geithner and the others involved have long claimed they had no legal tools to rescue Lehman Brothers and prevent its bankruptcy filing because the company was insolvent . . . . Does the latest reporting by my colleagues change that view? It does. Inside the New York Fed there were teams who concluded that Lehman was narrowly solvent, and thus potentially eligible for a bailout. . . . By the weekend of Sept. 13, 2008, there was bailout fatigue. Fannie Mae and Freddie Mac had been taken over by the government a week earlier . . . . There was a ‘no more bailouts’ consensus in the Bush administration and in both parties in Congress.”).

that markets should not expect help at each difficult juncture.”<sup>110</sup> Governor Jeffrey Lacker followed with similar views, stating:

I don't want to be sanguine about it, but the silver lining to all the disruption that's ahead of us is that it will enhance the credibility of any commitment that we make in the future to be willing to let an institution fail and to risk such disruption again.<sup>111</sup>

FOMC member Thomas Hoenig said, “what we did with Lehman was the right thing because we did have a market beginning to play the Treasury and us . . . .”<sup>112</sup> Eric Rosengren was less sanguine, stating that letting Lehman fail was “*a calculated bet*. If we have a run on the money market funds or if the nongovernment tri-party repo market shuts down, that bet may not look nearly so good.”<sup>113</sup>

Lehman was one of the largest commercial paper dealers, and its withdrawal from the market left an enormous hole.<sup>114</sup> Lehman was also a large commercial paper issuer, whose bankruptcy directly impacted holders of its debt, fostered widespread uncertainty over the stability of other financial institutions, and led to a “near-universal retreat by all investors from securities issued by financial institutions.”<sup>115</sup> Moreover, the government's reversal, in first rescuing Bear, and then letting Lehman fail, had a severe destabilizing

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<sup>110</sup> *Meeting of the Federal Open Market Committee on September 16, 2008*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. 36 (Sept. 16, 2008), <http://www.federalreserve.gov/monetarypolicy/files/FOMC20080916meeting.pdf> [<http://perma.cc/2RNX-WZMW>].

<sup>111</sup> *Id.* at 48.

<sup>112</sup> *Id.* at 51. Thomas Hoenig, currently Vice Chair of the FDIC, was President of the Kansas City Fed at the time and a member of the FOMC.

<sup>113</sup> *Id.* (emphasis added).

<sup>114</sup> Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper During the Financial Crisis of 2007–2009*, 24 J. ECON. PERSPECTIVES 29, 40–41 (2010) (noting that along with the collapse of the asset-backed commercial paper market, Lehman's collapse caused a “major negative shock in the commercial paper market”).

<sup>115</sup> Mike McNamee, *Correcting the Record: Uncovering Regulators' False Narrative of 2008*, ICI (Aug. 13, 2012), [http://www.ici.org/viewpoints/view\\_12\\_mmfs\\_misstatements\\_2](http://www.ici.org/viewpoints/view_12_mmfs_misstatements_2) [<http://perma.cc/HR2V-7BCZ>].

impact on the markets. As FCIC member Peter Wallison later wrote,

[W]hen Lehman Brothers—an investment bank even larger than Bear—was allowed to fail, market participants were shocked; suddenly, they were forced to consider the financial health of their counterparties . . . . This caused a halt to lending and a hoarding of cash—a virtually unprecedented period of market paralysis and panic . . . .<sup>116</sup>

Late in the day on September 16, thirty-six hours after Lehman declared bankruptcy, a large money market fund, the Reserve Primary Fund, announced that, because of its mark down of Lehman debt, it had to reprice shares below a dollar per share.<sup>117</sup> Shortly thereafter, the markets were hit with the announcement that the government was bailing out yet another huge financial institution—insurance giant AIG.<sup>118</sup> Rumors swirled about which financial institution would be the next to fail and what the government’s response would be.<sup>119</sup> Fed Chairman Bernanke later testified to the FCIC, of “13 of the most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two.”<sup>120</sup> Many investors in prime money market funds rushed to redeem shares and/or move assets to government funds and out of prime funds—which they feared could be holding debt of the next institution to

<sup>116</sup> FCIC REPORT, *supra* note 61, at 445.

<sup>117</sup> Joshua Brockman, *Lehman Fallout Hits Money Market Fund*, NAT’L PUB. RADIO (Sept. 17, 2008, 12:29 PM), <http://www.npr.org/templates/story/story.php?storyId=94714363> [<http://perma.cc/GT9R-TH4L>].

<sup>118</sup> These events are cataloged in detail in numerous reports and articles on the financial crisis, notably the FCIC REPORT, *supra* note 61, at 344–52, the Valukas Report, *supra* note 78, at 13, and Andrew Ross Sorkin’s book, *TOO BIG TO FAIL*, *supra* note 89, at 394–408.

<sup>119</sup> FCIC REPORT, *supra* note 61, at 353.

<sup>120</sup> *Id.* at 354 (quoting a FCIC closed-door session with Chairman Bernanke on Nov. 17, 2009) (emphasis added).

fail.<sup>121</sup> Moreover, investors *other than money market funds* that had begun their retreat before the crisis hit money market funds continued to pull back from the commercial paper market in significant numbers; banks also quit lending to each other.<sup>122</sup>

Former FDIC Chairman Sheila Bair later wrote that the Lehman bankruptcy “defied market expectations. Bear Stearns had been bailed out, and most market players assumed that the government would step in with Lehman as well, given that it was a much bigger institution. Markets hate uncertainty, and the Lehman failure confused them.”<sup>123</sup> As the FCIC Report pointed out, the government had shocked investors by *not* rescuing Lehman, but then less than forty-eight hours later reversing itself by bailing out AIG.<sup>124</sup> In its analysis of the financial crisis, Treasury Strategies, Inc., a Treasury consulting firm to corporations and financial institutions, marks the AIG announcement as the tipping point, when the financial markets “skidded into a total liquidity collapse.”<sup>125</sup>

The FCIC Report identified the lack of predictable government action as a major cause of the panic that hit the markets in September 2008:

[T]he government was ill prepared for the crisis . . . .  
[Its] inconsistent handling of major financial institutions during the crisis—the decision to rescue Bear Stearns and then to place Fannie Mae and Freddie Mac into conservatorship, followed by its decision not to save Lehman Brothers and then to

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<sup>121</sup> In the week immediately following Lehman’s collapse, investors redeemed \$349 billion from prime money market funds. FCIC REPORT, *supra* note 61, at 357.

<sup>122</sup> Geithner later told the FCIC, “You had people starting to take their deposits out of very, very strong banks, long way removed in distance and risk and business from . . . Wall Street.” FCIC REPORT, *supra* note 61, at 353–54.

<sup>123</sup> SHEILA BAIR, BULL BY THE HORNS 107 (2012).

<sup>124</sup> FCIC REPORT, *supra* note 61, at xxi, 445.

<sup>125</sup> TREASURY STRATEGIES, *supra* note 18, at 8.



save AIG—increased uncertainty and panic in the market.<sup>126</sup>

***Did money market funds’ pricing structure “cause” the freezing of the short-term markets?*** In light of these facts, how accurate is the statement that the *structural features* of money market funds *caused* a run on prime money market funds and the freezing of the short-term credit markets in September 2008? The Investment Company Institute in an analysis detailing many of the above facts has called this a “startling mischaracterization of that time of crisis.”<sup>127</sup> Clearly money market funds and their investors were part of the retreat from securities issued by financial institutions in the wake of Lehman’s collapse and the events that followed. But, the key question for policy makers in evaluating reform proposals is whether this can be blamed on the *structural features* of money market funds—particularly where the reform proposal under consideration is a structural change in money market funds, namely, the elimination of their stable NAV pricing.

Academic research published by Jeffrey Gordon and Christopher Gandia, comparing redemptions from floating NAV money market funds in the United States with redemptions from comparable accumulating NAV funds in Europe during “Lehman week,” refutes the proposition that the stable pricing versus variable pricing distinction impacts the run risk of money market funds during periods of heightened market stress.<sup>128</sup> Moreover, one can look to earlier crises to evaluate how the short-term credit markets would have reacted to Lehman’s bankruptcy, under the

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<sup>126</sup> FCIC REPORT, *supra* note 61, at xxi.

<sup>127</sup> McNamee, *Correcting the Record: Uncovering Regulators’ False Narrative of 2008*, *supra* note 115.

<sup>128</sup> See Jeffrey N. Gordon & Christopher M. Gandia, *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?*, 2014 COLUM. BUS. L. REV. 313, 327 (2014) (“[T]he circumstance that produces genuine concern that the fund may break the buck and therefore will trigger a run on a fixed NAV fund will also produce strong concerns that [money market fund] assets will generally decline in value, which is sufficient to trigger a run on a floating NAV fund.”).

circumstances at the time, had there been no money market funds in existence. In 1970, Penn Central defaulted on its commercial paper and filed for bankruptcy, after the FRBNY declined to give it a loan that market participants widely expected would be made to the troubled company to enable it to meet its immediate obligations.<sup>129</sup> Suddenly, other commercial paper issuers no longer were able to roll over their paper as it matured; holders of commercial paper were unable to sell it.<sup>130</sup> The threat of a liquidity crisis for issuers and dealers led to a collapse in demand, a freezing of the market, and a flight to cash.<sup>131</sup> Stock prices plunged.<sup>132</sup> The Federal Reserve had to step in to provide an extraordinary credit facility to banks, secured by commercial paper purchased by the banks, as a way to encourage banks to purchase and hold commercial paper and provide liquidity to the commercial paper market.<sup>133</sup> Concerns about the liquidity of the market were so severe that the Chairman of the Federal Reserve at the time, Arthur Burns, announced that the Federal Reserve stood ready to lend directly or indirectly to firms that were unable to retire commercial paper.<sup>134</sup> *Notably, money market funds did not even exist at the time.*

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<sup>129</sup> Charles W. Calomiris, *Is the Discount Window Really Necessary? A Penn Central Perspective* 10–11 (Nat'l Bureau of Econ. Research, Working Paper No. 4573, 1993), <http://www.nber.org/papers/w4573.pdf> [<http://perma.cc/9725-G9GC>]. Congress also rejected a plan to provide a guarantee to a syndicate of banks to support a loan to Penn Central. *Id.*

<sup>130</sup> *Id.* at 13; *see also* Dusan Stojanovic & Mark D. Vaughan, *The Commercial Paper Market: Who's Minding the Shop?*, *THE REGIONAL ECONOMIST*, Apr. 1998, at 8.

<sup>131</sup> Calomiris, *supra* note 129, at 15–16.

<sup>132</sup> *Id.* at 15.

<sup>133</sup> *Id.* at 14–18.

<sup>134</sup> *Id.* at 19–20. Direct lending became unnecessary, however, since the other steps resolved the crisis.

#### IV. FEDERAL RESERVE AND TREASURY CRISIS PROGRAMS AFFECTING MONEY MARKET FUNDS

In September 2008, Federal Reserve and Treasury officials instituted a broad series of programs to flood the financial markets with liquidity and prop up major financial institutions.<sup>135</sup>

One program initiated by the Treasury on September 19, 2008 has been described as “Treasury’s guarantee of more than \$3 trillion of [money market fund] shares.”<sup>136</sup> While it is true that the total assets in money market funds in September 2008 were \$3 trillion, the Treasury guarantee program, which was designed to cover losses in money market funds that paid premiums to participate in the program, was structured to ensure that any losses (and in fact there were none) would be a very small portion of the total assets of participating funds.<sup>137</sup> No money market fund that had broken a dollar or suspended redemptions could participate.<sup>138</sup> If a participating fund’s value dropped by just a half a percent, the fund was required to liquidate and pay off its investors. Balances were insured only as of September 19, 2008; thus, any purchases of fund shares after that time were uninsured. In the end, this was the “bailout” that wasn’t. The program was limited in size and duration, was never called upon, expired on September 18, 2009, and

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<sup>135</sup> See *Credit and Liquidity Programs and the Balance Sheet: Crisis Response*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., [http://www.federalreserve.gov/monetarypolicy/bst\\_crisisresponse.htm](http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm) [<http://perma.cc/3QYP-KB4F>] (last updated June 4, 2015).

<sup>136</sup> Geithner, *supra* note 30; see also FSOC Release, *supra* note 3, at 69,455.

<sup>137</sup> McNamee, *Correcting the Record: Uncovering Regulators’ False Narrative of 2008*, *supra* note 115.

<sup>138</sup> Thus, the Reserve Fund Primary Fund, which had broken a dollar, was prohibited from participating; the U.S. Putnam Institutional Prime Money Market Fund, which suspended redemptions on September 18, 2008, also was barred from participating. See *infra* note 300, regarding the transfer of Putnam’s assets.

earned the Treasury \$1.2 billion in premiums.<sup>139</sup> In contrast, the Transaction Account Guarantee program, a special insurance program initiated during the crisis for banks, provided *unlimited* deposit insurance for banks, continued for more than four years, and led to losses under the expanded deposit insurance program of approximately \$2.2 billion (as of June 2012).<sup>140</sup>

Another program, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (“AMLF”), provided funding for banks’ purchases of commercial paper from money market funds.<sup>141</sup> But this program was small in size and duration compared to the massive government liquidity programs addressing the broader market problems. Over the life of the program, the amount loaned under the AMLF constituted less than two percent of the government’s total emergency funds outstanding on a weighted average monthly basis.<sup>142</sup> The AMLF was one of the smaller and

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<sup>139</sup> Press Release, U.S. Dep’t of the Treasury, Treasury Announces Expiration of Guarantee Program for Money Market Funds (Sept. 19, 2009), <http://www.treasury.gov/press-center/press-releases/Pages/tg293.aspx> [<http://perma.cc/LKL2-C8TE>].

<sup>140</sup> Letter from Martin J. Gruenberg, Acting Chairman, Fed. Deposit Ins. Corp., to Hon. Shelley Moore Capito (June 29, 2012), <http://www.aba.com/Issues/Index/Documents/FDICResponsetoCapitoonTAG.pdf> [<http://perma.cc/A98V-9YSN>].

<sup>141</sup> See *Credit and Liquidity Programs and the Balance Sheet: Crisis Response*, *supra* note 135.

<sup>142</sup> As calculated by comparing the utilization of the AMLF to the following crisis-related government programs: the Term Auction Facility, Central Bank Liquidity Swap Lines opened in December 2007, Single-Tranche Term Repurchase Agreements conducted by the Federal Reserve beginning in March 2008, bridge loans and “Maiden Lane” loans funded primarily by the FRBNY to facilitate the acquisition of Bear Stearns by J.P. Morgan Chase & Co., the Primary Dealer Credit Facility, the Term Securities Lending Facility and Term Options Program, aid to Fannie Mae and Freddie Mac in the form of Preferred Stock Purchase Agreements and the Agency MBS Purchase Programs of the Department of Treasury and Federal Reserve, a revolving credit facility and securities borrowing facility provided to AIG, the Commercial Paper Funding Facility, and the Term Asset-Backed Securities Loan Facility. *Busting Through the Folklore About Money Market Funds: The Fact is They Cost Taxpayers Nothing*, AM. BANKER, Jan. 19, 2012, at 8. See generally OFFICE OF THE INSPECTOR GEN.,

shorter-lived liquidity programs of the Federal Reserve and Treasury during the financial crisis, it had no losses, and the Federal Reserve earned \$543 million from its advances.<sup>143</sup>

Federal Chairman Bernanke, in making the case for new limitations on money market funds, later stated, “The runs in 2008 were stopped only by extraordinary interventions by the government, the Treasury, the Federal Reserve *using powers which, incidentally, are no longer available.*”<sup>144</sup> Of course, the Federal Reserve did not lend directly to money market funds during the financial crisis; the AMLF program worked through banks, in much the same way as the credit facility set up by the Fed in 1970 to provide liquidity to the commercial paper market after Penn Central’s collapse. Moreover, the government’s goal in the 2008 programs involving money market funds was not to save money market funds or their shareholders, but to sustain the funding mechanisms for large financial institutions reliant upon short-term funding.<sup>145</sup>

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BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE’S SECTION 13(3) LENDING FACILITIES TO SUPPORT OVERALL MARKET LIQUIDITY: FUNCTION, STATUS, AND RISK MANAGEMENT (2010), [http://oig.federalreserve.gov/reports/FRS\\_Lending\\_Facilities\\_Report\\_final-11-23-10\\_web.pdf](http://oig.federalreserve.gov/reports/FRS_Lending_Facilities_Report_final-11-23-10_web.pdf) [<http://perma.cc/FFM3-YXHT>]. AMLF utilization peaked at \$152.1 billion. *Id.* at 5.

<sup>143</sup> See OFFICE OF THE INSPECTOR GEN., *supra* note 142, at 66.

<sup>144</sup> Open Session Meeting of the FSOC (Nov. 13, 2012) (statement of Ben Bernanke), <http://www.yorkcast.com/treasury/ondemand/asx/2012/11/13/FSOC.asx> [<http://perma.cc/9Z2Q-UWVZ>] (emphasis added). We addressed these issues in more detail in comments filed with the FSOC. See John D. Hawke, Jr., Arnold & Porter LLP, on behalf of Federated, Comment Letter on Proposed Recommendations Regarding Money Market Mutual Fund Reform (Feb. 15, 2013), <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0116> [<http://perma.cc/D4CU-ALLB>].

<sup>145</sup> A former Treasury official also made the point that the programs were aimed at staving off pressure on banks that had guaranteed the commercial paper of banks’ off-balance sheet conduits and other issuers. See Peter Wallison, *Money Market Funds Were a Victim, Not a Cause, Of the Financial Crisis*, REALCLEARMARKETS (May 2, 2014), [http://www.realclearmarkets.com/articles/2014/05/02/money\\_market\\_funds\\_were\\_a\\_victim\\_not\\_a\\_cause\\_of\\_the\\_financial\\_crisis\\_101033.html](http://www.realclearmarkets.com/articles/2014/05/02/money_market_funds_were_a_victim_not_a_cause_of_the_financial_crisis_101033.html) [<http://perma.cc/DJ3K-6T2U>].

Federal law now prohibits the Treasury from providing a money market fund guarantee program in the future,<sup>146</sup> and the Dodd-Frank Act prohibits bailouts of individual firms.<sup>147</sup> However, the Federal Reserve continues to have the authority to step in to provide broad-based liquidity to the markets in the event the commercial paper market freezes up in the future, due to a financial panic or other stress.<sup>148</sup> Indeed, the Federal Reserve was created for the purpose of providing short-term credit to banks and liquidity to the secondary markets in commercial paper particularly during economic downturns and periods of stress.<sup>149</sup> It has used this

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<sup>146</sup> Emergency Stabilization Act of 2008 § 131(b), 12 U.S.C. § 5236(b) (2012).

<sup>147</sup> Dodd-Frank Act § 1101, 12 U.S.C. § 343 (2012) (amending section 13 of the Federal Reserve Act). *See also* S. REP. NO. 111-176, at 182 (2010). The report cites then-Section 1151, “Federal Reserve Act amendment on emergency lending authority,” as follows:

Emergency lending to an individual entity is no longer permitted. The Board of Governors now is authorized to lend to a participant in any program or facility with broad-based eligibility. Policies and procedures governing emergency lending must be established by regulation, in consultation with the Secretary of the Treasury. The Treasury Secretary must approve the establishment of any lending program. Lending programs must be designed to provide liquidity and not to aid a failing financial company. Collateral or other security for loans must be sufficient to protect taxpayers from losses. The Board of Governors must report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services on any 13(3) lending program within 7 days after it is initiated, and periodically thereafter.

*Id.*

<sup>148</sup> Dodd-Frank Act § 1101, 12 U.S.C. § 343 (2012) (amending section 13 of the Federal Reserve Act); Extensions of Credit by Federal Reserve Banks, 79 Fed. Reg. 615 (proposed Jan. 6, 2014) (to be codified at 12 C.F.R. pt. 201).

<sup>149</sup> The Federal Reserve was created after a long history of financial panics in the United States. These panics led to the creation of the National Monetary Commission (“NMC”) in 1907 to develop a set of recommendations to prevent or reduce the harms caused by financial panics, by providing a mechanism for providing extraordinary credit to

power in the past—as it did when commercial paper markets froze after the Penn Central bankruptcy discussed above<sup>150</sup>—and no doubt will be called upon to fulfill this responsibility in a future crisis. But market participants may still be left guessing as to the manner in which the Fed will exercise its authority in any future market emergency. While Section 1101 of the Dodd-Frank Act specifically preserved the Federal Reserve’s authority to institute broad-based emergency lending programs, it also mandated that the Fed write rules governing such lending programs “[a]s soon as is practicable after the date of enactment” of Dodd-Frank.<sup>151</sup> The Fed did not initiate the rulemaking until three-and-a-

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short-term credit markets in times of stress. The plan recommended by the NMC formed the basis for the Federal Reserve Act, which was enacted by Congress in 1913. S. DOC. NO. 243, at 10 (1912). Notable financial panics (and their economic aftermaths) include the Panics of 1819 and 1837 (both of which were related to the Bank of the United States); the Panic of 1857 (triggered by an economic downturn, the sinking of the S.S. Central America with a loss of 550 passengers and crew and a cargo of 30,000 pounds of California gold, and the collapse of an Ohio insurance company and trust company); the Panic of 1873 (triggered by economic downturn, tumult in the silver market, the failure of Jay Cooke & Co., and the bankruptcy of numerous railroads and businesses); the “Hard Times” of 1893 (triggered by rapid overexpansion in agriculture and agricultural debt, decline in agricultural commodities prices, and general economic contraction); the Panic of 1901; and the Financial Panic of 1907. Of course, notable panics after the creation of the Federal Reserve occurred during the Great Depression of 1929–1939, the Penn Central bankruptcy in 1970, and the financial crisis of 2007–2009. The purpose underlying the Federal Reserve Act of 1913, as stated by Congress, was “[t]o provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.” Federal Reserve Act, Pub. L. No. 63-43, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. ch. 3 (2012)) (emphasis added); *see also* BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTION 2 (9th ed. 2005), [http://www.federalreserve.gov/pf/pdf/pf\\_complete.pdf](http://www.federalreserve.gov/pf/pdf/pf_complete.pdf) [<http://perma.cc/6TSX-APZG>].

<sup>150</sup> *See supra* text accompanying notes 129–134.

<sup>151</sup> Dodd-Frank Act § 1101, 12 U.S.C. § 343 (2012).

half years after the law's enactment, and the proposed rules provide few details on how the Fed intends to proceed.<sup>152</sup>

Money market funds were the first institutions to recover from the financial crisis, as evidenced by the fact that after September 19, 2008, when the temporary guarantee program was capped, and through year end 2008, investors poured a net \$170 billion of *uninsured* investments back into prime money market funds.<sup>153</sup> In contrast, banks and other institutions continued to draw from Fed and Treasury borrowing programs, including \$1.5 trillion through the discount window and special liquidity programs set up by the Federal Reserve during the financial crisis,<sup>154</sup> \$204.9 billion distributed under the TARP's Capital Purchase Program to a total of 707 depository institutions, and even over \$80 billion to bail out the automobile industry.<sup>155</sup>

Therefore, while it is accurate to state that money market funds ultimately were hit by the financial crisis and that they participated in government programs to help staunch the panic, it is not accurate to suggest that the *structural features* of money market funds—namely their ability to

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<sup>152</sup> Extensions of Credit by Federal Reserve Banks, *supra* note 148, at 615–17.

<sup>153</sup> See TREASURY STRATEGIES, *supra* note 18, at 3.

<sup>154</sup> *Why did the Federal Reserve lend to banks and other financial institutions during the financial crisis?*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/faqs/why-did-the-Federal-Reserve-lend-to-banks-and-other-financial-institutions-during-the-financial-crisis.htm> [<http://perma.cc/9Z2Q-UWVZ>] (last updated Jan. 24, 2014). The \$1.5 trillion does not include the AMLF but does include the following liquidity facilities: Term Auction credit, primary credit, secondary credit, seasonal credit, Primary Dealer Credit Facility, Term Asset-Backed Securities Loan Facility, Commercial Paper Funding Facility, and central bank liquidity swaps. The numbers reflected above are as reported by the Federal Reserve and other government sources, but as most loans were short-term or even overnight, these numbers significantly understate the aggregate liquidity provided during this period, which totaled in the trillions. *Id.*

<sup>155</sup> OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 46, 144 (2012), [http://www.sigtar.gov/Quarterly%20Reports/July\\_25\\_2012\\_Report\\_to\\_Congress.pdf](http://www.sigtar.gov/Quarterly%20Reports/July_25_2012_Report_to_Congress.pdf) [<http://perma.cc/TK5X-7SEP>].



price at a stable value, conditioned upon compliance with all of the SEC's risk-limiting rules—were its cause or at its core. As discussed above, money market funds were the last to be hit and the first to recover. Money market funds also were the first institutions to be subject to comprehensive new regulation—the SEC's 2010 amendments to its money market fund rules, which directly addressed and enhanced money market fund liquidity, credit quality, transparency, and regulatory monitoring, making money market funds more resilient to future market turmoil.<sup>156</sup>

## V. THE SEC'S EARLY RULEMAKING RESPONSE

***The SEC's 2009–2010 Rulemaking.*** The SEC, acting on its own and under no mandate from Congress, responded to the experience of money market funds in the crisis by proposing in 2009, and adopting in 2010, new liquidity, portfolio duration, credit quality, and other rules for money market funds to make them more resilient to large-scale shareholder redemptions.<sup>157</sup> Among other things, the 2010 amendments required that a money market fund hold at least ten percent of its assets in cash or other securities that can be convertible to cash within one day, and thirty percent of its assets in securities convertible into cash within one week—reforms designed to enable money market funds to meet high levels of redemptions.<sup>158</sup> The amendments also shortened the maturity limits on money market fund portfolios in order to limit the risks associated with changing interest rates.<sup>159</sup> As a result of these reforms, U.S. money market funds effectively weathered large-scale redemptions during the summer of 2011 related to the European debt crisis (prime money market funds), the U.S. debt-ceiling

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<sup>156</sup> 2010 Adopting Release, *supra* note 21, at 10,060.

<sup>157</sup> 2010 Proposing Release, *supra* note 21, at 32,688 (proposing risk-limiting conditions to Rule 2a-7); 2010 Adopting Release, *supra* note 21, at 10,060 (adopting the proposed risk-limiting conditions with certain modifications).

<sup>158</sup> 2010 Adopting Release, *supra* note 21, at 10,076.

<sup>159</sup> *Id.* at 10,070.

impasse, and concerns about the downgrading of U.S. debt (government money market funds); they weathered yet another period of large redemptions during the debt-ceiling standoff in 2013 (government money market funds).<sup>160</sup>

However, with the ink barely dry on the SEC's 2010 amendments, the Federal Reserve and the newly-created FSOC pressed the SEC to adopt additional, more stringent regulations to impose structural changes on money market funds.<sup>161</sup> Indeed, from 2009 through the first half of 2014, numerous speeches, reports, testimony, and other statements by current and former Federal Reserve officials asserted that money market funds were at the heart of the financial crisis, that they presented a systemic risk, that they were part of the "shadow banking system," and that stringent measures, including requiring money market funds to hold capital and/or to convert to floating NAVs, were needed.<sup>162</sup>

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<sup>160</sup> See the discussion of money market fund performance during these periods in the SEC's 2014 Adopting Release, *supra* note 1, at 47,746.

<sup>161</sup> Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., *Fostering Financial Stability: Remarks at the 2012 Federal Reserve Bank of Atlanta Financial Markets Conference* (Apr. 9, 2012), <http://www.federalreserve.gov/newsevents/speech/bernanke20120409a.htm> [<http://perma.cc/Z96N-GBC7>]; FSOC Release, *supra* note 3, at 69,455–56.

<sup>162</sup> See, e.g., Bernanke, *supra* note 161; Thomas Hoenig, President, Fed. Reserve Bank of Kansas City, *Back to the Business of Banking: Address at the 29th Annual Monetary and Trade Conference* (May 24, 2011), <http://www.kc.frb.org/publicat/speeches/Hoenig-MonetaryandTradeConference-05-24-11.pdf> [<http://perma.cc/S3NB-RMY2>]; Eric S. Rosengren, President, Fed. Reserve Bank of Bos., *Money Market Mutual Funds and Financial Stability: Remarks at the Federal Reserve Bank of Atlanta's 2012 Financial Markets Conference* (Apr. 11, 2012), <http://www.bostonfed.org/news/speeches/rosengren/2012/041112/> [<http://perma.cc/X33V-MGX6>]; Daniel K. Tarullo, Governor, Fed. Reserve, *Financial Stability Regulation: Distinguished Jurist Lecture, University of Pennsylvania Law School* (Oct. 10, 2012), <http://www.federalreserve.gov/newsevents/speech/tarullo20121010a.htm> [<http://perma.cc/6QAK-E8N6>]; Daniel K. Tarullo, Governor, Fed. Reserve, *Shadow Banking After the Financial Crisis: Remarks at the Federal Reserve Bank of San Francisco Conference on Challenges in Global Finance* (June 12, 2012), <http://www.federalreserve.gov/newsevents/speech/tarullo20120612a.pdf> [<http://perma.cc/2L3P-LLCL>]

The SEC began soliciting comments on various options for further reform in November 2010, when it requested comments on seven different “Money Market Fund Reform Options” put forward in a report by the President’s Working Group on Financial Markets (“PWG Report”).<sup>163</sup> A total of 2503 comments were submitted for the record, which remained open until the SEC issued proposed rules in 2013. The SEC held a “roundtable” on money market funds in May 2011.<sup>164</sup> In various interagency meetings among staff of the SEC, Federal Reserve, and Treasury, agency staffs developed proposals for various types of capital requirements for money market funds, as well as proposals involving various types of redemption restrictions. Various informal proposals were discussed from time to time with money market fund industry representatives.

***Chairman Schapiro’s further initiatives on money market funds.*** In a November 2011 speech, then-SEC Chairman Mary Schapiro announced that she hoped the SEC in “very short order” would issue proposals to require money market funds to price shares at a floating NAV and maintain a “capital buffer,” possibly with redemption restrictions.<sup>165</sup> In a speech the following February, Schapiro said, “Funds remain vulnerable to the reality that a single money market fund breaking of the buck could trigger a broad and

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[hereinafter Tarullo, Shadow Banking]; Paul A. Volcker, Three Years Later, Unfinished Business in Financial Reform: Group of 30, William Taylor Memorial Lecture No. 13 (Sept. 23, 2011), [http://www.group30.org/images/PDF/ReportPDFs/GRP30\\_WTML13\\_Volcker\\_FNLlo.pdf](http://www.group30.org/images/PDF/ReportPDFs/GRP30_WTML13_Volcker_FNLlo.pdf) [<http://perma.cc/B63H-LQXX>]; see also Rosengren, *supra* note 45.

<sup>163</sup> PWG Report, *supra* note 3, at 1. The members of the PWG were the heads of the Treasury, Federal Reserve, SEC and Commodity Futures Trading Commission (“CFTC”). *Id.*

<sup>164</sup> *Unofficial Transcript: Roundtable on Money Market Funds and Systemic Risk*, SEC (May 10, 2011), <http://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm> [<http://perma.cc/GDW2-7EPH>].

<sup>165</sup> Mary L. Schapiro, Chairman, SEC, Remarks at Securities Industry and Financial Markets Association (SIFMA) 2011 Annual Meeting (Nov. 7, 2011), <http://www.sec.gov/news/speech/2011/spch110711.mls.htm> [<http://perma.cc/7U4Q-65QY>].

destabilizing run.”<sup>166</sup> She identified “two serious options” the SEC was considering for addressing the “core structural weakness” of money market funds: floating the NAV and imposing capital requirements with limitations or fees on redemptions.<sup>167</sup> Federal Reserve officials subsequently made speeches supporting Schapiro’s proposals.<sup>168</sup>

On the eve of a June 21, 2012 hearing before the Senate Banking Committee, the Wall Street Journal reported that, according to a new SEC study that had not been released to the public, “[m]oney market mutual funds have been rescued from financial trouble by their parent companies more than 300 times since the 1970s,” information the reporters said “appears to bolster SEC Chairman Mary Schapiro’s contention that the \$2.6 trillion industry needs stronger regulation.”<sup>169</sup> At the hearing, Schapiro testified that on more than 300 occasions since money market funds were first offered in the 1970s, fund sponsors had provided their own capital “to absorb losses or protect their funds from falling below \$1.”<sup>170</sup> She warned, “[r]ecurrent sponsor support has taught investors to look beyond disclosures that these investments are not guaranteed and can lose value. As a result, when a fund breaks a dollar, investors lose confidence and rush to redeem.”<sup>171</sup> Some Senators were critical of Schapiro’s failure to produce data backing up her

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<sup>166</sup> Mary L. Schapiro, Chairman, SEC, Remarks at the Practising Law Institute’s SEC Speaks (Feb. 24, 2012), <http://www.sec.gov/News/Speech/Detail/Speech/1365171489938> [<http://perma.cc/URM7-92Z3>].

<sup>167</sup> *Id.*

<sup>168</sup> *See, e.g.*, Bernanke, *supra* note 161; Tarullo, Shadow Banking, *supra* note 162.

<sup>169</sup> Andrew Ackerman & Kirsten Grind, *SEC Builds Money Fund Case*, WALL ST. J. (June 21, 2012, 12:12 AM), <http://www.wsj.com/articles/SB10001424052702304898704577478623645078562> [<http://perma.cc/63ZT-5SWQ>].

<sup>170</sup> *Perspectives on Money Market Mutual Fund Reform*, *supra* note 57, at 2 (testimony of Mary Schapiro, Chairman, SEC).

<sup>171</sup> *Id.* at 30–31 (prepared statement of Mary Schapiro, Chairman, SEC).

statements about sponsor support; Schapiro promised to provide the data after the hearing.<sup>172</sup>

When the SEC released the details of the more than 300 instances of sponsor support six weeks after the hearing, Chairman Schapiro was subject to scathing criticism. One industry leader called Chairman Schapiro's characterization of the data "misleading" in suggesting that the SEC's tally represented sponsor rescues of funds about to break the buck, and he noted that there are reasons sponsors might engage in transactions with a money market fund that in no way reflect a fund teetering on breaking a dollar.<sup>173</sup> Moreover, he said, "the SEC's current stance is a complete reversal of prior positions. For decades, the SEC has encouraged sponsors to support their money market funds."<sup>174</sup> In fact, the SEC, in a release two years earlier, had said that sponsor support transactions "appear to be fair and reasonable and in the best interests of fund shareholders" and that such transactions would not "materially change

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<sup>172</sup> *Id.* at 8–11 (exchange between Senator Patrick Toomey and Chairman Mary Schapiro).

<sup>173</sup> Paul Schott Stevens, *The SEC's Data Dump on Money Market Funds is Misleading*, ICI (Aug. 10, 2012), [http://www.ici.org/viewpoints/view\\_12\\_pss\\_mmfs\\_300](http://www.ici.org/viewpoints/view_12_pss_mmfs_300) [<http://perma.cc/N4C9-9D34>] ("The [SEC] has finally delivered on Chairman Mary Schapiro's June promise to give Congress data to back up her claim that money market fund sponsors 'have voluntarily provided support to money market funds on more than 300 occasions.' Regrettably, the full list exposes just how flimsy the SEC's claims are. The tabulation reveals that the dramatic figure—previewed in an interview with the *Wall Street Journal* two days before the hearing—was more showmanship than science. After the figure was disclosed with such fanfare, it took the SEC fully six weeks to provide any documentation. Even so, the final list lacks crucial detail and appears concocted to create a misleading impression on a vital matter of public policy. To make matters worse, the SEC frames the list as representing that 'sponsor support' was necessary in each instance to rescue a fund on the brink of failure. . . . [N]umerous incidents on the list don't match the claim that sponsors 'provided support' to their funds." Stevens' statement goes on to pick apart the SEC's data, stating, "one thing is clear. Such slipshod data provides no basis for the sort of drastic changes in money market funds that Chairman Schapiro has been urging.").

<sup>174</sup> *Id.*

shareholders' perceptions about money market funds or the likelihood of sponsor support during times of market turmoil."<sup>175</sup>

Chairman Schapiro raised the issue of money market fund sponsor support to make two points in support of her case for reform: that money market funds were not as stable as their forty-year history of breaking the buck only twice would suggest; and that sponsors' transactions to support their funds at various times may have lulled investors into disregarding money market fund risks.<sup>176</sup> These issues were among many appropriate for study in order to provide a factual basis for regulation; indeed, Federal Reserve Bank staffs and others have produced informative analyses of incidences of sponsor support during the financial crisis.<sup>177</sup>

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<sup>175</sup> 2010 Adopting Release, *supra* note 21, at 10,087 (discussing amendments to Rule 17a-9, which made it easier for a sponsor to provide support to a fund without seeking SEC preapproval). Critics also pointed out that Schapiro's statements were at odds with survey information showing investors were well aware of the risk. McNamee, *Correcting the Record: Uncovering Regulators' False Narrative of 2008*, *supra* note 115 (citing surveys by Fidelity Investments and statements by the SEC).

<sup>176</sup> *Perspectives on Money Market Mutual Fund Reform*, *supra* note 57, at 2–3 (testimony of Mary Schapiro, Chairman, SEC).

<sup>177</sup> Steffanie A. Brady et al., *The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011* (Fed. Reserve Bank of Bos., Working Paper No. RPA12-3, 2012), <http://www.bostonfed.org/bankinfo/qau/wp/2012/qau1203.pdf> [<http://perma.cc/4WXY-3UML>]. The authors of the study reported that twenty-one funds would have broken the buck during the financial crisis in the absence of sponsor support. *Id.* at 1. A reading of that study reveals that eight of these instances involved holdings of Lehman debt, while ten of the instances involved defaults of structured vehicles. *Id.* at 13; *see also* Patrick E. McCabe, *The Cross Section of Money Market Fund Risks and Financial Crises* (Fin. & Econ. Discussion Series, Fed. Reserve, Working Paper No. 2010-51, 2010), <http://www.federalreserve.gov/pubs/feds/2010/201051/201051pap.pdf> [<http://perma.cc/H76T-4P79>] (discussing, among other things, incidences of sponsor support for money market funds during the 2007 asset-backed commercial paper crisis and other aspects of what the author termed "sponsor risk" in money market funds). University of Pennsylvania Law School Professor Jill E. Fisch recently published an article advocating that money market fund sponsors be required to explicitly guarantee the \$1 share price as a condition of stable NAV funds. Jill E. Fisch, *The Broken*

However, Chairman Schapiro's release of the raw numbers, without providing further context or an opportunity for an assessment by the other SEC commissioners, appears to have been a factor undermining consensus within the SEC on an approach to money market fund reform.<sup>178</sup>

As a consequence, Chairman Schapiro's money market fund proposals, which had been the subject of press reports for months, were never issued.<sup>179</sup> In an August 22, 2012 statement, Chairman Schapiro announced that three commissioners, constituting a majority of the SEC, had informed her that they would not support the proposal.<sup>180</sup> Chairman Schapiro's statement outlined her case for requiring money market funds to float their NAV "and use mark-to-market valuation like every other mutual fund" or, alternatively, to hold capital and hold back a "minimum balance" from shareholder redemptions to serve as a first

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*Buck Stops Here: Embracing Sponsor Support in Money Market Fund Reform*, 93 N.C. L. REV. 935, 979–92 (2015).

<sup>178</sup> See Luis A. Aguilar, Comm'r, SEC, Statement Regarding Money Market Funds (Aug. 23, 2012), <http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171491044#.VGEzFTTF-uM> [<http://perma.cc/K6DW-FSYP>] ("Unfortunately, the lack of a foundation for and the rush to act on the proposal are also illustrated in the letters the Commission has received within the last week questioning the accuracy, veracity, and credibility of an SEC staff list of 300 money market funds that received sponsor support. The Commission was never given the chance to assess the staff's underlying methodology to understand how the list was compiled. Now, the Commission is receiving letters stating that there are serious discrepancies with the list. This list has been touted publically as a prime example of why additional reform is needed. Now, the credibility of that list is in doubt. It is impossible to understand what is true, and this demands more time to sort out the facts.").

<sup>179</sup> Articles referred to a "337-page" release and described the anticipated proposals in detail. See, e.g., Steven Sloan, *Fed Officials Signal Tighter Rules on Bank-Sponsored Money Funds*, BLOOMBERG BUSINESS (July 3, 2012, 6:00 AM), <http://www.bloomberg.com/news/articles/2012-07-03/fed-officials-signal-tighter-rules-on-bank-sponsored-money-funds> [<http://perma.cc/7TU2-FT2Y>]; Andrew Ackerman & Kirsten Grind, *SEC-Money Fund Showdown: Aug. 29*, WALL ST. J. (Aug. 7, 2012, 7:07 PM), <http://www.wsj.com/articles/SB10000872396390443517104577575551404791574> [<http://perma.cc/J4PC-ED5P>].

<sup>180</sup> Schapiro Statement on MMF Reform, *supra* note 46.

loss.<sup>181</sup> Chairman Schapiro said the declaration by the three commissioners “now provides the needed clarity for other policymakers as they consider ways to address the systemic risks posed by money market funds. I urge them to act . . . .”<sup>182</sup>

The three commissioners followed with statements of their own. On August 23, Commissioner Aguilar, and on August 28, Commissioners Gallagher and Paredes, released statements explaining that the staff draft proposals lacked sufficient foundation; specifically, the draft proposals “were not supported by the requisite data and analysis, were unlikely to be effective in achieving their primary purpose, and would impose significant costs on issuers and investors while potentially introducing new risks into the nation’s financial system.”<sup>183</sup> The commissioners called for additional study and analysis but did not rule out further money market fund reforms.<sup>184</sup> Three months later in November 2012, in response to specific questions posed by the three commissioners, the SEC’s Division of Risk, Strategy and Financial Innovation published a report with the detailed analyses the commissioners had been seeking to inform their decisions on the rulemaking.<sup>185</sup>

## VI. THE NEW FSOC THREATENS ACTION ON MONEY MARKET FUNDS

In 2010, Congress responded to the financial crisis by enacting the Dodd-Frank Act, an 849-page statute, which authorized and directed various financial regulatory agencies to take action to address gaps and failures in regulatory oversight that policy makers believed had led to

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<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> Daniel M. Gallagher & Troy A. Paredes, Comm’rs, SEC, Statement on the Regulation of Money Market Funds (Aug. 28, 2012), <http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm> [http://perma.cc/S7AD-4FKC]; see also Aguilar, *supra* note 178.

<sup>184</sup> Gallagher & Paredes, *supra* note 183; Aguilar, *supra* note 178.

<sup>185</sup> RSFI REPORT, *supra* note 57.



the crisis.<sup>186</sup> The law authorized or directed well over 300 separate agency rulemakings.<sup>187</sup> Almost a hundred were aimed at the SEC, forty-six of which were mandated rulemakings.<sup>188</sup> Not a single word in the entirety of the Dodd-Frank Act either mandated or authorized new rulemaking for money market funds.

The Dodd-Frank Act also created a new financial oversight body, the FSOC, authorizing it to identify and designate systemically important financial institutions (“SIFIs”) deemed so big, interconnected, and important that special oversight and regulation by the Federal Reserve would be imposed upon them. The law also authorized the FSOC to take other actions with respect to nonfinancial companies under the primary jurisdiction of other agencies.<sup>189</sup>

Neither SEC Chairman Schapiro nor Treasury Secretary Geithner, who served as Chairman of the newly-created FSOC, were willing to wait for the further analysis of money market funds requested by SEC Commissioners Aguilar, Paredes, and Gallagher in August 2012. Shortly after Schapiro withdrew her proposal from consideration by the SEC, Geithner in a September 27, 2012 letter to the full FSOC stated that the SEC had failed to act, and he urged the FSOC to use its new authority under Section 120 of the Dodd-Frank Act to recommend that the SEC proceed with reforms.<sup>190</sup> While acknowledging that the SEC, “by virtue of its institutional expertise and statutory authority, is best

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<sup>186</sup> Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

<sup>187</sup> According to the Congressional Research Service, the law mandated 148 separate rulemakings and authorized an additional 182. CRS REPORT, *supra* note 15, at 7. A monthly publication by the law firm Davis Polk suggests the number of total rulemakings authorized or directed is 398. DAVIS POLK & WARDWELL LLP, DODD-FRANK PROGRESS REPORT: OCTOBER 2014 2 (2014), [http://www.davispolk.com/sites/default/files/October2014\\_Dodd.Frank\\_.Progress.Report.pdf](http://www.davispolk.com/sites/default/files/October2014_Dodd.Frank_.Progress.Report.pdf) [<http://perma.cc/ZER3-6CGD>].

<sup>188</sup> CRS REPORT, *supra* note 15, at 7.

<sup>189</sup> Dodd-Frank Act §§ 111–113, 12 U.S.C. §§ 5321–5323 (2012).

<sup>190</sup> Geithner, *supra* note 30, at 1–2.

positioned to implement reforms” to money market funds, Geithner said the FSOC should “take active steps in the event the SEC is unwilling to act in a timely and effective manner.”<sup>191</sup> Geithner said that if the SEC did not act, the FSOC should evaluate the money market fund industry to identify any firm that met the standard for designation under Section 113 of the Dodd-Frank Act as a SIFI.<sup>192</sup> Alternatively, he said the FSOC could use its authority under Title VIII of the Dodd-Frank Act to apply heightened risk management standards on an industry-wide basis.<sup>193</sup> Thus, a threat was issued. The SEC should pursue reform on its own, or the FSOC would consider using any authority it might have available to “throw the book” at money market funds, including naming money market funds as SIFIs, making them subject to prudential regulation by the Federal Reserve.

***The FSOC’s Purpose and Structure.*** The FSOC was established under the Dodd-Frank Act for the purpose of (1) identifying risks to U.S. financial stability that could arise from the material financial distress, failure, or ongoing activities of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (2) promoting market discipline by eliminating expectations that the Government

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<sup>191</sup> *Id.* at 3.

<sup>192</sup> *Id.* We address the issue of whether money market funds are subject to FSOC authority under the Dodd-Frank Act and appropriate for SIFI designation *infra*.

<sup>193</sup> *Id.* Title VIII gives the FSOC authority to designate certain “financial market utilities” and “activities” as systemically important. Dodd-Frank Act § 804, 12 U.S.C. § 5463 (2012). We believe it would be difficult for the FSOC to attempt to shoehorn a money market fund into the definition of either of these terms. Section 803(6)(B)(ii) generally excludes investment companies from the definition of *financial market utility*, and in any event the FSOC cannot use this authority to designate an entire industry as a financial market utility. Dodd-Frank Act § 803, 12 U.S.C. § 5462 (2012). The definition of *activity* in Sections 803(2) and (7) is in respect to a particular company, but it excludes certain offers or sales of a security, and in any event Section 805(a) provides that the SEC (if the appropriate regulator) may assert regulation in these areas. Dodd-Frank Act §§ 803, 805, 12 U.S.C. §§ 5462, 5464 (2012).

would shield shareholders, creditors, and counterparties of SIFIs from losses; and (3) responding to emerging threats to the stability of the U.S. financial system.<sup>194</sup> Its ten voting members include the major financial regulators and one independent member with insurance expertise.<sup>195</sup> Half of the ten voting members are banking regulators. Among the FSOC's duties are two that are particularly relevant to the issues discussed in this Article and that are authorized and limited by special sections of the Dodd-Frank Act: (1) the FSOC's authority under Section 113 to designate a nonbank financial company as a SIFI, subject to prudential standards promulgated by the Federal Reserve; and (2) its authority under Section 120 to make recommendations to a primary financial regulatory agency to apply new or heightened standards and safeguards.

***The FSOC's Section 113 Authority.*** Under Section 113 of the Dodd-Frank Act, the FSOC, upon a vote of at least two-thirds of the voting members, may determine that a U.S. nonbank financial company shall be supervised by the Federal Reserve and subject to prudential standards under Title I of the Dodd-Frank Act, if the FSOC “determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities” of the company “could pose a threat to the financial stability of the United States.”<sup>196</sup> The use of this authority involves a lengthy process of evaluation by the FSOC staff against certain

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<sup>194</sup> Dodd-Frank Act § 112(a)(1), 12 U.S.C. § 5322(a)(1) (2012).

<sup>195</sup> They are the Secretary of the Treasury, the Chairman of the Federal Reserve, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, the Chairman of the SEC, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the CFTC, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration, and an independent insurance member. Dodd-Frank Act § 111(b), 12 U.S.C. § 5321(b) (2012). The FSOC also has the following nonvoting members: the Director of the Office of Financial Research, the Director of the Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner. *Id.*

<sup>196</sup> Dodd-Frank Act § 113(a)(1), 12 U.S.C. § 5323(a)(1) (2012).

criteria, an opportunity for the nonbank financial company to submit materials, followed by recommendations from the staff to the full FSOC, a preliminary determination by the FSOC, a nonpublic notification to the nonbank financial company of a proposed SIFI determination, the opportunity for the potential designee to request a written or oral presentation, a final determination by the FSOC, and judicial review if requested by a designee.<sup>197</sup> If the potential designee is unsuccessful in contesting the designation, it must register and become subject to prudential standards promulgated by the Federal Reserve.<sup>198</sup>

The use of the FSOC's Section 113 authority also rests upon various other interrelated provisions of Titles I and II of the Dodd-Frank Act, which have been the subject of various rulemaking proceedings by the FSOC, the FDIC, and the Federal Reserve.<sup>199</sup> Our law firm, on behalf of a large asset manager and sponsor of money market funds, filed comments in these various proceedings.<sup>200</sup> Among other

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<sup>197</sup> Dodd-Frank Act § 113(e)–(h), 12 U.S.C. § 5323(e)–(h) (2012). The standards and procedures to be used by the FSOC are set forth in rules adopted to implement the statutory provisions. Authority to Require Supervised Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (Apr. 11, 2012) (to be codified at 12 C.F.R. pt. 1310); *see also Supplemental Procedures Relating to Nonbank Financial Company Determinations*, FSOC (Feb. 4, 2015), <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf> [<http://perma.cc/P9BH-FL4C>].

<sup>198</sup> Dodd-Frank Act § 114, 12 U.S.C. § 5324 (2012).

<sup>199</sup> Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations; Final Rule, 79 Fed. Reg. 17,240 (Mar. 27, 2014) (to be codified at 12 C.F.R. pt. 252); Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (Apr. 11, 2012) (to be codified at 12 C.F.R. pt. 1310); Definitions of “Predominantly Engaged in Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company, 76 Fed. Reg. 7731 (Feb. 11, 2011) (to be codified at 12 C.F.R. pt. 225); Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4207 (Jan. 25, 2011) (to be codified at 12 C.F.R. pt. 380).

<sup>200</sup> Arnold & Porter LLP, Comment Letter on Authority to Require Supervision and Regulation of Certain Nonbank Entities (Dec. 15, 2011),

points addressed in various comment letters, we (as well as other commenters) argued that money market funds and fund sponsors did not meet the criteria for designation under Section 113, that the prudential bank-type regulation by the Federal Reserve that would accompany such designation was inappropriate for a money market fund or fund sponsor and that, in any event, money market funds were not “nonbank financial companies” within the meaning of the Dodd-Frank Act.<sup>201</sup>

This last point warrants further discussion. Under Section 102 of the Dodd-Frank Act, a “nonbank financial company” is defined as a company that is “predominantly engaged in financial activities,” as further defined by the definition of “activities that are financial in nature” in Section 4(k) of the Bank Holding Company Act (“BHC Act”).<sup>202</sup> Section 4(k) includes activities specifically listed in the statute and activities that were determined by the Board of Governors of the Federal Reserve System under Section 4(c)(8) of the BHC Act by rule or order prior to November 12, 1999 as being so closely related to banking as to be a proper incident thereto, or permitted to be conducted outside the United States by a bank holding company under Section

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<http://www.regulations.gov/#!documentDetail;D=FSOC-2011-0001-0053> [<http://perma.cc/27LW-6YXC>] [hereinafter Arnold & Porter Letter (Dec. 15, 2011)]; Arnold & Porter LLP, on behalf of Federated, Comment Letter to Federal Reserve on Definitions of “Predominantly Engaged in Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company (Mar. 30, 2011), [http://www.federalreserve.gov/SECRS/2011/April/20110401/R-1405/R-1405\\_033011\\_69273\\_5895579\\_07011\\_1.pdf](http://www.federalreserve.gov/SECRS/2011/April/20110401/R-1405/R-1405_033011_69273_5895579_07011_1.pdf) [<http://perma.cc/SJ7S-XUEZ>] [hereinafter Arnold & Porter Letter (Mar. 30, 2011)]; Arnold & Porter LLP, Comment Letter to FDIC on Orderly Liquidation Authority (Mar. 28, 2011), <https://www.fdic.gov/regulations/laws/federal/2011/11c09Orderly.PDF> [<https://perma.cc/F26Z-L5CC>].

<sup>201</sup> Arnold & Porter Letter (Dec. 15, 2011), *supra* note 200; ICI, Comment Letter on Authority to Require Supervision and Regulation of Certain Nonbank Entities (Dec. 19, 2011), <http://www.regulations.gov/#!documentDetail;D=FSOC-2011-0001-0083> [<http://perma.cc/7HUT-2ULN>].

<sup>202</sup> See Dodd-Frank Act § 102(a)(6), 12 U.S.C. § 5311(a)(6) (2012); Bank Holding Act § 4(k), 12 U.S.C. § 1843(k) (2012).

4(c)(13) of the BHC Act.<sup>203</sup> Although the Board of Governors has implemented Sections 4(c)(8) and 4(c)(13) of the BHC Act through rulemakings and individual orders, which establish the activities permitted for banks, it specifically has *not* permitted a bank holding company or its nonbank subsidiaries to be or control an open-end investment company such as a money market fund under those sections, and it did not do so prior to November 12, 1999.<sup>204</sup>

The FSOC's authority under Section 113 to designate a nonbank financial company as systemically important—a SIFI—as well as under Section 120 to make recommendations to a primary financial regulator with regard to nonbank financial companies under the regulator's primary jurisdiction, turns upon whether the company fits

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<sup>203</sup> 12 U.S.C. § 1843(k)(4) (2012).

<sup>204</sup> See 12 C.F.R. §§ 225.28(b)(6), 225.125(e) (2015); *Travelers Grp. Inc.*, 84 Fed. Res. Bull. 985 (1998); *Lloyds TSB Grp. plc*, 84 Fed. Res. Bull. 116 (1998); *Societe Generale*, 84 Fed. Res. Bull. 680 (1998); *Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A., Rabobank Nederland*, 84 Fed. Res. Bull. 852 (1998); *Commerzbank AG*, 83 Fed. Res. Bull. 678 (1997); *Bankers Tr. N.Y. Corp.*, 83 Fed. Res. Bull. 780 (1997); *BankAmerica Corp.*, 83 Fed. Res. Bull. 913 (1997); *Mellon Bank Corp.*, 79 Fed. Res. Bull. 626 (1993); 12 C.F.R. §§ 211.10(a)(11), 225.86(b)(3) (2015). Because money market funds have never been permitted by the Federal Reserve to be bank holding companies or nonbank subsidiaries of a bank holding company under Sections 4(c)(8) and 4(k) of the BHC Act and had not as of November 12, 1999, the activities of money market funds by definition are not “financial in nature” under Section 4(k) of the BHC Act and they may not be deemed “nonbank financial companies” within the meaning of Section 120(a) of Dodd-Frank. See also ICI, Comment Letter on Proposed Recommendations Regarding Money Market Mutual Fund Reform (Jan. 24, 2013), <http://www.regulations.gov#!documentDetail;D=FSOC-2012-0003-0071> [<http://perma.cc/Q6E7-YCFJ>] [hereinafter ICI Letter (Jan. 24, 2013)]; U.S. Chamber of Commerce, Comment Letter on Proposed Recommendations Regarding Money Market Mutual Fund Reform, (Jan. 23, 2013), <http://www.regulations.gov#!documentDetail;D=FSOC-2012-0003-0070> [<http://perma.cc/FU7P-X6TG>] [hereinafter Chamber of Commerce Letter]; Arnold & Porter LLP, Comment Letter on Proposed Recommendations Regarding Money Market Mutual Fund Reform (Dec. 17, 2012), <http://www.regulations.gov#!documentDetail;D=FSOC-2012-0003-0016> [<http://perma.cc/AK38-USDS>] [hereinafter Arnold & Porter Letter (Dec. 17, 2012)].

the above definition under the Dodd-Frank Act. We and others, in various comment letters to the FSOC and to the Federal Reserve, challenged whether money market funds or investment companies could ever meet the definitional criteria for FSOC designation or recommendations.<sup>205</sup> We made these points in a comment letter filed in connection with a proposed rulemaking by Federal Reserve to establish, for purpose of Title I of the Dodd Frank Act, the definition of “predominantly engaged in financial activities.”<sup>206</sup> We also made these points in response to the Fed’s supplemental release in that rulemaking, in which the Fed attempted to respond to comments we and others filed by explaining that the referenced statutory provisions could not mean what they said, because Congress could not have intended to limit the Fed’s and the FSOC’s authority (to designate, regulate, supervise) under the Dodd-Frank Act with respect to nonbank financial institutions.<sup>207</sup> The Federal Reserve nonetheless adopted final rules, accompanied by an adopting release in which the Fed argued that the reference in Section 102 of Dodd-Frank Act to financial activities “as defined in

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<sup>205</sup> Arnold & Porter Letter (Dec. 17, 2012), *supra* note 204.

<sup>206</sup> Arnold & Porter Letter (Mar. 30, 2011), *supra* note 200; see Definitions of “Predominantly Engaged in Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company, *supra* note 199, at 7731.

<sup>207</sup> Definition of “Predominantly Engaged in Financial Activities”, 77 Fed. Reg. 21,494, 21,495–96 (proposed Apr. 10, 2012) (to be codified at 12 C.F.R. pt. 225); Arnold & Porter LLP, Comment Letter on Definition of “Predominantly Engaged in Financial Activities” (May 24, 2012), [http://www.federalreserve.gov/SECRS/2012/October/20121017/R-1405/R-1405\\_052412\\_107697\\_403310114866\\_1.pdf](http://www.federalreserve.gov/SECRS/2012/October/20121017/R-1405/R-1405_052412_107697_403310114866_1.pdf) [<http://perma.cc/8KNA-4CJ2>] (responding to the Federal Reserve supplemental release). We commented that, indeed, the clear language of the statute did mean what it said and that Congress could have created a new definition of the term “financial in nature” had it wished to do so. *Id.* Instead, we argued further, Congress in the Dodd-Frank Act referred to other existing definitions *precisely* in order to restrain the Fed from expanding the universe of entities subject to regulation under relevant provisions of the new law. *Id.*

section 4(k)” of the BHC Act is “ambiguous,” and, therefore, the Federal Reserve may resolve the ambiguity.<sup>208</sup>

Moreover, other statutory provisions enacted as Section 115 of the Gramm-Leach-Bliley Act, which were never repealed, amended, or superseded by the Dodd-Frank Act, specifically prohibit any Federal banking agency from inspecting or examining any registered investment company that is not a bank holding company.<sup>209</sup> Thus, it would be impossible in any event (and Congress in the Dodd-Frank Act did not change or provide for it) for the Federal Reserve to exercise prudential authority over any investment company the FSOC may attempt to designate as a SIFI. Significantly, the fact that the Gramm-Leach-Bliley Act treats mutual funds as not being subsidiaries of the bank holding companies that service them and shields them from banking agency examination further demonstrates that, under the Dodd-Frank-Act—which looks to the activities approved by the Federal Reserve prior to passage of that Act in defining “nonbank financial services”—an open-end investment company, such as a money market fund, is not within the definition of a “nonbank financial company” subject to FSOC designation.

***The FSOC’s initial designations under Section 113 and potential for further action.*** The FSOC has begun to exercise its authority under Section 113 to designate nonbank SIFIs. Two insurers, AIG and Prudential, and another nonbank financial company, GE Capital, were the first nonbank institutions to be designated as “systemically important” and subject to heightened prudential regulation; in the case of Prudential, the decision by the FSOC was made over the objection of the independent member of the

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<sup>208</sup> Definitions of “Predominantly Engaged in Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company; Final Rule, 78 Fed. Reg. 20,756, 20,758–59 (Apr. 5, 2013) (to be codified at 12 C.F.R. pt. 242). We continue to believe there is no ambiguity in the statutory language.

<sup>209</sup> 12 U.S.C. § 1820a(a) (2012).



FSOC with insurance experience.<sup>210</sup> Another insurance company, MetLife, was designated a SIFI by the FSOC on December 18, 2014 (also over the objection of the insurance member of FSOC).<sup>211</sup> MetLife has challenged this designation in federal court, asserting, among other things, that the FSOC's conclusion that MetLife meets the statutory criteria for designation is arbitrary and capricious, that MetLife is not “predominantly engaged in financial activities” within the meaning of relevant provisions of the Dodd-Frank Act and the BHC Act, and that the FSOC made critical errors in its assessment of MetLife's business and existing regulation.<sup>212</sup>

The FSOC's processes for designating nonbank financial institutions as SIFIs have been criticized for lack of transparency and procedural fairness, prompting it to issue supplemental procedures for designations.<sup>213</sup> Its actions also

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<sup>210</sup> *Designations*, FSOC, <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> [<http://perma.cc/G8JA-C3AB>] (last updated July 27, 2015). In dissenting to the designation of Prudential, Mr. S. Roy Woodall, the insurance member, argued that key aspects of the FSOC's analysis were not supported by the record and that the analysis “utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance . . . .” *Dissents of Voting and Nonvoting Members of the Council*, FSOC (Sept. 19, 2013), <http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf> [<http://perma.cc/C5PN-CTCZ>].

<sup>211</sup> *Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc.*, FSOC (Dec. 18, 2014), <http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf> [<http://perma.cc/8558-FK5D>]; *Views of the Council's Independent Member Having Insurance Expertise* (Dec. 18, 2014), <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf> [<http://perma.cc/RM3B-8FQL>].

<sup>212</sup> Complaint at 3, *MetLife, Inc. v. Fin. Stability Oversight Council*, No. 1:15-CV-00045 (D.D.C. filed Jan. 13, 2015). Litigation is ongoing as of the date of publication.

<sup>213</sup> Am. Council of Life Insurers et al., *Comment Letter on Petition for FSOC Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* (Aug. 19, 2014), <http://www.sifma.org/issues/item.aspx?id=8589950444> [<http://perma.cc/RV6U-ADDP>] (petitioning for amendment, after a public notice and comment period, to the FSOC's current designation processes); *Supplemental*

have triggered congressional scrutiny, including a hearing on the FSOC's designation process, proposals for a moratorium on designations, and legislative proposals to change the designation process.<sup>214</sup>

The FSOC also sparked controversy by identifying asset managers broadly as a category for review. A report on asset managers issued in September 2013 by the Office of Financial Research ("OFR"), an entity created under the Dodd-Frank Act to serve as the research arm of the FSOC and housed in the Treasury Department, took aim at certain characteristics and practices of asset managers, arguing that they presented risks to the financial markets ("OFR Report").<sup>215</sup> The report, which was requested by the FSOC to lay a foundation for the FSOC's future consideration of various asset managers for SIFI designation, said that certain activities by asset managers "could pose, amplify, or transmit a threat to the financial system."<sup>216</sup> SEC Chairman Mary Jo White posted the OFR Report for public comment, facilitating a barrage of highly critical comment letters (including from our law firm), arguing that the report lacked empirical data to support its generalizations, that its

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*Procedures Relating to Nonbank Financial Company Determinations*, *supra* note 197.

<sup>214</sup> H.R. 1550, 114th Cong. (2015); H.R. 1309, 114th Cong. (2015); H.R. 4881, 113th Cong. (2014); *FSOC Accountability: Nonbank Designations: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 114th Cong. (2015). In addition to legislation addressing FSOC reform, four Senators introduced legislation barring any federal assistance to money market funds and permitting all money market funds to continue to use amortized cost accounting to maintain a stable NAV. S. 1802, 114th Cong. (2015).

<sup>215</sup> OFFICE OF FIN. RESEARCH, ASSET MANAGEMENT AND FINANCIAL STABILITY (Sept. 2013), [http://financialresearch.gov/reports/files/ofr\\_asset\\_management\\_and\\_financial\\_stability.pdf](http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf) [<http://perma.cc/8CAQ-ZZCT>] [hereinafter OFR REPORT]. The establishment of the OFR and its duties and purposes are set forth in Subtitle B of Title 1 of the Dodd-Frank Act, beginning at § 151. 15 U.S.C. §§ 5341–5343 (2012).

<sup>216</sup> OFR REPORT, *supra* note 215, at 7 ("[A] certain combination of fund- and firm-level activities within a large, complex firm, or engagement by a significant number of asset managers in riskier activities, could pose, amplify, or transmit a threat to the financial system.").

methodologies were flawed, that it reflected a lack of understanding of the differences between asset managers and banks, and that it exaggerated the risks associated with asset managers.<sup>217</sup>

The threat of potential SIFI designation of asset managers, as well as the potential for action in this area by Europe's Financial Stability Board ("FSB"),<sup>218</sup> also drew an unusual "comment letter" by a sitting SEC Commissioner, Daniel Gallagher, who wrote in May 2014,

The FSOC and FSB initiatives are pure—and dangerous—folly. Applying bank regulatory principles to capital markets regulation is a fatally misguided approach . . . . Bank regulators should resist their apparently innate urge to regulate asset managers—and, for that matter, all other non-bank entities—like banks. Forcibly imposing bank-like regulation on these capital market participants will negatively impact the U.S. economy and work to the

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<sup>217</sup> Press Release, SEC, Public Feedback on OFR Study on Asset Management Issues (Sept. 30, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539852635> [<http://perma.cc/935F-HTUZ>]; see Arnold & Porter LLP, Comment Letter on OFR Report of Asset Management and Financial Stability (Nov. 1, 2013), <http://www.sec.gov/comments/am-1/am1-18.pdf> [<http://perma.cc/777Q-BXM2>]; ICI, Comment Letter on OFR Report of Asset Management and Financial Stability (Nov. 1, 2013), <http://www.sec.gov/comments/am-1/am1-26.pdf> [<http://perma.cc/4SQR-LLET>]; Fidelity Mgmt. & Research Co., Comment Letter on OFR Report of Asset Management and Financial Stability (Nov. 1, 2013), <http://www.sec.gov/comments/am-1/am1-19.pdf> [<http://perma.cc/3K8H-4CBE>]. These and other comments are available in the SEC's comment file. See *Comments on OFR Study on Asset Management Issues*, SEC, <http://www.sec.gov/comments/am-1/am-1.shtml> [<http://perma.cc/2VKK-53CU>] (last updated Sept. 4, 2015).

<sup>218</sup> FIN. STABILITY BD., CONSULTATIVE DOCUMENT: ASSESSMENT METHODOLOGIES FOR IDENTIFYING NON-BANK NON-INSURER GLOBAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (Jan. 8, 2014), <http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf> [<http://perma.cc/2ER4-BMVJ>].

detriment of the investing public while doing nothing at all to protect taxpayers or investors.<sup>219</sup>

Gallagher's letter also criticized the fact that, as a presidentially-appointed and Senate-confirmed SEC Commissioner, he had "no statutory standing" in the FSOC's deliberations over whether to designate asset managers as SIFIs.<sup>220</sup> In this regard, his letter echoed earlier complaints by SEC Commissioner Michael Piwowar that the FSOC had turned down his requests to attend or observe at FSOC meetings, despite the fact that the Federal Reserve generally sent three representatives to the meetings.<sup>221</sup>

In response to the controversy created by the OFR Report and the challenges to its credibility, the FSOC on May 19, 2014 held a public conference on asset management and received comments from asset managers, academics, and regulators as participants.<sup>222</sup> SEC Chairman White subsequently announced a number of steps the SEC would be taking to monitor and address risks in the asset

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<sup>219</sup> Daniel M. Gallagher, Comm'r, SEC Comment Letter on Public Feedback on OFR Study on Asset Management Issues (May 15, 2014), <http://www.sec.gov/comments/am-1/am1-52.pdf> [<http://perma.cc/8LYJ-GTPS>].

<sup>220</sup> *Id.*

<sup>221</sup> Michael S. Piwowar, Comm'r, SEC, Advancing and Defending the SEC's Core Mission: Address before the U.S. Chamber of Commerce (Jan. 27, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370540671978#.VGE1qzTF-uM> [<http://perma.cc/2J9C-CGWH>].

<sup>222</sup> Media Advisory, Dep't of the Treasury, Financial Stability Oversight Council (FSOC) Hosts Public Conference on Asset Management on Monday, May 19 (May 13, 2014), <http://www.treasury.gov/press-center/media-advisories/Pages/05132014.aspx> [<http://perma.cc/Y333-TWYN>]. Opening the conference, Under Secretary of the Treasury Mary Miller emphasized that there was no "predetermined outcome" of the FSOC's fact-finding process. Mary Miller, Under Secretary of the Treasury, Opening Remarks at The Financial Stability Oversight Council Conference on Asset Management (May 19, 2014), <http://www.treasury.gov/press-center/press-releases/Pages/jl2404.aspx> [<http://perma.cc/EH52-YDSW>]. But she also asserted that the FSOC had a role in determining what, "if any," risks exist in the asset management industry and said the FSOC could use various authorities to "deploy the most appropriate remedy" for any identified risks. *Id.*

management industry, including addressing issues such as leverage, liquidity, and stress testing, as well as transitioning assets of a troubled firm.<sup>223</sup> The FSOC nonetheless has continued to suggest that asset managers may warrant further regulation, including potential FSOC designation and Fed oversight. On December 18, 2014, the FSOC issued a release requesting comments on four areas of potential risk with respect to asset managers.<sup>224</sup> Specifically, the FSOC's release asked "whether risks associated with liquidity and redemptions, leverage, operational functions, and resolution in the asset management industry could affect U.S. financial stability."<sup>225</sup> The release stated that the SEC "is undertaking several initiatives that would apply to investment companies and investment advisers regulated by the SEC and *may* address *some* of the risks described" in the release.<sup>226</sup> Thus, the FSOC left open the possibility that, after review, it may determine that SEC regulation over SEC-regulated asset managers is insufficient. The SEC issued proposed rules to address asset manager risk in June

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<sup>223</sup> Mary Jo White, Chairman, SEC, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry: Remarks at The New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VKHmxsAA> [<http://perma.cc/9LEW-QS7Z>].

<sup>224</sup> Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014); *see also* Katz & Schmidt, *supra* note 34; *Minutes of the Financial Stability Oversight Council*, FSOC (Oct. 6, 2014), [http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/October%206,%202014%20\(Meeting%20Minutes\).pdf](http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/October%206,%202014%20(Meeting%20Minutes).pdf) [<http://perma.cc/S8TC-FPMU>]. As noted above, the FSB has announced that it will suspend its work on designating asset managers; the FSOC has announced no similar intent. Weinberger, *supra* note 34.

<sup>225</sup> Notice Seeking Comment on Asset Management Products and Activities, *supra* note 224, at 77,489.

<sup>226</sup> *Id.* (emphasis added). The comment period on the FSOC's release ended with 59 comments and, as of the date of publication, the FSOC has taken no specific action in response to comments received. *Docket Browser: Notice Seeking Public Comment on Certain Aspects of the Asset Management*, REGULATIONS.GOV, <http://www.regulations.gov#!/docketBrowser;rpp=25;po=0;dct=PS;D=FSOC-2014-0001> [<http://perma.cc/XZ8Q-NQAB>] (last visited Oct. 23, 2015).

2015.<sup>227</sup> While SEC Chairman White has said that she believes the FSOC's review is a "complement" to the SEC's work,<sup>228</sup> others view the FSOC's actions (together with those of the FSB) with great concern and suggest that investment companies and their advisers are being targeted for bank-like prudential regulation by entities whose regulatory goals are antithetical to the SEC's approach to capital markets.<sup>229</sup>

***The FSOC's Section 120 Authority.*** Under Section 120 of the Dodd-Frank Act, the FSOC has authority to issue "recommendations" to other financial regulators to take action with respect to financial activities under their primary jurisdiction. Specifically, the FSOC

may provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards . . . for a financial activity or practice conducted by bank holding companies or nonbank financial companies under their respective jurisdictions, if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of

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<sup>227</sup> Investment Company Reporting Modernization, 80 Fed. Reg. 33,590 (proposed June 12, 2015) (to be codified at 17 C.F.R. pts. 200, 210, 230, 232, 239, 240, 249, 270, 274); Amendments to Form ADV and Investment Advisers Act Rules, 80 Fed. Reg. 33,718 (proposed June 12, 2015) (to be codified at 17 C.F.R. pts. 275, 279).

<sup>228</sup> White, *supra* note 223.

<sup>229</sup> Michael S. Piwowar, Comm'r, SEC, Remarks at the 2015 Mutual Funds and Investment Management Conference (Mar. 16, 2015), <http://www.sec.gov/news/speech/031615-spch-cmsp.html#.VR1qDvzF-uM> [<http://perma.cc/QM7P-9WC5>]; Peter J. Wallison & Daniel M. Gallagher, Opinion, *How Foreigners Became America's Financial Regulators*, WALL ST. J. (Mar. 19, 2015, 7:09 PM), <http://www.wsj.com/articles/peter-wallison-and-daniel-gallagher-how-foreigners-became-americas-financial-regulators-1426806547> [<http://perma.cc/7HG6-HXNJ>].

the United States, or low-income, minority, or underserved communities.<sup>230</sup>

The process under Section 120 requires the FSOC to consult with the primary financial regulator and provide the public with notice and opportunity to comment on any proposed recommendations by the FSOC. After the FSOC reviews the comments, it may make a final recommendation. The primary regulator must either impose the recommended standards or write to the FSOC, no later than ninety days after the issuance of the recommendation, explaining why the primary regulator determined not to follow the recommendation. The FSOC must report to Congress on any recommendation made, as well as on a primary regulator's implementation or failure to implement a recommendation.<sup>231</sup>

Six weeks after Treasury Secretary Geithner's September 27, 2012 letter to the FSOC urging that it use its Section 120 authority to recommend SEC regulatory action on money market funds, the FSOC voted to use that authority for the first time.<sup>232</sup> At a November 13, 2012 meeting to consider a proposed release, SEC Chairman Schapiro, as a member of the FSOC, spoke strongly in favor of it—urging the FSOC to take action to tell the agency she chaired what to do.<sup>233</sup> The open meeting lasted twenty minutes; the proposed release was approved unanimously.<sup>234</sup>

Chairman Schapiro left the SEC shortly thereafter; a sitting commissioner, Elisse Walter, was named chairman, and she with other commissioners continued the work on a

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<sup>230</sup> Dodd-Frank Act § 120, 12 U.S.C. § 5330 (2012).

<sup>231</sup> *Id.*

<sup>232</sup> Press Release, FSOC, Financial Stability Oversight Council Releases Proposed Recommendations for Money Market Mutual Fund Reform (Nov. 11, 2012), <http://www.treasury.gov/press-center/press-releases/Pages/tg1764.aspx> [<http://perma.cc/5WBL-ELH8>]; FSOC Release, *supra* note 3.

<sup>233</sup> *Minutes of the Financial Stability Oversight Council*, FSOC (Nov. 13, 2012), <http://www.treasury.gov/initiatives/fsoc/Documents/November%2013,%202012.pdf> [<http://perma.cc/3EPA-642C>].

<sup>234</sup> *Id.*

possible money market fund proposal.<sup>235</sup> On April 10, 2013, Mary Jo White was sworn in as SEC Chairman.<sup>236</sup>

***The FSOC's Section 120 proposals on money market funds.*** The FSOC's proposed recommendations were based upon two key premises: that “the 2007–2008 financial crisis demonstrated that [money market funds] are susceptible to runs that can have destabilizing implications for financial markets and the economy”;<sup>237</sup> and that characteristics and activities of money market funds “could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies . . . .”<sup>238</sup> Fed Chairman Bernanke argued that the “basic run issue has not been solved.”<sup>239</sup> The FSOC's Release pointed to “[h]eavy outflows from institutional prime [money market funds] in the summer of 2011” as evidence of money market funds' “continued vulnerability to runs, even after the [SEC's] 2010 reforms.”<sup>240</sup> The release said that institutional prime money market funds experienced net outflows of \$179 billion—16% of assets—over the eight weeks ending August 3, 2011, in response to concerns about the funds' European holdings and the U.S. debt-ceiling impasse. However, the release stated, “[b]ecause the pace of outflows in 2011 was well below that experienced during the run in September 2008” money market funds “were able to withstand redemption pressures without further repercussions.”<sup>241</sup> It noted, “these outflows occurred despite the fact that the [money market funds] suffered no material

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<sup>235</sup> Press Release, White House, Statement by President Obama on the Departure of SEC Chairman Mary Schapiro (Nov. 26, 2012), <http://www.whitehouse.gov/the-press-office/2012/11/26/statement-president-obama-departure-sec-chairman-mary-schapiro> [<https://perma.cc/TYC3-NMZA>].

<sup>236</sup> Press Release, SEC, Mary Jo White Sworn in as Chair of SEC (Apr. 10, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514548#.VFfdzzTF-uN> [<http://perma.cc/7ZZR-X7HK>].

<sup>237</sup> FSOC Release, *supra* note 3, at 69,455.

<sup>238</sup> *Id.* at 69,456.

<sup>239</sup> Open Session Meeting of the FSOC, *supra* note 144.

<sup>240</sup> FSOC Release, *supra* note 3, at 69,465.

<sup>241</sup> *Id.*



losses during this episode.”<sup>242</sup> Comments that we and others filed have challenged the FSOC on its characterization of the role of money market funds in the 2007–2008 financial crisis (citing many of the facts discussed in Part III of this article). We also argued that the outflow of sixteen percent of money market fund assets over a period of eight weeks in 2011, in response to investor perceptions of risk in money market funds’ European holdings and the U.S. debt-ceiling impasse, should be viewed as evidence of appropriate market discipline, not a cause for regulatory concern.<sup>243</sup>

The FSOC’s recommendations picked up two proposals that had been part of Chairman Schapiro’s failed proposing release and added a third. The FSOC’s alternative one required money market funds to use a floating NAV, with their initial shares priced at \$100.00 per share in order to be more sensitive to fluctuations in value.<sup>244</sup> Alternative two required money market funds to hold up to one percent capital against their assets (depending on the nature of the fund’s assets) and “hold back” from redemptions three percent of a shareholder’s account value over \$100,000 for a period of up to thirty days.<sup>245</sup> Alternative three required money market funds to have a “risk-based NAV buffer” of three percent.<sup>246</sup> As discussed below, commenters, in

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<sup>242</sup> *Id.*

<sup>243</sup> Arnold & Porter Letter (Dec. 17, 2012), *supra* note 204. We argued that this activity seemed to be evidence (1) that the funds were well-managed and had sufficient liquidity (a result of the 2010 amendments and the funds’ prudent management); (2) that the funds were transparent; (3) that investors acted on their assessments of risk in money market fund portfolio holdings; and (4) that managers acted appropriately in response to this market discipline by subsequently reducing the size of their European holdings. *Id.* The language in the release suggested that the FSOC’s reform goal was to halt or impede the type of redemption activity that occurred during this period in 2011—to mute the discipline of investors voting with their feet in response to their assessment of risk. In our view, this reflected a bank regulator’s concern about maintaining sources of short-term funding for banks, but not an investor-oriented capital markets perspective. *Id.*

<sup>244</sup> FSOC Release, *supra* note 3, at 69,466.

<sup>245</sup> *Id.* at 69,469.

<sup>246</sup> *Id.* at 69,474.

addition to challenging the premises of the FSOC's proposals, were critical of the FSOC's assertion of jurisdiction, its interference with the SEC's ongoing deliberations on money market funds, and the substantive content of the proposed recommendations.

***Jurisdiction, process, and policy concerns raised by the FSOC's action.*** Section 120 of the Dodd-Frank Act gives the FSOC authority to make recommendations for regulation only as to the activities or practices of bank holding companies and nonbank financial companies.<sup>247</sup> The FSOC's release stated that it believed money market funds "are 'predominantly engaged in financial activities' as defined in Section 4(k) of the Bank Holding Company Act of 1956 and thus are 'nonbank financial companies' for purpose of Title I of the Dodd-Frank Act."<sup>248</sup> For the reasons discussed above relating to the FSOC's Section 113 authority, comments we filed in the proceeding argued that money market funds are not subject to the FSOC's jurisdiction under Section 120 as a matter of law, because their activities are not "financial in nature" under the language of the Dodd-Frank Act, the BHC Act, and applicable rules and agency orders.<sup>249</sup> Other commenters pointed out that the FSOC had not established its own rules regarding proceedings under Section 120, nor had the Federal Reserve at the time promulgated rules to define "predominately engaged in financial activities" for purposes of the Dodd-Frank Act.<sup>250</sup>

We and other commenters also argued that, as a process and policy matter, the FSOC should not arbitrarily invoke Section 120 of the Dodd-Frank Act, simply because an agency's chair is unable to prevail on a particular rulemaking approach at a particular time.<sup>251</sup> In this case, the

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<sup>247</sup> Dodd-Frank § 120, 12 U.S.C. § 5330 (2012).

<sup>248</sup> FSOC Release, *supra* note 3, at 69,460 (citations omitted).

<sup>249</sup> See *supra* text accompanying notes 199–208.

<sup>250</sup> See ICI Letter (Jan. 24, 2013), *supra* note 204; Chamber of Commerce Letter, *supra* note 204.

<sup>251</sup> Arnold & Porter Letter on Alternative One, *supra* note 48; ICI Letter (Jan. 24, 2013), *supra* note 204; Thomas P. Vartanian, Dechert LLP, Comment Letter Regarding FSOC Chairman Timothy F. Geithner's

FSOC issued the Section 120 release because the SEC's chairman was unable to obtain support from a majority of the SEC's commissioners for a draft rulemaking release proposing significant structural changes to money market funds.<sup>252</sup> Commenters made the point that the concerns raised by a majority of members of the SEC—an agency bound by statute and its own administrative procedures to consider and assess the economic consequences of any regulatory action—should have been respected by the FSOC.<sup>253</sup> The commissioners who withheld their support, based on their review of the SEC's docket of comments and other materials filed by a range of money market fund users, market participants, government officials and academics,<sup>254</sup> said they had concluded that the staff draft proposals were problematic and lacked sufficient foundation.<sup>255</sup> These commissioners called for further study and analysis but did not rule out further reform.<sup>256</sup>

***Former SEC chairmen and commissioners weigh in on the FSOC's action.*** The process and policy issues raised by the FSOC's first use of its Section 120 authority also prompted a letter to the SEC from a bipartisan group of former SEC officials, including four former chairmen and five former commissioners.<sup>257</sup> They emphasized that their

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Letter to FSOC (Nov. 1, 2012), [https://www.dechert.com/files/upload/2012\\_11\\_01\\_Letter\\_to\\_Financial\\_Stability\\_Oversight\\_Council.pdf](https://www.dechert.com/files/upload/2012_11_01_Letter_to_Financial_Stability_Oversight_Council.pdf) [<https://perma.cc/J4GG-ESAT>] [hereinafter Vartanian Letter (Nov. 1, 2012)].

<sup>252</sup> See FSOC Release, *supra* note 3, at 69,456; see also Schapiro Statement on MMF Reform, *supra* note 46.

<sup>253</sup> Arnold & Porter Letter on Alternative One, *supra* note 48; ICI Letter (Jan. 24, 2013), *supra* note 204; Vartanian Letter (Nov. 1, 2012), *supra* note 251.

<sup>254</sup> See PWG Docket, *supra* note 17.

<sup>255</sup> Aguilar, *supra* note 178; Gallagher & Paredes, *supra* note 183.

<sup>256</sup> Aguilar, *supra* note 178; Gallagher & Paredes, *supra* note 183.

<sup>257</sup> Paul S. Atkins et al., Comment Letter on Proposed Recommendations Regarding Money Market Mutual Fund Reform (Feb. 20, 2013), <http://www.regulations.gov#!documentDetail;D=FSOC-2012-0003-0130> [<http://perma.cc/B3CR-NAPP>] (letter signed by four former SEC Chairmen, five former SEC Commissioners, and six former senior staff of the SEC).

letter was not intended to express a position on the substantive issues relating to money market fund regulation. But they criticized the FSOC as having ignored the statutory requirement that FSOC consult with the *agency* prior to making a recommendation under Section 120—a requirement they said could not be satisfied by consulting only with the SEC’s chair.<sup>258</sup> They argued that the structure of the SEC, established as a *bipartisan* regulator with no more than three commissioners from any one party and where the chair had only one vote, was a structure that fostered vigorous internal debate and collaborative decision-making. They said the FSOC should not be used to pressure the agency to adopt the views of just one member, even its chairman. Their letter said the statements issued by the three commissioners “demonstrated thoughtful consideration of a serious issue, and a desire to obtain additional data to support ultimate conclusions, something the SEC is required to do by statute.”<sup>259</sup> The officials urged the FSOC to defer to the SEC.<sup>260</sup>

***The FSOC makes three substantive proposals.*** The major elements of the three proposals put forward in the FSOC’s release—to require money market funds to hold

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<sup>258</sup> *Id.*

<sup>259</sup> *Id.*

<sup>260</sup> *Id.* Arthur Levitt, a former SEC chairman, did not sign the letter by former SEC officials and subsequently wrote an article in which he said that he refused to sign the officials’ letter because he could not place his loyalty to the SEC “above the larger goal of protecting individual investors.” Arthur Levitt, *SEC Missed Chance on Money Funds, Should Step Aside Now*, BLOOMBERG (Feb. 25, 2013, 6:30 PM), <http://www.bloombergvew.com/articles/2013-02-25/sec-missed-chance-on-money-funds-should-step-aside-now> [<http://perma.cc/ASQ4-9L92>]. He wrote, “For the agency to refuse to engage the issue, even after Schapiro elevated it, struck me as a failure to meet its primary mandate.” *Id.* However, there is no evidence that the agency was refusing to engage the issue of money market fund reform. Three commissioners had been presented with a draft release they believed was deficient, and they asked for further analysis by the SEC staff in order to craft a better proposal for public comment. There was no congressional or other deadline forcing them to agree to a deficient proposing release. It appears that they were very much engaged in trying to improve the product.

capital and/or to hold back a minimum balance from redemptions, as well as to convert to pricing shares at a floating NAV—previously had been analyzed and criticized in studies, reports and comments filed earlier in the SEC’s docket on money market fund options in the PWG Report.<sup>261</sup> The FSOC’s own release conceded that the proposals would not necessarily remove run risks, and the proposals received little support from the 128 comments that were filed in the Section 120 proceeding.<sup>262</sup>

**1. Comments on the FSOC’s Floating NAV proposal.**

In the release’s discussion of the floating NAV proposal, the FSOC said, “while a floating NAV would remove the ability of a shareholder to redeem shares at \$1.00 when the market value is less than \$1.00, it would not remove a shareholder’s incentive to redeem whenever the shareholder believes that the NAV will decline significantly in the future . . . .”<sup>263</sup> Most commenters in the SEC’s PWG Report docket, as well as comments filed in the FSOC’s proceeding, agreed that requiring money market funds to use a floating NAV would not advance the regulatory goal of reducing or eliminating heavy redemptions from money market funds in a crisis.<sup>264</sup>

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<sup>261</sup> Comments received by the SEC from late 2010 through late 2012 generally responded to the SEC’s request for comments on money market fund reform options presented by the PWG, as well as proposals that subsequently were put forward by the Federal Reserve and others regarding capital and the minimum balance at risk proposals. See PWG Report, *supra* note 3; PWG Docket, *supra* note 17. Arnold & Porter referenced many of these earlier letters in several letters it filed in the FSOC proceeding. Arnold & Porter Letter (Dec. 17, 2012), *supra* note 204; Arnold & Porter Letter on Alternative One, *supra* note 48.

<sup>262</sup> FSOC Release, *supra* note 3, at 69,467; see also *Docket Browser: Recommendations Regarding Money Market Mutual Fund Reform*, REGULATIONS.GOV, <http://www.regulations.gov#!/docketBrowser;rpp=25;po=0;D=FSOC-2012-0003> [<http://perma.cc/7Y46-TTGD>].

<sup>263</sup> FSOC Release, *supra* note 3, at 69,467.

<sup>264</sup> See, e.g., Arnold & Porter Letter on Alternative One, *supra* note 48 (citing the positions of other commenters in the SEC’s PWG Report docket); ICI Letter (Jan. 24, 2013), *supra* note 204. See also Fisch & Roiter, *supra* note 48, at 32–33, nn.186–88 (citing data from floating NAV funds and ultra-short bond funds during the financial crisis, which confirm this conclusion).

Commenters also pointed to surveys and other evidence that the vast majority of investors understand that money market funds are not insured and may lose value and that the value of the underlying assets may deviate from \$1.00 per share.<sup>265</sup>

**2. Comments on the Minimum Balance at Risk proposal.** Explaining its minimum balance at risk proposal, the FSOC said that in combination with the floating NAV, it “likely would not be sufficient to stop a run on [a money market fund] if investors anticipate very large losses” or stop a run on other funds if “investors expect that large losses would be incurred across MMFs.”<sup>266</sup> The staff of the FRBNY in 2012 published a report advocating a minimum balance at risk requirement for money market funds.<sup>267</sup> However, the analyses, surveys and other commentary existing in the SEC’s docket (some of which responded directly to the FRBNY proposal), including detailed reports and analyses submitted by the Investment Company Institute, Blackrock, DST Systems, Inc., the American Benefits Council, and others, argued that the minimum balance at risk/capital proposal’s impact in reducing runs was speculative, unproven, and costly. These commentators also stated that such a requirement could and likely would precipitate runs under certain circumstances, harm investors by layering

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<sup>265</sup> Comments filed by our law firm and others pointed out that money market funds publish their “shadow” NAV as a regular benchmark reflecting those variations, and it is not credible to suggest that investors are misinformed or that requiring investors to transact at a floating NAV would better inform them of risks. Comment letters explained that many instruments in a money market funds portfolio cannot be marked to market in any event, and therefore to promote a floating NAV as a true mark-to-market price is misleading. *See, e.g.*, Arnold & Porter Letter on Alternative One, *supra* note 48 (citing the positions of other commenters in the SEC’s PWG Report docket).

<sup>266</sup> FSOC Release, *supra* note 3, at 69,471.

<sup>267</sup> MCCABE ET AL., *supra* note 2, at 60–61. The report also includes an analysis of valuations of money market funds during the financial crisis. *See* Arnold & Porter LLP, on behalf of Federated, Comment Letter on President’s Working Group Report on Money Market Fund Reform (Aug. 9, 2012), <https://www.sec.gov/comments/4-619/4619-222.pdf> [<https://perma.cc/G25L-FBAA>] [hereinafter Arnold & Porter Letter (Aug. 9, 2012)] (commenting on the FRBNY report).

costs and operational impediments upon their access to funds, and make money market funds unavailable to investors who are precluded by state law or fiduciary requirements from investing in funds with minimum balance or subordination features.<sup>268</sup>

**3. Comments on the Capital proposal.** The FSOC said its proposed capital requirements were “unlikely to be large enough to absorb all possible losses and may not be sufficient to prevent investors from redeeming when they expect possible losses in excess of the NAV buffer.”<sup>269</sup> The Investment Company Institute eight months earlier provided the SEC with a detailed analysis of two possible sources of funding for a capital buffer—requiring fund sponsors to commit capital or requiring funds to build a capital buffer

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<sup>268</sup> Data and commentary on each of these impacts is discussed in Arnold & Porter’s letter of August 9, 2012 filed with the SEC. Arnold & Porter Letter (Aug. 9, 2012), *supra* note 267. In light of these costs and inefficiencies, we argued that the FSOC’s proposed changes, if imposed on money market funds, would shrink the size of the industry, reduce money market fund demand for commercial paper and state and local government debt, and adversely impact the broader economy. Arnold & Porter Letter on Alternative One, *supra* note 48; *see also* ICI, Comment Letter on President’s Working Group Report on Money Market Fund Reform (June 20, 2012), <https://www.sec.gov/comments/4-619/4619-200.pdf> [<https://perma.cc/X2YD-XCWC>]; BlackRock, Comment Letter on President’s Working Group Report on Money Market Fund Reform (Mar. 2, 2012), <https://www.sec.gov/comments/4-619/4619-127.pdf> [<https://perma.cc/C4NV-T48T>] (referencing BlackRock, *Money Market Funds: The Debate Continues*); DST Systems, Inc., Comment Letter on President’s Working Group Report on Money Market Fund Reform (Mar. 2, 2012), <https://www.sec.gov/comments/4-619/4619-128.pdf> [<https://perma.cc/GVP4-S6QK>]; Am. Benefits Council, Comment Letter on President’s Working Group Report on Money Market Fund Reform (June 19, 2012), <https://www.sec.gov/comments/4-619/4619-204.pdf> [<https://perma.cc/BFS6-7DRD>]; Federated Investors, Inc., Comment Letter on President’s Working Group Report on Money Market Fund Reform (Mar. 16, 2012), <https://www.sec.gov/comments/4-619/4619-140.pdf> [<https://perma.cc/LFV5-CGVE>]; Treasury Strategies, Inc., Comment Letter on President’s Working Group Report on Money Market Fund Reform (Apr. 27, 2012), <https://www.sec.gov/comments/4-619/4619-172.pdf> [<https://perma.cc/4QKV-TER4>].

<sup>269</sup> FSOC Release, *supra* note 3, at 69,475.

from fund income—and found that a buffer coming from either adviser’s profits or investor yield would take years to build up.<sup>270</sup> A third alternative, raising subordinated/third-party capital, already had been analyzed and discussed with SEC and Federal Reserve staff and found to be unmarketable and not viable.<sup>271</sup> Numerous letters, surveys, reports and other analyses in the SEC’s docket raised concerns about the imposition of any capital requirements on money market funds. Many focused on the increased risk created by a capital requirement.<sup>272</sup> Commenters stated that a capital buffer would accelerate, rather than prevent, runs.<sup>273</sup>

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<sup>270</sup> ICI, Comment Letter on President’s Working Group Report on Money Market Fund Reform (May 16, 2012), <https://www.sec.gov/comments/4-619/4619-177.pdf> [<https://perma.cc/MR4K-J3DZ>]. ICI considered funding the capital buffer from the market as a third possibility and noted “significant legal, business, accounting, and economic hurdles to raising capital in the market.” *Id.*

<sup>271</sup> For example, Charles Schwab commented, “We do not believe there is a viable market for a subordinated share class that would take first loss position in exchange for a higher return.” Charles Schwab Inv. Mgmt., Comment Letter on President’s Working Group Report on Money Market Fund Reform (May 31, 2012), <https://www.sec.gov/comments/4-619/4619-187.pdf> [<https://perma.cc/6FWJ-9944>]; *see also* Fidelity Invs., Comment Letter on President’s Working Group Report on Money Market Fund Reform (May 30, 2012), <https://www.sec.gov/comments/4-619/4619-185.pdf> [<https://perma.cc/Q868-3RK8>] (“It is highly speculative that any market will develop for such subordinated shares.”).

<sup>272</sup> *See* Treasury Strategies, Inc., Comment Letter on President’s Working Group Report on Money Market Fund Reform (Mar. 19, 2012), <https://www.sec.gov/comments/4-619/4619-154.pdf> [<https://perma.cc/3FXQ-25HQ>] [hereinafter Treasury Strategies Letter (Mar. 19, 2012)]. The report filed by Treasury Strategies described how adding a capital requirement to funds places increased pressure on fund managers to drive yield; the “guaranteed” return of principal implied by a capital requirement promotes the false notion that money market funds are deposits, increasing moral hazard from the investor’s perspective as well.

<sup>273</sup> *See* Fisch & Roiter, *supra* note 48, at 2. Professors Fisch and Roiter explained that, once a money market fund taps the capital buffer in an effort to avoid breaking the buck,

investors are put on notice that the fund might not be able to sustain its \$1 NAV. Knowing that the capital buffer is



## VII. THE SEC PROMULGATES MONEY MARKET FUND REFORM RULES

### A. The SEC's 2013 Rule Proposal

After issuing its Section 120 release, the FSOC took no further action to move forward with its proposed recommendations. The SEC developed its own set of proposals. On June 6, 2013, the SEC, under Chairman White, voted unanimously to issue for public comment proposed amendments to its money market fund rules (“Proposing Release”), which the SEC said were “designed to address money market funds’ susceptibility to heavy redemptions, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, the benefits of money market funds.”<sup>274</sup> The SEC rejected, and the Proposing Release explained in detail the SEC’s reasons for rejecting, two of the FSOC proposals that also had been part of Chairman Schapiro’s original draft proposals, the minimum balance at risk and capital proposals.<sup>275</sup> The release proposed a floating NAV

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limited (somewhere between, perhaps, 0.5% to 3% of NAV), investors might have an *extra* incentive to redeem before the cushion is exhausted, thereby aggravating rather than reducing problems of collective action.

*Id.* Commenters also expressed concerns that a capital requirement could change both the expectations and nature of investors in money market funds—investors would be more likely to view a money market fund as a deposit rather than an investment, which “would attract an investor class that is *more* likely to flee at the first sign of distress or rumor, thus *increasing* the likelihood of a run.” Treasury Strategies Letter (Mar. 19, 2012), *supra* note 272.

<sup>274</sup> Proposing Release, *supra* note 3, at 36,834.

<sup>275</sup> *Id.* at 36,905–10. The SEC explained,

we presently believe that the imposition of either a NAV buffer combined with a minimum balance at risk or a stand-alone NAV buffer, while advancing some of our goals for money market fund reform, might prove costly for money market fund shareholders and could result in a contraction in the money market fund industry that could

requirement that was more tailored than the FSOC proposal and which attempted to preserve stable value money market funds for substantial categories of investors.

**1. *Alternative One—Floating NAV.*** The Proposing Release described its floating NAV proposal as Alternative One. It required money market funds other than “retail”<sup>276</sup> or

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harm the short-term financing markets and capital formation to a greater degree than the proposals under consideration.

*Id.* at 36,906. The SEC also later published a subsequent study prepared by a member of the SEC’s Division of Economic and Risk Analysis (“DERA”), who concluded that a capital buffer large enough to absorb substantial losses could eliminate the utility of money market funds to investors. See CRAIG M. LEWIS, SEC, THE ECONOMIC IMPLICATIONS OF MONEY MARKET FUND CAPITAL BUFFERS (2013), <https://www.sec.gov/divisions/riskfin/workingpapers/rsfi-wp2014-01.pdf> [<https://perma.cc/JB3T-CXFK>]. DERA also added four memoranda to the comment file on March 17, 2014. DERA, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Mar. 17, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-324.pdf> [<https://perma.cc/DK8F-JZWE>] (attaching memorandum titled *Demand and Supply of Safe Assets in the Economy*); DERA, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Mar. 17, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-323.pdf> [<https://perma.cc/P4EF-UPXR>] (attaching memorandum titled *Municipal Money Market Funds Exposure to Parents of Guarantors*); DERA, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Mar. 17, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-322.pdf> [<https://perma.cc/NN9K-KBN6>] (attaching memorandum titled *Government Money Market Fund Exposure to Non-Government Securities*); DERA, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Mar. 17, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-321.pdf> [<https://perma.cc/NLB5-FAE9>] (attaching memorandum titled *Liquidity Cost During Crisis Periods*). We and Federated submitted comments regarding several of these memoranda. See Arnold & Porter LLP on behalf of Federated, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Apr. 23, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-345.pdf> [<https://perma.cc/X9RB-9LCF>]; Federated, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Apr. 23, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-359.pdf> [<https://perma.cc/9N7G-B7DT>] (discussing the demand and supply of safe assets and money market fund exposure to parents of guarantors).

<sup>276</sup> The Proposing Release defined a retail money market fund as a fund that did not permit any shareholder of record to redeem more than

“government”<sup>277</sup> money market funds to sell and redeem shares based on a floating “market-based” NAV rounded to the fourth decimal place (\$1.0000)—a pricing level ten times more sensitive than that of other mutual funds, which generally price to the third decimal place (\$1.000).<sup>278</sup> Under the proposal, retail and government funds would not be permitted to use the amortized cost method of valuation to maintain a stable value but could “penny round[]” to the nearest half cent from valuations determined by market based estimates.<sup>279</sup>

The Proposing Release speculated that a floating NAV “*could* alter investor expectations,” that investors therefore “*should* become more accustomed to, and tolerant of,” fluctuations in money market fund NAVs, and that investors therefore “*may* be less likely to redeem shares in times of stress,”<sup>280</sup> although it offered no data in support of this

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\$1,000,000 per business day. Proposing Release, *supra* note 3, at 37,000. The definition was changed in the final rule to provide that a retail fund is any fund that has policies and procedures in place “reasonably designed to limit all beneficial owners of the fund to natural persons.” Adopting Release, *supra* note 1, at 47,960.

<sup>277</sup> The Proposing Release defined a government money market fund as a fund holding eighty percent or more of its total assets “in cash, government securities, and/or repurchase agreements that are collateralized fully.” Proposing Release, *supra* note 3, at 37,000. The final rule raises that standard to 99.5%. Adopting Release, *supra* note 1, at 47,959.

<sup>278</sup> Proposing Release, *supra* note 3, at 36,853 & n.163. In the Adopting Release for the final rule, the SEC made the point that “basis point rounding,” which would require money market fund investors to transact at prices ten times as sensitive as other mutual funds, was necessary because the underlying market-based valuations of money market funds is generally so stable that pricing them like other mutual funds would result in few fluctuations at all. Adopting Release, *supra* note 1, at 47,779–80. The SEC found that only five percent of money market funds would have fluctuated in price using ten basis point rounding during the period November 2010 to November 2011, but fifty-three percent of funds would have fluctuated in price over the twelve-month period with a NAV priced using basis point rounding. *Id.* (information derived from Form N-MFP data).

<sup>279</sup> Proposing Release, *supra* note 3, at 36,855.

<sup>280</sup> *Id.* at 36,851 (emphasis added).

proposition. The Proposing Release conceded that “a floating NAV may not eliminate investors’ incentives to redeem fund shares, particularly when financial markets are under stress and investors are engaging in flights to quality, liquidity, or transparency.”<sup>281</sup>

**Public comments overwhelmingly opposed the Floating NAV proposal.** Investors, issuers, and other commenters overwhelmingly rejected the SEC’s floating NAV alternative. Although the SEC later stated that commenters on the floating NAV proposal “expressed a diversity of views,” it was not by any measure close. By our count, 1397 of the 1417 commenters who addressed the issue voiced direct opposition to or raised serious concerns regarding the floating NAV proposal.<sup>282</sup> Numerous commenters rejected the proposition that a floating NAV would prevent or reduce the potential for large-scale redemptions from money market funds in a crisis or in response to a significant credit event.<sup>283</sup> Commenters argued

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<sup>281</sup> *Id.*

<sup>282</sup> For purposes of tallying the number of commenters supporting or opposing the SEC’s proposals, we excluded duplicates and counted the letters filed by or on behalf of Federated only once. *See* Proposing Release Docket, *supra* note 17. Our record of commenter positions is on file with CBLR.

<sup>283</sup> *See, e.g.*, U.S. Bancorp Letter (Sept. 16, 2013), *supra* note 51 (a floating NAV “completely fails to address [money market fund] run risk”); Nat’l League of Cities, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-174.pdf> [<https://perma.cc/9W87-F934>]; Indep. Dirs. Council, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-197.pdf> [<https://perma.cc/3LYX-M2CB>] [hereinafter Indep. Dirs. Letter (Sept. 17, 2013)]; Invesco Ltd., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-235.pdf> [<https://perma.cc/QC97-W26N>] [hereinafter Invesco Letter (Sept. 17, 2013)]; The Dreyfus Corp., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-167.pdf> [<https://perma.cc/7JUW-L34G>] [hereinafter Dreyfus Corp. Letter (Sept. 17, 2013)]; Fidelity Invs., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313->

that requiring investors to transact in money market fund shares at a floating NAV is an unnecessary means to communicate what investors already know, namely that the underlying fair value of a money market fund portfolio fluctuates and that a money market fund may lose value.<sup>284</sup>

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149.pdf [<https://perma.cc/FK2U-X3FD>] [hereinafter Fidelity Letter (Sept. 16, 2013)]; BlackRock, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 12, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-115.pdf> [<https://perma.cc/6UMD-FX5D>] [hereinafter BlackRock Letter (Sept. 12, 2013)]; ICI, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-200.pdf> [<https://perma.cc/R7QQ-LT3D>] [hereinafter ICI Letter (Sept. 17, 2013)]; UBS Global Asset Mgmt. (Americas) Inc., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-151.pdf> [<https://perma.cc/P7JY-VC9J>]; Wells Fargo Funds Mgmt., LLC, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-148.pdf> [<https://perma.cc/425T-RULA>] [hereinafter Wells Fargo Letter (Sept. 16, 2013)]; Silicon Valley Bank, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-153.pdf> [<https://perma.cc/3A6G-8CK6>] [hereinafter Silicon Valley Bank Letter (Sept. 16, 2013)]; SunGard Institutional Brokerage, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 13, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-125.pdf> [<https://perma.cc/9PMW-U9GF>] [hereinafter SunGard Letter (Sept. 13, 2013)]. Many of these comments are summarized in Arnold & Porter's letter on behalf of Federated filed November 21, 2013. Arnold & Porter Letter (Nov. 21, 2013), *supra* note 13; *see also* Gordon & Gandia, *supra* note 128, *reprinted in* Jeffrey Gordon, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Nov. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-278.pdf> [<https://perma.cc/2X5V-PZLQ>].

<sup>284</sup> SunGard commented,

In view of the very extensive and prominent prospectus disclosures of the risk that a [money market fund] can “break a buck” (not to mention the extensive discussion of the issue in the press and regulatory commentary), the many surveys and testimony documenting that investors understand this risk, and the fact that institutional investors clearly can grasp this issue, the second stated purpose behind Alternative 1 does not warrant the

This point was particularly salient with regard to institutional prime money market fund investors, who were the target of the SEC's proposed floating NAV reform. Commenters pointed to the more cost-effective alternative of requiring daily mark-to-model NAV disclosure, additional portfolio disclosure and other enhanced disclosures proposed in the rulemaking.<sup>285</sup> Commenters also strongly opposed the aspect of the floating NAV proposal requiring money market funds to calculate their NAVs to the nearest basis point for shareholder transactions in order to create fluctuations in price, when all other mutual funds are held to only a ten basis point standard of valuation.<sup>286</sup>

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tremendous costs and disruption that the [floating NAV] proposal would bring about.

SunGard Letter (Sept. 13, 2013), *supra* note 283. *See also* ICI Letter (Sept. 17, 2013), *supra* note 283; Silicon Valley Bank Letter (Sept. 16, 2013), *supra* note 283; Mercatus Ctr. at George Mason Univ., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-157.pdf> [<https://perma.cc/U6PR-2YW8>]; Am. Bar Ass'n, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 30, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-249.pdf> [<https://perma.cc/DB58-UBZV>]; Indep. Dirs. Letter (Sept. 17, 2013), *supra* note 283; J.P. Morgan Asset Mgmt., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-156.pdf> [<https://perma.cc/Z9WC-7FUG>] [hereinafter J.P. Morgan Letter (Sept. 17, 2013)]; Comm. on Capital Mkts. Regulation, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-210.pdf> [<https://perma.cc/M4E4-Y2A8>] [hereinafter Comm. on Capital Mkts. Regulation Letter (Sept. 17, 2013)]; Wells Fargo Letter (Sept. 16, 2013), *supra* note 283.

<sup>285</sup> Federated's letter dated September 17, 2013 discusses appropriate additional disclosures in greater detail. Federated, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-186.pdf> [<https://perma.cc/47GW-M8HC>] (letter titled "Comments Regarding Amendments to Disclosure Requirements for Money Market Funds and Current Requirements of Rule 2a-7").

<sup>286</sup> Even money fund sponsors managers who expressed qualified support for the floating NAV proposal, such as Schwab, objected to requiring their funds to transact at a four decimal place NAV. *See* Charles Schwab Inv. Mgmt., Comment Letter on Money Market Fund Reform;

The Proposing Release acknowledged, and commenters provided substantial data on this point, that the operational burdens of overhauling the complex software and other systems of large institutional investors, intermediaries, transfer agents, and fund sponsors to accommodate a floating NAV would be substantial,<sup>287</sup> that the costs would be enormous,<sup>288</sup> and that by eliminating the stability upon

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Amendments to Form PF (Sept. 12, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-109.pdf> [<https://perma.cc/7QH9-MASP>] [hereinafter Charles Schwab Letter (Sept. 12, 2013)]. A number of other fund sponsors, including Dreyfus, Fidelity, Invesco, Goldman, J.P. Morgan, and BlackRock, argued strongly that the proposal for basis point pricing was unjustified. See Dreyfus Corp. Letter (Sept. 17, 2013), *supra* note 283 (“We think this intentional effort to overstate [money market fund] price fluctuations . . . is inappropriate and should not be undertaken by the Commission. It has no place in making the risk of [constant NAV money market funds] more transparent.”); Fidelity Letter (Sept. 16, 2013), *supra* note 283; Invesco Letter (Sept. 17, 2013), *supra* note 283; Goldman Sachs Letter (Sept. 17, 2013), *supra* note 51; J.P. Morgan Letter (Sept. 17, 2013), *supra* note 284; BlackRock Letter (Sept. 12, 2013), *supra* note 283.

<sup>287</sup> See Proposing Release, *supra* note 3, at 36,870. DST, State Street, and SunGard, among others, filed detailed comments explaining the operational challenges of accommodating a floating NAV. See DST Sys., Inc., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 18, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-241.pdf> [<https://perma.cc/H8M2-CQPT>] [hereinafter DST Sys. Letter (Sept. 18, 2013)]; State St. Corp., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-176.pdf> [<https://perma.cc/E8T2-HGCF>] [hereinafter State St. Letter (Sept. 17, 2013)]; SunGard Letter (Sept. 13, 2013), *supra* note 283.

<sup>288</sup> See Proposing Release, *supra* note 3, at 36,868–73. See also, e.g., Gov’t Fin. Officers Ass’n et al., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-220.pdf> [<https://perma.cc/SAR4-KAA3>] [hereinafter Gov’t Fin. Officers Ass’n Letter (Sept. 17, 2013)]; Am. Benefits Council, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-135.pdf> [<https://perma.cc/8Q8U-2LDN>] [hereinafter Am. Benefits Council Letter (Sept. 16, 2013)]; Comm. on Capital Mkts. Regulation Letter (Sept. 17, 2013), *supra* note 284; The Boeing Co., Comment Letter on Money Market Fund Reform; Amendment to Form PF (Sept. 9, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-120.pdf> [<https://perma.cc/FK3J-HZ53>]; Am. Bankers Ass’n,

which investors rely, the floating NAV proposal would cause investors to withdraw assets from money market funds and seek alternative products.<sup>289</sup>

Commenters warned that imposing a floating NAV would hinder same-day settlement of transactions and thereby produce settlement bottlenecks and delays for investors and intermediaries, create new risks from potential technology breakdowns and systems failures at the pricing vendors responsible for supplying intraday portfolio valuations, and increase risks on payment systems and markets.<sup>290</sup>

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Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-181.pdf> [<https://perma.cc/Y5ZS-5PKW>] [Am. Bankers Ass'n Letter (Sept. 17, 2013)]; *see also* Arnold & Porter LLP on behalf of Federated, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 13, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-123.pdf> [<https://perma.cc/4ESD-2XPZ>] (letter titled "Problems with the Floating NAV") [hereinafter Arnold & Porter Letter on Floating NAV Problems].

<sup>289</sup> Proposing Release, *supra* note 3, at 36,915; *see* Dreyfus Corp. Letter (Sept. 17, 2013), *supra* note 283; Fidelity Letter (Sept. 16, 2013), *supra* note 283; U.S. Bancorp Letter (Sept. 16, 2013), *supra* note 51; Silicon Valley Bank Letter (Sept. 16, 2013), *supra* note 283; Cleco Corp., Comment Letter on Money Market Fund Reform; Amendment to Form PF (July 18, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-28.pdf> [<https://perma.cc/CB4J-SUC6>]; BlackRock Letter (Sept. 12, 2013), *supra* note 283; SunGard Letter (Sept. 13, 2013), *supra* note 283. In addition, institutional and public sector commenters expressed concern that legal or investment restrictions may prevent them from investing in floating NAV money market funds. *See* Treasurer Stephanie Neely, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 24, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-245.htm> [<https://perma.cc/7SHH-M6F6>] (letter from City Treasurer of Chicago); Gov't Fin. Officers Ass'n Letter (Sept. 17, 2013), *supra* note 288; Am. Benefits Council Letter (Sept. 16, 2013), *supra* note 288; Am. Bankers Ass'n Letter (Sept. 17, 2013), *supra* note 288; Ass'n for Fin. Prof'ls, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-162.pdf> [<https://perma.cc/RL3Q-DDHU>] [hereinafter Ass'n for Fin. Prof'ls Letter (Sept. 17, 2013)]; Arnold & Porter Letter (Nov. 21, 2013), *supra* note 13.

<sup>290</sup> SIFMA, ICI, SunGard, and DST, among others, raised concerns with respect to same-day settlement in their comment letters on the Proposing Release. *See, e.g.*, SIFMA, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013),



Commenters also warned that reducing or eliminating the utility of money market funds for investors would contract the market for, and raise the costs of, short-term public and private financing. In effect, this would force issuers to pay higher interest, extend the duration of their debt burdens, and/or resort to bank lending on less favorable terms as a result.<sup>291</sup> The SEC received significant commentary explaining that the floating NAV requirement would have a negative effect on efficiency, competition, and capital formation by lowering yields for investors and raising costs for users and issuers.<sup>292</sup>

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<https://www.sec.gov/comments/s7-03-13/s70313-199.pdf> [<https://perma.cc/H6FT-H6AF>] [hereinafter SIFMA Letter (Sept. 17, 2013)]; ICI Letter (Sept. 17, 2013), *supra* note 283; SunGard Letter (Sept. 13, 2013), *supra* note 283; DST Sys. Letter (Sept. 18, 2013), *supra* note 287; *see also* Arnold & Porter Letter on Floating NAV Problems, *supra* note 288 (discussing risks related to pricing vendors); Arnold & Porter Letter (Nov. 21, 2013), *supra* note 13. These commenters also noted that the elimination of the amortized cost method of valuing stable value funds, in favor of penny rounding, would nonetheless create pricing and settlement delays, because of the need to obtain market-based estimates from which to round.

<sup>291</sup> *See, e.g.*, Ctr. for Capital Mkts. Competitiveness, U.S. Chamber of Commerce, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-234.pdf> [<https://perma.cc/SS6N-Z359>] [hereinafter Ctr. for Capital Mkts. Letter (Sept. 17, 2013)]; ICI Letter (Sept. 17, 2013), *supra* note 283; Ass'n for Fin. Prof'ls Letter (Sept. 17, 2013), *supra* note 289; Nat'l Ass'n of State Auditors, Comptrollers & Treasurers, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-155.pdf> [<https://perma.cc/77MG-VCN9>] [hereinafter Nat'l Ass'n of State Auditors, Comptrollers & Treasurers Letter (Sept. 17, 2013)].

<sup>292</sup> *See, e.g.*, Ctr. for Capital Mkts. Letter (Sept. 17, 2013), *supra* note 291; ICI Letter (Sept. 17, 2013), *supra* note 283; Nat'l Ass'n of State Auditors, Comptrollers & Treasurers Letter (Sept. 17, 2013), *supra* note 291; Treasurer of Virginia, Comment Letter on Proposed Rulemaking on Money Market Reform (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-223.pdf> [<https://perma.cc/CM3C-SPAL>]; Treasurer of the City of St. Louis, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-193.pdf> [<https://perma.cc/96N6-BWRT>]. Our November 21, 2013 letter cites others discussing these issues. Arnold &

The SEC received a small number of comments in favor of the floating NAV. Some fund sponsors with predominantly retail client bases supported the floating NAV proposal in concept (while suggesting further changes to narrow the proposal).<sup>293</sup> Letters from the twelve Federal Reserve Bank Presidents, the Systemic Risk Council, and a handful of other commenters, also supported some form of the floating NAV.<sup>294</sup>

**2. Alternative Two—Gates and Fees.** Alternative Two, the “gates and fees” proposal, required funds to impose a two percent liquidity fee on redemptions if a fund’s weekly liquid assets fell below a specified threshold (fifteen percent of total assets) and permitted a fund’s board to suspend redemptions temporarily (to “gate” the fund) under the same circumstances for up to thirty days.<sup>295</sup> The release stated that the SEC could adopt either Alternative One or Two, or adopt them in combination.<sup>296</sup> It also proposed enhanced

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Porter Letter (Nov. 21, 2013), *supra* note 13. Many commenters also commented that the SEC’s “retail” exemption, as proposed, was unworkable, and they further objected to the potential tax and accounting burdens of a floating NAV. *See, e.g., id.* The SEC addressed some of these concerns in its final rule; however, the above-listed operational, technology, and settlement burdens and costs will continue to impede floating NAV money market funds under the final rules.

<sup>293</sup> These included T. Rowe Price, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-203.pdf> [<https://perma.cc/FHT7-8NGD>]; Vanguard, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-179.pdf> [<https://perma.cc/X7K3-82MJ>]; and Charles Schwab Letter (Sept. 12, 2013), *supra* note 286.

<sup>294</sup> *See, e.g.,* Eric S. Rosengren, Fed. Reserve Bank of Bos., on behalf of the twelve Federal Reserve Bank Presidents, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 12, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-111.pdf> [<https://perma.cc/882B-7NCP>] [hereinafter Rosengren Letter (Sept. 12, 2013)]; Systemic Risk Council, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-131.pdf> [<https://perma.cc/A3WY-JDAK>] [hereinafter Systemic Risk Council Letter (Sept. 16, 2013)].

<sup>295</sup> Proposing Release, *supra* note 3, at 36,878, 36,884.

<sup>296</sup> *Id.* at 36,834.

disclosure, stress testing, and diversification requirements.<sup>297</sup> In contrast to the SEC's statements that the floating NAV proposal may not eliminate investors' incentive to redeem when markets are under stress, the Proposing Release stated that "gates are the one regulatory reform in this Release . . . that definitively stops a run on a fund (by blocking all redemptions)."<sup>298</sup>

**Public comments largely supported the gates and fees proposal.** By our count, a total of 1267 of 1344 letters that addressed the SEC's gates and fees proposal supported it, with some commenters also proposing modifications.<sup>299</sup> Many commenters who addressed the proposal agreed with the SEC's own assessment that where a money market fund is facing the threat of heavy redemptions or another event that could result in material dilution or unfair results to shareholders, a temporary suspension of redemptions is the one regulatory reform in the proposal that would stop a run.<sup>300</sup> The SEC also received academic research and data

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<sup>297</sup> *Id.*

<sup>298</sup> *Id.* at 36,880.

<sup>299</sup> Our record of commenter positions is on file with *CBLR*.

<sup>300</sup> *See, e.g.*, Indep. Dirs. Letter (Sept. 17, 2013), *supra* note 283; Deutsche Inv. Mgmt. Americas Inc., Comment Letter on Proposed Rules on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-213.pdf> [<https://perma.cc/6YPE-4A9D>] [hereinafter Deutsche Letter (Sept. 17, 2013)]; Dreyfus Corp. Letter (Sept. 17, 2013), *supra* note 283; Fidelity Letter (Sept. 16, 2013), *supra* note 283; ICI Letter (Sept. 17, 2013), *supra* note 283; State St. Letter (Sept. 17, 2013), *supra* note 287; Indep. Trustees of the Federated Funds, Comment Letter on Proposed Rules on Money Market Fund Reform; Amendments to Form PF (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-237.pdf> [<https://perma.cc/EQY5-NZFQ>]; U.S. Bancorp Letter (Sept. 16, 2013), *supra* note 51. A letter we filed on behalf of Federated also pointed to experience from the financial crisis, when the board of directors of the U.S. Putnam Institutional Prime Money Market Fund on September 18, 2008, confronted with heavy redemptions that could have led to material dilution and unfair results to its shareholders, voted to suspend redemptions and liquidate the fund, allowing the board sufficient time to negotiate a solution. The fund's assets and investors were transferred to another fund managed by Federated, in a process so smooth that investors were able to redeem within seven days without investment loss. Investors

regarding the historical use and effectiveness of gating in sectors other than money market funds.<sup>301</sup> Many commenters also told the SEC that the gates and fees alternative was the only alternative that could be implemented in a cost effective manner, that would preserve the utility and day-to-day operational efficiency of money market funds for investors and that, as a result, would maintain money market funds as a source of short-term financing for corporate and governmental issuers.<sup>302</sup>

A small number of commenters argued that the potential for imposition of a gate or fee could lead to preemptive redemptions by investors who closely monitored a money market fund as it approached a gate or fee trigger.<sup>303</sup> While

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benefited significantly from the Putnam board's action. Federated's experience led it to advocate for a regulatory change allowing money market fund boards, under those rare circumstances when investors are at risk of material dilution, to gate a fund and provide its board time to look for a solution, without liquidating the fund as SEC rules required prior to the recent amendments. *See* Arnold & Porter LLP on behalf of Federated, Comment Letter on Money Market Fund Reform; Amendments to Form PF (May 14, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-360.pdf> [<https://perma.cc/UY6C-TN6U>] [hereinafter Arnold & Porter Letter (May 14, 2014)].

<sup>301</sup> Hester Peirce & Robert Greene, Mercatus Ctr. at George Mason Univ., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Apr. 8, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-335.pdf> [<https://perma.cc/4VYG-RAV2>] [hereinafter Peirce & Greene Letter (Apr. 8, 2014)]. Peirce and Greene cite other research finding that gates mitigated the severity of runs on U.S. commercial banks in the early 1900s: “[R]edemption restrictions protected the banking system, ensured that the failure of banks did not set off a chain reaction, provided distressed banks with the time to raise adequate liquidity, and gave time for the immediate panic to wear off.” *Id.* at 72, n.297. The Peirce and Greene paper further observes that gates have been effective in preventing runs in hedge funds, noting that by December 2008 “roughly 100 hedge funds had imposed restrictions on withdrawals.” *Id.* at 43.

<sup>302</sup> Commenters on these issues included Indep. Dirs. Letter (Sept. 17, 2013), *supra* note 283; Wells Fargo Letter (Sept. 16, 2013), *supra* note 283; Deutsche Letter (Sept. 17, 2013), *supra* note 300; Fidelity Letter (Sept. 16, 2013), *supra* note 283; Peirce & Greene Letter (Apr. 8, 2014), *supra* note 301.

<sup>303</sup> Those commenters included the Mutual Fund Dirs. Forum, Comment Letter on Money Market Fund Reform; Amendments to Form

most commenters provided no data on this point, the FRBNY staff published a report in which it argued that allowing financial intermediaries to impose redemption fees or gates in a crisis could lead to preemptive runs.<sup>304</sup> We wrote in a comment letter responding to the report that the key assumption underlying the FRBNY's entire analysis, that banks are currently prohibited from imposing gates or fees on redemptions, is demonstrably false.<sup>305</sup> Other than demand deposit accounts, which constitute less than nine percent of large bank deposits, banks (1) are required by Federal Reserve Regulation D to reserve the right to require seven days' advance notice of a withdrawal from MMDAs, NOW accounts and other savings accounts; (2) are not required to allow early withdrawal from CDs and other time deposits; and (3) are allowed to impose early withdrawal fees on time deposits if they choose to permit an early withdrawal from a time deposit.<sup>306</sup> Thus, if the authors' conclusion were correct, one would expect to see preemptive runs on banks. The

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PF (Sept. 16, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-138.pdf> [<https://perma.cc/93R4-7KTB>]; Rosengren Letter (Sept. 12, 2013), *supra* note 294; Sec'y to the State Inv. Comm'n of Ky., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 6, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-86.pdf> [<https://perma.cc/2JQ4-U97U>]; Ams. for Fin. Reform, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-227.pdf> [<https://perma.cc/4YXP-3ZE6>]; Systemic Risk Council Letter (Sept. 16, 2013), *supra* note 294.

<sup>304</sup> MARCO CIPRIANI, ANTOINE MARTIN, PATRICK MCCABE & BRUNO M. PARIGI, GATES, FEES, AND PREEMPTIVE RUNS 1 (FRBNY Staff Report No. 670, Apr. 2014), [http://www.ny.frb.org/research/staff\\_reports/sr670.pdf](http://www.ny.frb.org/research/staff_reports/sr670.pdf) [<http://perma.cc/PYW7-LFH5>] [hereinafter FRBNY STAFF REPORT]; *see also* Proposing Release, *supra* note 3, at 36,881 n.361 (citing a Jan. 8, 2013 letter from Professors Samuel Hanson, David Scharfstein, and Adi Sunderam, Harvard Bus. Sch., to the FSOC).

<sup>305</sup> *See* Arnold & Porter LLP on behalf of Federated, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Apr. 25, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-352.pdf> [<https://perma.cc/BBW5-WHL3>] (submitting comments on the FRBNY Staff Report).

<sup>306</sup> *Id.*

report's authors acknowledged that the report's conclusion "contrasts with the existing literature . . . ." <sup>307</sup>

Supporters of the gates and fees concept proposed modifications to the SEC's proposal to facilitate its operation and minimize its potential impact on shareholders. <sup>308</sup>

**3. Commenters almost completely rejected combining a floating NAV with gates and fees.** By our count, only three commenters in the SEC's rulemaking file supported adopting Alternatives One and Two in combination to impose both a floating NAV and gates and fees on money market funds. <sup>309</sup> Commenters opposing the combination explained that such a product would not be viable, with one commenter stating that such a combination would make money market funds a product "no rational investor would select." <sup>310</sup>

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<sup>307</sup> FRBNY STAFF REPORT, *supra* note 304, at 3.

<sup>308</sup> See Federated, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 16, 2014), <https://www.sec.gov/comments/s7-03-13/s70313-130.pdf> [<https://perma.cc/XR5K-2RC6>]. The modifications Federated proposed included: (1) reducing the fifteen percent threshold for weekly liquid assets to ten percent; (2) reducing the maximum temporary suspension period to ten days; and (3) permitting a board to implement a liquidity fee or redemption suspension before the end of the business day if it determines there is a risk that weekly liquid assets will be reduced to less than ten percent or it determines that action is appropriate to avoid material dilution or other unfair results to shareholders. The SEC's final rule largely incorporated these proposals. Federated also urged the SEC to exempt tax-exempt money market funds from the gates/fees provisions, as the proposal does for government money market funds, but the SEC did not adopt this change.

<sup>309</sup> Those three commenters were Better Markets, Inc., TIAA-CREF, and Charles Schwab. See Better Mkts., Inc., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-260.pdf> [<https://perma.cc/4PWF-3J8L>]; TIAA-CREF, Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-161.pdf> [<https://perma.cc/4PZT-SL4H>]; Charles Schwab Letter (Sept. 12, 2013), *supra* note 286.

<sup>310</sup> Invesco Letter (Sept. 17, 2013), *supra* note 283; see also Arnold & Porter Letter (May 14, 2014), *supra* note 300; Wells Fargo Letter (Sept. 16, 2013), *supra* note 283; Dreyfus Corp. Letter (Sept. 17, 2013), *supra* note 283; Fidelity Letter (Sept. 16, 2013), *supra* note 283; OFI Global Asset

## B. The SEC's Final Rule

On July 23, 2014, by a vote of 3–2, the SEC adopted new money market fund rules (“final rules”).<sup>311</sup> The major elements of the rules will not be in force until their compliance date of October 14, 2016.<sup>312</sup> The final rules include enhanced disclosure, diversification and stress testing requirements, as well as major elements of the SEC’s gates and fees and floating NAV proposals, with modifications.<sup>313</sup>

Chairman White and Commissioners Gallagher and Aguilar voted in favor of adopting the final rule.<sup>314</sup> Commissioner Piwowar opposed the final rule, stating his concerns that the floating NAV provisions would be enormously costly and would not prevent or mitigate potential runs, and that the combination of a floating NAV and gates and fees on institutional prime and institutional tax-exempt funds would undermine the utility of money market funds for investors.<sup>315</sup> Commissioner Stein opposed

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Mgmt., Comment Letter on Money Market Fund Reform; Amendments to Form PF (Sept. 17, 2013), <https://www.sec.gov/comments/s7-03-13/s70313-230.pdf> [<https://perma.cc/L2LK-AT68>]; BlackRock Letter (Sept. 12, 2013), *supra* note 283; Goldman Sachs Letter (Sept. 17, 2013), *supra* note 51; SIFMA Letter (Sept. 17, 2013), *supra* note 290; ICI Letter (Sept. 17, 2013), *supra* note 283; State St. Letter (Sept. 17, 2013), *supra* note 287.

<sup>311</sup> Press Release, SEC, SEC Adopts Money Market Fund Reform Rules (July 23, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542347679#.VFqYfjTF-uM> [<https://perma.cc/LD53-TAXY>].

<sup>312</sup> Adopting Release, *supra* note 1, at 47,932.

<sup>313</sup> *Id.* at 47,736.

<sup>314</sup> Chairman White and Commissioners Gallagher and Aguilar made statements in support of the final rules. Mary Jo White, Chairman, SEC, Statement at SEC Open Meeting on Money Market Reform (July 23, 2014), <http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542389025> [<https://perma.cc/M5YM-YNMC>]; Daniel M. Gallagher, Comm’r, SEC, Statement (July 23, 2014) <http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542723950> [<https://perma.cc/54YF-VVMD>]; Luis Aguilar, Comm’r, SEC, Statement on Strengthening Money Market Funds to Reduce Systemic Risk (July 23, 2014) <http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542553625> [<https://perma.cc/C26Y-CPVW>].

<sup>315</sup> Commissioner Piwowar stated at the SEC’s open meeting: “While the floating NAV will not stop runs, it will impose costs on money market

the final rule, stating that she believed the potential for gates or fees could precipitate runs.<sup>316</sup> She also emphasized that the SEC and other financial regulators should move beyond focusing on money market funds to address vulnerabilities in the short-term funding markets.<sup>317</sup>

**1. *The Gates and Fees provisions in the final rules.***

The final rules give fund boards discretion to impose either a liquidity fee of up to 2% or a temporary suspension of redemptions if a fund's level of weekly liquid assets falls below 30% of its total assets; the rules require a board to impose a 1% liquidity fee if the fund's weekly liquid assets fall below 10%, unless the fund's board of directors determines that imposing the fee would not be in the best interests of the fund.<sup>318</sup> Gates are limited to no more than ten business days (a change from the thirty-day period in the proposal), and the release accompanying the final rule ("Adopting Release") states the SEC's expectation that gates will be used only rarely. The gates and fees requirements apply to all money market funds, except those that invest 99.5% of their total assets in cash or government securities (a change from 80% in the proposed rules). Gates and fees provisions were not part of former Chairman Schapiro's original draft proposal, nor were they part of the FSOC's proposed recommendations. However, the SEC's release emphasized that gates and fees are the most effective

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funds that will ultimately be borne by its shareholders in the form of higher fees and expenses, and lower returns." Michael S. Piwowar, Comm'r, SEC, Dissenting Statement at Open Meeting Regarding Money Market Fund Reform (July 23, 2014), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370542553721#.VFqY9TTF-uM> [<https://perma.cc/J4BX-WTJY>]. Commissioner Piwowar also noted that he had proposed an alternative, under which investors would be given a choice between funds with floating NAVs or funds with gates and liquidity fees. *Id.*

<sup>316</sup> Kara M. Stein, Comm'r, SEC, Statement of Commissioner Kara M. Stein (July 23, 2014), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370542553868#.VFqY9TTF-uM> [<https://perma.cc/ZPD9-WFAX>]. In her comments, Commissioner Stein also raised broader concerns regarding the overreliance of issuers on short-term funding. *Id.*

<sup>317</sup> *Id.*

<sup>318</sup> 17 C.F.R. § 270.2a-7(c)(2) (2015).



mechanism to stop runs and that they would have enabled money market funds to better manage the heavy redemptions that occurred in 2008 and limit contagion.<sup>319</sup> The release explains that these provisions give money market fund boards the time and tools in such circumstances to protect shareholders from dilution and to avoid the potential market impact of fire sales to meet redemptions.<sup>320</sup>

**2. The Floating NAV provisions in the final rules.**

Under the final rules, all prime and tax-exempt money market funds that do not limit beneficial owners to natural persons are prohibited from using the amortized cost method of valuation for their portfolios (except for portfolio instruments with sixty or fewer days to maturity) and are required to price their shares based on a floating NAV at the nearest hundredth of a cent.<sup>321</sup> These requirements are *in addition to* the gates and fees requirements that apply to all money market funds except government funds. “Retail” investors will continue to have the benefit of stable value money market funds of all types; both retail and institutional investors will have the benefit of stable value government money market funds.<sup>322</sup> The SEC’s final rules adopt a more workable carve-out for “retail” funds than the proposed rules and retain the amortized cost method of valuation for those funds.<sup>323</sup> Through separate action by the Treasury, certain tax consequences of floating NAV money market funds are being addressed.<sup>324</sup> The restructuring and operational

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<sup>319</sup> Adopting Release, *supra* note 1, at 47,748–49.

<sup>320</sup> *Id.*

<sup>321</sup> 17 C.F.R. § 270.2a-7(c)(1)(ii) (2015).

<sup>322</sup> *Id.* § 270.2a-7(c)(1)(i).

<sup>323</sup> The SEC rejected its proposed definition of retail investors (\$1 million daily redemption limit) and instead used a “natural person” test. Specifically, under the final rules a retail fund is a money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons. 17 C.F.R. § 270.2a-7(a)(25) (2015); *see* Adopting Release, *supra* note 1, at 47,794–95 (explaining the “retail” exemption).

<sup>324</sup> *Fact Sheet: Treasury Guidance on Accounting for Gains and Losses in Certain Money Market Funds*, DEP’T OF THE TREASURY (July 23, 2014),

changes necessary to accommodate the floating NAV provisions of the rules nonetheless will result in significant disruption and costs for users, funds, sponsors, and issuers. The SEC release claims no measurable benefit commensurate with these costs.<sup>325</sup>

The SEC's rulemaking goals—"to address money market funds' susceptibility to heavy redemptions in times of stress, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, their benefits"<sup>326</sup>—are addressed in the provisions of the rules relating to gates and fees, enhanced disclosures, and stress testing. While these reforms are costly and the gates and fees provisions may make affected money market funds less attractive for some investors, the SEC had no trouble explaining why it decided to adopt these reforms, given their investor protection benefits. But the Adopting Release struggles to explain why, to the extent the SEC believes the gates and fees provisions address potential run risk and the disclosure enhancements address transparency concerns, the SEC believes it is necessary to impose the floating NAV requirements and force certain money market fund investors, fund sponsors, issuers and others to bear the significant costs that flow from these changes.

The Adopting Release explains the SEC's rationale for adopting the floating NAV provisions as follows:

- “[W]hile many investors may redeem because of concerns about liquidity, quality, or lack of transparency—and our fees and gates, disclosure, and reporting reforms are primarily intended to address those incentives—an *incremental incentive to redeem* is created by money market funds' current valuation and pricing methods.”<sup>327</sup>

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<http://www.treasury.gov/press-center/press-releases/pages/j12579.aspx>  
[<http://perma.cc/CXQ6-R3WS>].

<sup>325</sup> See generally Adopting Release, *supra* note 1.

<sup>326</sup> *Id.* at 47,736.

<sup>327</sup> *Id.* at 47,774 (emphasis supplied.).

- “We do not intend, and the floating NAV reform does not seek, to deter redemptions that constitute rational risk management by shareholders or that reflect a general incentive to avoid loss.” Instead, “the floating NAV requirement is designed to . . . disincentiviz[e] redemption activity that can result from investors attempting to exploit the possibility of redeeming shares at the stable share price even if the portfolio has suffered a loss . . . .”<sup>328</sup>
- “[W]e believe that [the incremental incentive to redeem] exists largely in prime money market funds because these funds exhibit higher credit risk that make declines in value more likely (compared to government money market funds).”<sup>329</sup>
- “We further believe history shows that, to date, institutional investors have been significantly more likely than retail investors to act on this [incremental] incentive.”<sup>330</sup>
- “[T]he floating NAV may make it more transparent to certain of the impacted [institutional] investors that they, not the fund sponsors or the federal government, bear the risk of loss.”<sup>331</sup>

Note that the Adopting Release says the floating NAV requirement for institutional prime funds is *not* intended to address redemptions based on rational risk management or an investor’s incentive to avoid loss. However, nowhere in the release does the SEC point to evidence that investors who engaged in heavy redemptions from money market

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<sup>328</sup> *Id.* at 47,775.

<sup>329</sup> *Id.* at 47,774.

<sup>330</sup> *Id.* Here, the Adopting Release cites data showing that institutional investors redeemed more heavily than retail investors during the financial crisis. *Id.* at 47,774 n.437. The release goes on to explain that “first movers” redeeming from a money fund with a declining NAV have an advantage over others, and that that institutional investors may redeem more heavily because they are sophisticated and may closely monitor their investments. *Id.* at 47,774.

<sup>331</sup> *Id.* at 47,775.

funds in 2008 or other periods acted on a basis *other than* to avoid loss or manage risk. The SEC points to no evidence that any investor has ever acted on the SEC's theoretical "incremental incentive to redeem," separate from an investor's incentive to avoid loss, manage risk, or redeem in the normal course for cash management.

In addition, while as a general rule most would agree that prime money market funds exhibit higher credit risk than government funds, the SEC fails to account for the fact that two of the three incidences of heavy redemptions from money market funds since 2010 involved government money market funds—heavy outflows from government funds in 2011 in response to the debt-ceiling impasse and potential default on U.S. debt and again in 2013 in response to another debt-ceiling crisis.<sup>332</sup> The SEC ignores these incidences of above-normal redemptions from government money market funds in stating that the "incremental incentive to redeem" exists more in prime funds than in government money market funds, which the SEC exempts from the floating NAV requirements.<sup>333</sup>

To support its statement that "institutional investors have been significantly more likely than retail investors to act on this incentive," the SEC points only to data that institutional investors redeemed more quickly than retail investors *during the depths of the financial crisis* and other periods of stress, when institutional investors were acting to avoid loss and manage their risks—incentives the SEC says

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<sup>332</sup> *Id.* at 47,746, 47,746 n.90 (citing the performance of government money market funds in the 2011 debt crisis and the 2013 U.S. debt-ceiling impasse).

<sup>333</sup> *Id.* at 47,774. Note that we are not here suggesting that the SEC should extend its floating NAV rule to government money market funds. We think the floating NAV requirement is costly and disruptive and, therefore, investors will benefit from the exemption for government money market funds. We simply question the SEC's rationale that prime funds are more susceptible to the unproved and speculative "incremental incentive to redeem" described in the release.

its floating NAV rule is not designed to address.<sup>334</sup> Moreover, there is nothing in the SEC's release to support the proposition that institutional investors are unaware that they bear the risk of loss in a money market fund or that institutional investors should be made to transact at a floating NAV to enable them better to understand the risks (and that disclosure will not suffice), while retail investors should not.<sup>335</sup> To suggest this contradicts the SEC's own evidence that institutional investors redeemed more heavily than retail investors in the financial crisis—reflecting that they certainly understood the risks.<sup>336</sup>

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<sup>334</sup> *Id.* at 47,774 n.437 (citing principally a study by the SEC's Division of Risk, Strategy, and Financial Innovation analyzing investor behavior during the 2008 financial crisis).

<sup>335</sup> We are not suggesting that the SEC should extend its floating NAV rule to retail money market funds. We think the floating NAV requirement is costly and disruptive and, therefore, investors will benefit from the exemption for retail funds. We simply question the SEC's justification for applying the floating NAV to institutional funds, based upon the rationale that they otherwise will not appreciate money market fund risks and that disclosure is insufficient. We also note here that the SEC has decided that disclosure *will* suffice to address concerns that sponsor support transactions over the years have lulled investors into a false sense of security about money market fund risks. After all of the controversy over this issue, the SEC determined not to prohibit sponsor support transactions. Indeed, the SEC found, once again, that such transactions are in the interests of shareholders. Adopting Release, *supra* note 1, at 47,822 (“We continue to believe . . . that permitting financial support (with adequate disclosure) will provide fund affiliates with the flexibility to protect shareholder interests.”); *see also id.* at 47,974 (providing Form N-CR Part C: Provision of Financial Support To Fund).

<sup>336</sup> The SEC's justification of its floating NAV provisions fail on numerous other accounts. For example, the Adopting Release minimizes the very real possibility that, instead of *reducing* investor incentives to redeem, its floating NAV rule will actually increase the incentives for investor redemptions at the first sign of trouble, especially by more sophisticated institutional investors. This is because it requires transactions in money market funds to be made at price fluctuations of a hundredth of a cent, which will increase the likelihood of realized losses from the currently very rare situation in which a stable NAV money market fund breaks a buck (if the price fluctuates a half a cent) to much more frequent occurrences. While the Adopting Release acknowledges that this may occur, it states that the floating NAV requirement “is not

The Adopting Release might better have explained the SEC's rationale for the floating NAV had it simply stated that imposing a floating NAV upon some appreciable segment of money market funds was necessary to fend off the FSOC and the Fed from taking other action against SEC-regulated entities. But such a justification for a rule, the costs of which will be in the billions,<sup>337</sup> would have been inconsistent with the statutory criteria for SEC rulemaking that it consider, in addition to investor protection, whether its rules further efficiency, competition, and capital formation.<sup>338</sup>

### VIII. CONCLUSION

Agencies in their rulemakings, in order to avoid challenges based on arbitrariness, must be able to explain the basis for their actions. Where a rulemaking is premised upon a market failure, the facts relating to the cause(s) of that failure should serve as the foundation for the agency's rulemaking solution. A narrative that states that *the structural features of money market funds caused a run on prime funds and the freezing of the short-term credit markets in 2008* might lead policy makers to conclude that the structural feature at issue—money market funds' stable NAV—must be changed to avoid future run risk and that changing that feature will in fact mitigate the risk. However, as we show above, that narrative simply is not true, although it ultimately led to a flawed agency rule that will

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intended to deter redemptions that constitute rational risk management by shareholders or that reflect a general incentive to avoid loss." *Id.* at 47,777.

<sup>337</sup> Arnold & Porter Letter (Sept. 17, 2013), *supra* note 8.

<sup>338</sup> National Securities Market Improvement Act of 1996 § 106, 15 U.S.C. §§ 77b, 78c, 80a–2 (2012). The National Securities Market Improvement Act of 1996 amended the Investment Company Act and other federal securities laws to require the SEC to consider efficiency, competition, and capital formation whenever it is engaged in rulemaking that requires the agency to consider or determine whether an action is necessary or appropriate in the public interest. *See* Investment Company Act of 1940 § 2, 15 U.S.C. § 80a–2(c) (2012).

eliminate a \$1.0 trillion segment of money market funds, at enormous costs to investors and the economy, with no marginal benefits in terms of reducing run risk. Nor will money market fund investors who transact at a floating NAV under the new rule necessarily get a better or more accurate “mark-to-market” price—the premise of advocates for a floating NAV who call the stable value yielded by the amortized cost method of valuation a “fiction.” As the SEC ultimately acknowledged, money market funds’ “market-based” floating valuations are based on matrix pricing or models (producing estimates) of valuations of the underlying portfolio instruments—a type of fair valuation.<sup>339</sup> In view of the stability of money market fund valuations over time, the only way the SEC could assure that floating NAV funds would in fact fluctuate in price was to adopt a rule requiring pricing at a level ten times more sensitive than that required for all other mutual funds, thereby achieving price fluctuation for the sake of fluctuation—a disruptive and costly change, with no benefit for investors.

The 2014 amendments to the SEC’s money market fund rules contain some beneficial things for investors, including enhanced transparency and enhanced tools for money market fund boards to protect investors in the very rare circumstances where unusually heavy redemptions could pose the threat of dilution to investors or otherwise threaten a money market fund.<sup>340</sup> But the floating NAV provisions, which completely eliminate stable value institutional prime money market funds and stable value institutional tax-exempt funds, come at extraordinarily high costs, with no benefits for investors or the economy. The attempts in the SEC’s Adopting Release to justify the floating NAV provisions may be creative, but they are not credible.

And so we arrive at the conclusion that the SEC’s adoption of the floating NAV provisions of the rules—which are unnecessary and ineffective in addressing run risk—was in substantial part influenced by the changed dynamics

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<sup>339</sup> Adopting Release, *supra* note 1, at 47,813.

<sup>340</sup> *Id.* at 47,736.

brought about by the FSOC's intrusion into the agency's work and the threat of further action by the FSOC against institutions regulated by the SEC. While an agency like the SEC can just say (a reasoned) "no" in response to a Section 120 recommendation by the FSOC, the potential scope of the FSOC's Section 113 authority to designate a nonbank SIFI for regulation by the Federal Reserve looms large. This is particularly the case in light of the history we recount in this Article, when a Treasury Secretary who chaired the FSOC had no apparent hesitation at threatening to throw the book at a regulated industry if its regulator, the SEC, did not act in line with the FSOC's desire to restrict money market funds. To the extent that the SEC may have heard from regulated asset managers as to their preferred poison from the FSOC, we think most would have opted for a money market fund rule targeting a portion of their assets, over the alternative presented to them: the potential for the FSOC to launch a Section 113 proceeding to designate an asset manager as a systemically important nonbank financial company, which would guarantee Federal Reserve regulation over the entirety of its business. But, based on its actions to date, it appears that the FSOC has not bought into this deal.

For institutional investors that need the stable value cash management function provided by money market funds, we have no doubt that asset managers will be able to address their needs through restructured money market funds and other vehicles, although at higher costs and/or lower efficiency. The larger concern, however, is not the particular substance of the SEC's money market fund rule but, as the very thoughtful letter submitted to the FSOC in 2013 by former SEC chairs and commissioners stated, the FSOC's threat to the SEC's bipartisan deliberative processes and independence in rulemaking, and its threat to the SEC's preeminence as the U.S. capital markets regulator. This is not a concern about the SEC's independence for the sake of independence. It is about the threat to an expert agency's decision-making structure, which Congress determined should be bipartisan and collaborative in order to bring the differing views of its members to bear on capital markets



regulation. One cannot disagree with the conclusion that in the debate over money market fund regulation, the FSOC acted to “muscle” an independent agency and circumvent its deliberative processes to force it to act, on the FSOC’s own timetable and in a manner dictated by the FSOC. In this case, there was no emergency that called for circumvention of agency processes. There was only a committed but frustrated agency head who could not assemble a majority of the SEC to act on a measure that other commissioners believed was not ready for prime time, and a bank-dominated and opportunistic uber-regulator, the FSOC, which felt no restraint on its authority.

What does this mean going forward? Will a bank-regulator-dominated FSOC bring a bank-regulatory focus to bear on capital markets regulation, which traditionally has been the province of the SEC? Is that a good thing?

We were encouraged by the actions of SEC Chair White and certain commissioners in calling for a pause in what appeared to be a rush to judgment by the FSOC on the question of whether SEC-regulated asset managers are appropriate for SIFI designation. These actions suggest an SEC aware of its mission and the strength of its regulation, and also aware of its independence and unafraid to assert it for the sake of the agency’s mission. Investors, and the capital market more broadly, can only benefit from this perspective. Still, the SEC has no veto if the FSOC votes to designate one or more SEC-regulated asset managers as a SIFI, subject to Federal Reserve regulation. The FSOC’s complete disregard for its insurance expert’s objections to the SIFI designations of large insurance organizations suggests what the outcome would be, should the SEC disagree with the FSOC’s designation of any SEC-regulated entity.

We take note of the fact that the FSOC itself has acknowledged the need to revise its processes for designating SIFIs, in order to address fairness and transparency concerns. However, this has not arrested concerns raised in Congress and elsewhere about the FSOC’s over-aggressive action and lack of accountability. We observe that a

regulator pushing the envelope too far and too fast risks jeopardizing its very existence.