



Money Fund Intelligence

August 2011

Reprinted w/Permission

ISSN 1931-3497

Morgan Lewis' Donohue: Changes Coming Soon

This month, *MFI* interviews **Andrew "Buddy" Donohue**, a Partner at **Morgan Lewis & Bockius** and the former director of the Division of Investment Management at the **U.S. Securities and Exchange Commission (SEC)**. We ask him about the **future of money funds** and **pending regulation**, and discuss **recent developments in money fund oversight**.

MFI: What are your thoughts on the status of possible regulatory changes?

Donohue: As we're thinking about potential changes, **I think it is helpful to understand the history of where we are and how we got here.** I'm not going back to the financial crisis but rather to what has transpired since the financial crisis. In early 2009 the **ICI Working Group** issued its report recommending regulatory reforms to strengthen money market funds.



Buddy Donohue

Then in June of 2009, we had the SEC propose changes to rule 2a-7. In addition to the proposals, the SEC solicited comment on the floating NAV and redemption in kind, recognizing that they hadn't addressed, in their proposal, all of the issues that needed to be addressed. The SEC then adopted 2a-7 in February 2010.

At that time, the Chairman was quite candid in saying that this was but the first step, and that more needed to be done. The PWG report then came out, in October of 2010, and set forth many of the concerns regulators had and some of the alternative means of addressing those concerns. I thought the PWG report was very well balanced, although I have to confess that my

group had a fair amount to do with the drafting of that report.

That report discussed a number of **alternatives for consideration that dealt with the susceptibility of money market funds to runs – the floating NAV; private emergency liquidity facility; mandatory redemption in kind; insurance; two tiers of money market funds; and, the possibility of treating mmfs with the stable NAV as special purpose banks.** There also was recognition of the challenge

[involving] unregulated alternatives to money market funds. [T]here may be a need to do more than to just address 2a-7.

In the PWG report they discuss the susceptibility of MMFs to runs. They attribute it really to a number of different factors – the maturity transformation that funds provide, the stable \$1.00 NAV, credit and interest rate risks, and the discretionary response of capital support. I think the PWG was balanced regarding the benefits and the detriments of the different approaches that they had identified. **I think that the report clearly showed that while the issues were quite important there are no easy answers.** And as I like to tell people, if there was an easy answer the SEC would've already done it.

After the **President's Working Group** report came out, the SEC asked for comments and received a significant number of them. Then, the SEC held a roundtable, [and subsequently] the ICI had a similar roundtable on money market funds. **Then just very recently, last month, the FSOC came out with their annual report to Congress and in their recommendations they highlighted that there was a need for additional reforms to address structural vulnerabilities for money market funds.**

The FSOC report had a particular emphasis on a **mandatory floating NAV, capital buffers to absorb fund losses** to sustain a stable NAV, and **'deterrents to redemption'** paired with capital buffers to mitigate investor runs. So there has been a fair

amount of work done by the regulators and the industry in this area.

Money market funds have also been the focus of attention in the press, particularly as money market fund exposures to the risks of **potential downgrades or defaults in Europe** from sovereign debt have been highlighted, and more recently with regard to our own Government securities. As an aside, it is the high level of transparency around their portfolio holdings provided by money market

funds on a monthly basis in regulatory filings and on their websites which enables this healthy discussion.

Another thing not to lose sight of is that we are approaching the third anniversary of **Lehman**. So I think more is going to happen. **I think the SEC will be making an additional proposal, and I think it'll be sooner rather than later.** I am also concerned that if the SEC does propose further reform other members of FSOC may feel that they may need to act.

MFI: Do you think recent reports have it right, that they're focusing on the floating NAV and buffers?

In response to the PWG report and [SEC] roundtable, it was very interesting [to see] the comments.... There seemed not to be an agreement with regard to what should be done. But there were some new ideas that were floated, many by industry participants, in terms of ways to strengthen money market funds.... [I]f you look across the landscape of the different proposals that came in, you had one proposal that was recommending that the fund itself built up a buffer over time of up to probably about 50 bps to help make the fund itself less susceptible to runs and to credit events and interest rate events.... Another proposal from the industry was that money market funds should be managed by entities that could be special purpose entities with their own capital requirements and access to the federal reserve. Another industry idea

(Morgan Lewis' Donohue from p.1)

that came back was the suggestion that unless you have some capital support for the stable \$1.00 NAV in some form, then you shouldn't have a stable net asset value, you should have a floating NAV.

Another participant proposed that the funds, in times of stress, should impose a redemption fee, to make the fund whole, for the costs of somebody leaving the fund during times of stress, and mandating redemptions in kind at a certain level. There was not widespread agreement, although there seemed to be a fair amount of support for the liquidity bank. From the outside, you had proposals such as the **Squam Lake**, where the proposal was that there should be some form of explicit support for money market funds. If my recollection is correct, Squam had suggested it could be via a subordinated share class, the commitment or dedication of other securities to support the money market fund, or alternatively insurance.

And of course there were some proposals for floating NAV. **What did come through in many of the forums where money market funds were being discussed was that mandating a floating NAV might have significant consequences for the funds, their investors and therefore potentially for the various enterprises that money market funds finance.** And a challenge for a floating NAV funds would also be, 'How do you transition from a stable to a floating NAV money market fund without encouraging everybody to leave before you do that?' However, floating rate NAV money market funds could, I believe, be encouraged by the regulators as an alternative to stable \$1.00 NAV money market funds.

MFI: *What do you expect to see? What would you like to see?*

Actually what I expect to see is not that far different from what I would like to see. I think one proposal, and there could be multiple proposals that the Commission

comes out with, but here is the proposal that I think has legs and one that I think would be beneficial. **First, limit the ownership of shares of money market fund by an individual or its affiliates to less than 5%.** You then have a decreased risk that an investor deciding to pull money from a money market fund can have a harmful effect on other shareholders.

Second, **require greater transparency from omnibus and similar accounts**, enabling the money market fund to better evaluate liquidity and other needs. If omnibus accounts don't provide that transparency then the omnibus account itself will be subject themselves to the 5% limit. We've heard that from several of the money market fund providers that if they're not going to have to maintain liquidity in excess to what they probably really need, they need greater transparency into who the beneficial owners are of their funds.

Third, **require money market funds which desire to maintain a stable \$1.00 NAV to have two classes of shares.** This is an idea I have been interested in for quite a period of time. I'll give you a concept that I think works, which is that you have income shares, and those would be your traditional money market fund shares that are now provided to investors and they would continue to have a stable NAV of \$1. Then you'd have capital shares. These would be sold to the investment advisor, and would constitute a certain percentage of the fund.

The fund itself would be mark-to-market, so you wouldn't have the criticism that the total fund is not subject to the discipline that regime imposes on financial institutions. The proposal would enable the investment advisor to actually recoup capital that's committed to the fund to support the \$1.00 NAV. During the crisis there considerable capital used to support money market funds, and the adviser (or an affiliate) would have to just write checks and had no ability to recoup it. With this new approach, if you're a

capital share owner over time you have the opportunity to take capital gains and recoup some of your losses.

So that is one of the ideas, I think, that is out there. It's similar, in part, to the Squam Lake proposal, although if I recall correctly they didn't necessary have the manger having to own the shares. I thought the manager owning the shares is actually the best way to go.... It aligns the manager's interest with regards to how much risk they are willing to take for the fund. It limits the growth of the fund to the manager's capabilities of supporting it.... It has the capital support for the stable \$1.00 NAV inside the fund, so you don't have to rely on anything or anybody outside of the fund make the fund income share owners whole. It happens automatically. I think it has a lot to argue for and of course if somebody doesn't want to do that, they can provide a floating net asset value fund for investors.

It addresses many of the concerns raised about stable NAV. It will enable money market fund investors to know how much support the fund has from the adviser, making the implicit support explicit. It significantly reduces the likelihood that a money market fund will "break the buck". It lessens the incentive for income investors to flee the fund, as there is a level of support for the investor shares provided by the capital shares and the adviser has a disincentive to allow hot money in the fund.

Something we all should be mindful about when evaluating the buffer proposal is that if the buffer is too great it's probably not economically feasible, and if it is too small it is probably more dangerous than not having any buffer. It may be providing a false level of security to investors and regulators. **As I have indicated previously, I don't think there are any easy answers here but it is important that we address the issues in a manner that works, that is economical and that preserves the benefits that money market funds have provided to investors, issuers and the capital markets.** ♦