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## Money Funds at Continued Cross Roads

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**T**o float or not to float? That is the question." This question and many more have been hotly debated since money market reforms were first proposed. While the recent impasse by the Securities and Exchange Commission met with a sigh of relief by many in the mutual funds industry, the "questions" will, at some point, be answered.

As most in the industry are aware, on August 23, 2012, SEC Chairman Mary Schapiro announced that the SEC could not obtain the majority vote necessary to further the proposed money fund reforms. Since this announcement, financial industry and commercial media outlets have continued to frequently report on this topic. The general consensus among the industry is that something will happen. It is only a question of when.

Opponents of the SEC proposals, including the Investment Company Institute (ICI) and many in the investment management industry, assert that while the 2008 financial crisis was an anomaly, some changes are warranted. Consensus appears to be that the SEC regulations as proposed went too far. So what are some of the specifics around those who don't agree with the proposed reforms? Industry groups including the ICI have stated their opposition based on the "adverse consequences of these proposals for investors, issuers and the economy."

On the other side of the coin, advocates, including current and former regulators, feel equally as strong

about enacting the proposed reforms, or something of similar impact, given the potential ramifications to the funds market should there be another significant economic event. Sheila Bair, former head of the Financial Stability Oversight Council, and a supporter of the SEC reform proposals, has gone on record to state her disappointment with the SEC impasse. In addition, former SEC Chairman Arthur Levitt made a similar yet more direct statement, referring to the SEC's lack of a majority vote as "a national disgrace."

### Some Background

The 2008 financial crisis presented financial markets, regulators and the U.S. Government with a rare development – headlined by the Reserve Primary Fund breaking the buck. Combined with an economy in crisis, there was essentially a "run" on prime money funds as a result of investor flight to "quality" and to U.S. Treasury money funds. Unprecedented actions were taken to support money market funds during this time, amounting in over \$2 trillion in support through varied programs of Treasury and the Federal Reserve.

Federal regulators are confronted with the fact that this 2008 "run" on funds reduced the commercial paper holdings of these funds by approximately 30 percent, and effectively froze the short-term credit market. In addition, similar intervention would be unlikely should another economic crisis occur. The money funds industry has a significant role on our overall investment manage-

ment system. Therefore, the resolve of many regulators is undiminished.

So who's looking closely and is positioned to act? In addition to the SEC, there is the Federal Reserve Board and the Financial Stability Oversight Council (FSOC). Title I and Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection ("Dodd-Frank") Act grants these entities the authority to propose and implement regulation or jurisdictional supervision of financial institutions, including money funds. Potential regulatory actions by these agencies have no interdependency on the SEC's recent impasse, but notably, the SEC could still take action.

Let's focus on what the FSOC, the Federal Reserve and the Treasury are considering.

### FSOC Capabilities under the Dodd-Frank Act

The Financial Stability Oversight Council was founded to promote financial market discipline and financial stability that could be at risk based on the activities of large interconnected bank holding companies (BHCs) or nonbank financial companies.

In April 2012, based on Section 113 of the Dodd-Frank Act, the FSOC finalized a proposed rule (12 C.F.R. Part 1310) enabling it to designate nonbank financial companies that are "predominantly engaged in financial activities" as "systemically important financial institutions" (SIFIs) to be placed under Federal Reserve supervision. In the final rule, the FSOC stated their "broad" interpretation



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of a nonbank financial company would include “corporations, limited liability companies, partnerships, business trusts and associations.” Now, the debate is whether or not money funds fall into this category and if they should be designated as SIFIs.

Title VIII of the Dodd-Frank Act enables the FSOC to designate financial market utilities (FMUs) – including financial institutions that conduct payment, clearing and settlement activities – as “systemically important financial institutions” (SIFIs) to be placed under Federal Reserve jurisdiction. To date, the FSOC has flexed this muscle designating eight clearing firms as SIFIs.

Under the Dodd-Frank Act Section 120, the FSOC can recommend that any primary regulatory body (e.g., the SEC) apply “heightened standards” or new rules to the activities of bank holding companies (BHCs) or nonbank financial companies under their jurisdiction, if the financial activities could result in liquidity or credit risk that could adversely impact the stability of the U.S. financial system. No action has been taken, yet.

### Regulatory Capabilities of the Federal Reserve

The Federal Reserve has the authority, based on the Dodd-Frank Act Sections 165 and 166, to establish “prudential standards” for nonbank financial companies and bank holding companies (BHCs) with assets over \$50 billion and for nonbank companies designated by the FSOC. Accordingly, in December 2011, the Federal Reserve issued a proposed rule (“Regulation YY”, 12 C.F.R. Part 252) to address enhanced prudential standards and early remediation requirements. The proposal seeks to strengthen the regulation and



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supervision of large bank holding companies and systemically important nonbank financial firms and includes measures to address the capital, liquidity, credit exposure, stress testing, risk management, and early remediation requirements. The comment period ended April 2012 and nothing has been finalized to date.

The Federal Reserve continues to approach money fund regulation. In a June 2012 speech, Federal Reserve Governor Daniel Tarullo stated that in the absence of SEC action “there are several second-best alternatives” such as supervisors setting new limits on banks’ reliance on funding provided by money market funds.

### The Treasury Speaks Out

On September 27, 2012 Treasury Secretary Timothy Geithner, issued a letter to the FSOC requesting that a formal recommendation for reform options be drafted and issued for comment at the November meeting. Options to be included are those put forth by the SEC, along with impos-

ing capital and enhanced liquidity standards coupled with a “minimum balance at risk” (MBR) requirement. Geithner also stated that the SEC “is best positioned to implement reforms to address the risks that MMFs present to the economy.”

### SEC Commissioner About Face?

In an interview with *Bloomberg News* on September 27, 2012, SEC Commissioner Daniel Gallagher stated that money funds with a fluctuating share price “is an attractive option that I am likely to support.” Further clarifying that his dissenting vote against moving forward with the SEC proposal was based on the capital buffer cushion being too small to protect investors. While it may appear to be an “about face” Gallagher’s actions can also be interpreted as “face time” tactics to stave off further FSOC action based on Dodd -Frank Section 120.

### Conclusion

Given the authority granted to the FSOC and the Federal Reserve by the Dodd-Frank Act, these regulators have been provided with a broad brushstroke to implement financial reform. With the intention of creating a stronger and more stable money market, the impact will most likely be increased oversight, further reporting requirements and more stringent guidelines (e.g., capital buffers, counterparty exposure limits, etc.) designed to reduce potential systemic risk by a nonbank financial company. Despite strong opinions both for and against money fund reform, media reports post-SEC decision share a common thread – the acknowledgement that while the SEC decision may be final, money market reform is not over.