SHOULD MONEY MARKET FUNDS BE DESIGNATED AS "SIFIS"?

ERIC D. ROITER*

More than three years after the financial meltdown of 2008, regulators are poised to put in place an early warning system to identify nonbank financial firms among whose number might be the next Lehman Brothers or Bear Stearns. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act")[1] entrusts this daunting task[2] to a new inter-agency body, the Financial Stability Oversight Council ("FSOC"),[3] chaired by the Secretary of the Treasury and joined by the heads of eight other federal financial regulators.[4] Further, the Act directs the Federal Reserve Board

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* Lecturer in Law, Boston University School of Law.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

[2] No less an authority than Federal Reserve Chairman Ben S. Bernanke struggled to explain how to uncover systemic risk *ex ante* when testifying before the Financial Crisis Inquiry Commission in September 2010:

> There's right now an active academic research literature looking at some of these things, trying to identify, for example, what some of the criteria are; how big; how interconnected, those sorts of things. . . . [T]o some extent it is going to ultimately remain subjective, and I think the systemic criticality of any individual firm depends on the environment. So our decisions vis-a-vis some of the firms we addressed might have been different in a more calm environment.

Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis Before the Fin. Crisis Inquiry Comm'n, 111th Cong. 100-01 (2010) (testimony of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.).

[3] *See* Dodd-Frank Act § 111(a) (to be codified at 12 U.S.C. § 5321(a)) (establishing a Financial Stability Oversight Council).

[4] Other voting members of FSOC are the heads of the three federal banking regulators (the Chairman of the Federal Reserve System, the Comptroller of the Currency, and the Chairman of the Federal Deposit Insurance Corporation), the Director of the newly-formed Bureau of Consumer Financial Protection (an independent bureau within the Federal Reserve System), the Director of the Federal Housing Finance Agency and the respective chairmen of the Securities and Exchange Commission,

("Fed") to supervise these nonbank firms by imposing a raft of bank-like rules on them, rules that have had rather mixed results in stabilizing our banking system.[5]

The FSOC and the Fed have proceeded with all deliberate speed, each proposing rules to deal with presumably risky nonbank financial firms inhabiting the "shadow banking system," the disparaging term used by commercial banks and their regulators when referring to companies who are not banks but compete with them in our capital markets.[6] In the meantime, those markets have thus far dodged some bullets, most notably, the deepening Eurozone sovereign debt crisis and the blow-up of MF Global, a hyper-leveraged commodities and securities firm that bet the house (and, it appears, customers' money) on Spanish and Italian bonds.

While the FSOC and the Fed have yet to completely meet their legislative mandate, the only agency that has put in place significant changes to its rules in the wake of the 2008 crisis is the Securities and Exchange Commission ("SEC"), the primary federal regulator of our capital markets. The SEC's rules impose new liquidity standards on money market funds, standards far surpassing any that commercial banks must meet.[7] In other ways, the SEC's

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Commodity Futures Trading Commission and National Credit Union Administration. *Id.* § 111(b)(1)(A)-(I). The tenth member, appointed by the President and subject to Senate confirmation, is to be an independent member having insurance expertise. *Id.* § 111(b)(1)(J). The FSOC also includes five non-voting members: the directors of the Office of Financial Research and the Federal Insurance Office (each established under the Act and housed within the Treasury Department), a State insurance commissioner, a State banking supervisor, and a State securities commissioner. *Id.* § 111(b)(2)(A)-(E).

[5] Going back to January 2008 (when the collapse of the subprime mortgage market was well underway) through 2011, more than four hundred banks have failed, notwithstanding the unprecedented level of capital investment and financial assistance provided by the federal government. Letter from John D. Hawke, Jr., Partner, Arnold & Porter LLP, to the Financial Stability Oversight Council 13-14 (Dec. 15, 2011), *available at* http://www.regulations.gov/#!document Detail;D=FSOC-2011-0001-0053.

[6] *See* ZOLTAN POZSAR ET AL., FED. RESERVE BANK OF N.Y., STAFF REPORT NO. 458, SHADOW BANKING 1-7 (2010) (summarizing the importance of shadow banks, their role in the financial crisis, and possible solutions for future regulation).

[7] Money market funds must allocate at least ten percent of their portfolios to cash , U.S. Government direct obligations and other specified "daily liquid assets," and at least 30% of their portfolios to assets that can readily

rules dramatically tighten limits under which money market funds must operate. The SEC's initiative responds not to insolvency of any money market fund or failure to pay off any debt arising during the 2008 crisis or its aftermath. Rather, one money market fund, the Reserve Primary Fund, lost about 1% of its equity value as a consequence of holding one unfortunate investment: commercial paper of Lehman Brothers. No creditor of the fund lost a dime because a loss meant that the fund could no longer price its shares at $1 each when it was liquidated. Fund shareholders wound up getting back about 99 cents on the dollar once the fund's liquidation proceeding was finished.[8]

Yet, money market funds remain among the "usual suspects" in the FSOC's pending rulemaking. This article contends that inclusion of money market funds among firms deemed systemically risky is misguided. Further, deputizing the Fed as a second regulator of money market funds is not only unnecessary, but also potentially disruptive to a cogent and effective regulatory regime overseen by the SEC. These outcomes are not preordained. The FSOC should remove money market funds from the lineup of systemic risk suspects. If it fails to do so, the Fed can, and should, find ways under the Dodd-Frank Act to avoid subjecting money market funds to ill-fitting banking rules that are, at once, both inapt and counterproductive.

This article reviews the basic structure of money market funds and then describes key provisions of the Dodd-Frank Act that apply to firms seen to pose systemic risk. It next takes up why major elements of the rulemaking process are ill-conceived for money market funds because they mischaracterize the essential nature of the funds and the claims held by fund shareholders. Finally, the article explains how the Fed can and should defer to the SEC, even if the FSOC mistakenly designates one or more money market funds as systemically risky.

This article contends that the basic premise underlying systemic risk is missing when it comes to money market funds. The premise is that systemic risk arises when large financial firms have

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be converted to cash within one week. *See* 17 C.F.R. § 240.2a-7(c)(5)(ii)-(iii) (2010).

[8] Fund Update, Reserve Primary Fund, Additional Information Regarding the Primary Fund-In Liquidation (July 29, 2011), *available at* http://www.primary-yieldplus-inliquidation.com/pdf/FundUpdate-July2011.pdf.

too little liquidity and too much leverage, too little capital and too much debt. This certainly describes bank-sponsored (and off-balance sheet) structured investment vehicles that precariously financed their long-term investments (mortgage-backed securities and collateralized debt obligations) with short-term debt (commercial paper and repurchase agreements) before cratering in 2007, investment banks that collapsed or teetered on the brink in the 2008 crisis, and commercial banks that were rescued by massive injections of taxpayer-supplied capital. But it hardly describes money market funds, which carry virtually no debt and virtually all capital.

I. Money Market Funds as Pools of Capital

Money market funds essentially are no different than any other mutual fund. They are vehicles by which investors pool their money to invest collectively in securities, and share profits, losses and expenses in accordance with their proportionate ownership interests in the pool.[9] The fund contracts with an investment adviser to obtain investment management services, and with other third parties (often affiliates of the adviser) to obtain ancillary services, such as accounting and recordkeeping, maintaining shareholder accounts and custody of fund assets.[10] Investors' ownership interests in the fund are represented by shares of common stock; the greater number of shares owned by an investor, the greater his or her proportionate ownership interest in the fund.[11]

Investors in money market funds, just like investors in any other mutual fund, are not guaranteed any particular rate of return. Indeed, they are not promised any return and are not guaranteed against loss. This follows from the nature of the claims they hold in respect to their shares. Their claims are equity claims, not debt claims. Like all mutual funds, money market funds do not "borrow" from shareholders when issuing shares, but instead receive capital contributions.[12]

Because fund investors are equity claimants, it is virtually impossible for any mutual fund, including any money market fund,

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[9] Jill Fisch & Eric D. Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy?*, 2012 U. ILL. L. REV. (forthcoming Spring 2012) (manuscript at 3), *available at* http://lsr.nellco.org/upenn_wps/390/.
[10] *Id.* (manuscript at 4).
[11] *Id.* (manuscript at 5).
[12] *Id.* (manuscript at 13).

to become bankrupt or insolvent. Indeed, money market funds, in particular, have very few debts or liabilities of any sort. Consider, for example, the T. Rowe Price Prime Reserve Fund ("T. Rowe Money Market Fund")[13] is a money market fund investing in commercial paper and other short-term debt obligations of highly creditworthy corporations, banks and municipalities. At the end of its most recent fiscal year, the fund had total assets (consisting almost entirely of portfolio investments) of roughly $5.470 billion and liabilities of only about $35 million. Its shareholders' equity (that is, net assets) was $5.435 billion.[14] If leverage is synonymous with risk, how much "leverage" did the T. Rowe Money Market Fund have at year-end? Virtually none. Measuring leverage as the ratio of equity to total assets, the fund's leverage ratio at year-end was 99.36%. Stated otherwise, for every $100 of assets, the fund had $99.36 of equity.[15]

How does this compare to banks' leverage? Under the capital adequacy rules, FDIC-insured banks, in general, are required to maintain a leverage ratio of merely four percent. So, for every $100 dollars of assets, a bank is allowed to have as little as $4 of equity.[16]

Why then are money market funds even in the discussion about systemic risk? It starts with fund shareholders' right of redemption, a right that is not typically held by corporate shareholders. In short, all mutual fund shareholders, including shareholders of money market funds, have a right to sell back some or all of their shares to the fund at the time of their choosing. A redeeming shareholder, even a money market fund shareholder, has

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[13] This fund should not be confused with the Reserve Primary Fund, which was managed by an investment adviser not affiliated with T. Rowe Price and which "broke the buck" in 2008.

[14] The precise figures were total assets of $5,470,107,000, total liabilities of $35,022,000, and shareholders' equity of $5,435,085,000. T. ROWE PRICE, T. ROWE PRICE PRIME RESERVE FUND: ANNUAL REPORT 26 (2011), *available at* http://individual.troweprice.com/gcFiles/pdf/arprf.pdf. The fund's liabilities consisted, in part, of management fees owed to its investment adviser at year end (fees typically paid monthly) and payments due on the purchase of securities for its investment portfolio. *Id.*

[15] It follows that the T. Rowe Money Market Fund, for every $100 of assets, carried debt of only 64 cents.

[16] Stated otherwise, a bank, for every $100 of assets, may carry debt of up to $96. Banks must also meet "risk-based" capital requirements, which are designed to take into account the degree of risk represented by different types of assets. *See generally* Risk-Based Capital Guidelines, 12 C.F.R. pt. 3 app. A § 1(a) (2010).

no right to receive from the fund an amount that equals his or her purchase price or, for that matter, any predetermined amount. Rather, because the redemption right represents an equity, rather than debt, claim, what a shareholder is entitled to receive is simply an amount that reflects the proportionate ownership interest that is being redeemed.[17] A shareholder redeeming one percent of a fund's outstanding shares is entitled to receive payment valued at one percent of the fund's net assets.

Shares of stock and bond funds change in value from day to day, reflecting the change in value of their investment portfolios. Accordingly, investors buying or redeeming shares in those funds will buy or redeem at different prices from day to day, based on the ever changing net asset values ("NAV") of those funds. How is it that a money market fund's shares are priced at $1 per share NAV day in and day out? Surely, this must be an arbitrary and artificial price, divorced from the "true" market value of a money market fund's portfolio. The answer is (and has been for more than forty years), absolutely not. The SEC's rules do not permit money market funds to attach an arbitrary or "fixed" $1 per share value to their shares, either in sales or redemptions.

In contrast to stock and bond funds, money market funds purchase their investments (short-term debt such as commercial paper, bank CDs and U.S. Treasury bills) with the expectation of holding them to maturity. Money market funds must meet stringent conditions, prescribed by SEC rules, relating to credit quality, diversification, short-term average maturity and liquidity of their investments.[18] Because short-term debt investments are invariably held to maturity, money market funds use amortized cost accounting in valuing their holdings. A short-term debt instrument when first acquired by a fund is given a value equal to its purchase price, which reflects a discount from the face amount to be paid upon maturity. For example, suppose a commercial paper note has a face amount (par) of $100, payable in thirty days. A fund will acquire the note at a

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[17] Shares of mutual funds (including money market funds) are "redeemable securities," meaning that a fund must pay a redeeming shareholder "approximately his proportionate share of the issuer's current net assets or the cash equivalent thereof." 15 U.S.C. § 80a-2(a)(32) (2006). Note that the fund can meet its obligation by paying redemption "in kind," that is, by actually delivering a slice of the fund's investment portfolio to the shareholder. *Id.*

[18] *See generally* 17 C.F.R. § 270.2a-7 (2010).

discount from face value, paying, perhaps $99. The $1 difference represents imputed interest, and under amortized cost accounting, in this example, 3.3 cents (one-thirtieth of $1) is added to the book value of the note each day until it matures. Money market funds can thus maintain their NAV at $1 per share because their debt investments are held to maturity and increase in value in a straight line fashion.

But money market funds cannot use historic cost accounting unless it also reflects a very close approximation of the market value of the fund's holdings – that is, the value of the fund's investment holdings if they were to be sold into the market. More specifically, the deviation between historic cost and market value of a money market fund's portfolio, under the SEC's rules, cannot exceed more than one-half of one percent without triggering consequences.[19] In other words, the market value of a money market fund's portfolio must be at least 99.5 cents per share. If the market value drops lower, even by one-tenth of one cent, the fund has "broken the buck," and likely will be placed in liquidation. In short, money market funds are like all other mutual funds in that they are permitted a very minor degree of rounding in calculating their net asset value per share. Money market funds have achieved remarkable success over forty years in maintaining portfolios that meet the SEC's valuation requirements.[20] A money market fund's $1 NAV per share is therefore "stable" but not "fixed."

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[19] *Id.* § 270.2a-7(c)(8)(ii)(B).

[20] *See* Fisch & Roiter, *supra* note 9 (manuscript at 30) ("[A] a representative group of taxable MMFs (accounting for 27% of all assets of MMFs in this category) [from January 2000 to April 2010] maintained portfolios whose mark-to-market values typically deviated within [a] narrow range of one-tenth of 1%, with occasional deviations of only two-tenths of 1%.") (citing INV. CO. INST., ICI RESEARCH REPORT: PRICING OF U.S. MONEY MARKET FUNDS 26 (2011), *available at* http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf).

II. The Dodd-Frank Act's Grand Design

Because money market funds are pools of capital and carry virtually no debt, and because their shares are closely tied to the market value of their portfolios, why has the Congressional response to the 2008 meltdown not drawn a sharp distinction between them and the coterie of highly leveraged firms, including hedge funds, broker-dealers and finance companies, that are the subject of potential regulation as SIFIs? The answer, of course, is that Congress would much rather err on the side of over rather than under-inclusion, and would much prefer to delegate the messy drawing of lines to the regulators.

So, just as the Great World War was the war to end all wars, the Dodd-Frank Act is the legislative enactment to end all financial meltdowns or, at least, all bailouts.[21] The FSOC, with the affirmative vote of at least two-thirds of its members,[22] must identify nonbank financial firms[23] that pose systemic risk or, as they have come to be called, "SIFIs." [24] Reflecting the mutable character of systemic risk,

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[21] Upon signing the Dodd-Frank Act, President Obama proclaimed, "Because of this reform, the American people will never again be asked to foot the bill for Wall Street's mistakes. There will be no more taxpayer-funded bailouts -- period." President Barack Obama, Remarks by the President on the Passage of Financial Regulatory Reform (July 15, 2010) (transcript available at http://www.whitehouse.gov/the-press-office/remarks-president-passage-financial-regulatory-reform).

[22] Dodd-Frank Act, Pub. L. 111-203, § 113(a)(1), 124 Stat. 1376, 1398 (2010) (to be codified at 12 U.S.C. § 5323(a)(1)). The Secretary of the Treasury must be among those voting in the affirmative. *Id.*

[23] The Dodd-Frank Act's sweep includes U.S. and foreign nonbank financial firms. A U.S. nonbank financial firm is any U.S. company "predominantly engaged in financial activities," a status reached when a company derives at least eighty-five percent of its annual consolidated gross revenues from financial activities or holds at least eighty-five percent of its consolidated assets in the form of financial assets. *Id.* §§ 102(a)(4)(B), (a)(6) (to be codified at 12 U.S.C. §§ 5311(a)(4)(B), 5311(a)(6)). A similar test of "financialness" applies to foreign nonbank financial companies with operations in the U.S. *Id.* §§ 102 (a)(4)(A), (a)(6) (to be codified at 12 U.S.C. §§ 5311(a)(4)(A), 5311(a)(6)).

[24] "SIFI" is an acronym for "systemically important financial institutions," although this term appears nowhere in the Act. The Act, instead, employs the anodyne phrase, "nonbank financial companies supervised by the Board of Governors [of the Federal Reserve System]." *Id.* § 115(a)(1) (to be

the Act offers no definition but rather describes the FSOC's mission: FSOC must identify nonbank financial firms that might experience "material financial distress" or pose a threat to the financial stability of the U.S. by virtue of their "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities."[25] The Act lists, beyond "material financial distress," ten factors for the FSOC to consider. Four look to a firm's balance sheet: (i) leverage, (ii) off-balance sheet exposures, (iii) amount and nature of financial assets, and (iv) amount and types of liabilities (including short-term funding).[26] A fifth looks to inter-connectedness ("the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies").[27] Two factors weigh against a finding of systemic risk: "the extent to which assets are managed rather than owned" by a financial firm[28] and the degree to which a firm is "already regulated by 1 or more primary financial regulatory agencies."[29] For good measure, the Act allows the FSOC to consider "any other risk-related factors" that it considers appropriate.[30] Finally, two factors seem concerned more with promoting access to credit than preventing systemic risk.[31]

How is any money market fund, or for that matter any hedge fund, private equity fund, finance company, insurance company, broker-dealer, swaps dealer or other player in the suspect shadow banking system, to know whether it will be deemed a SIFI and thus regulated as a quasi-bank by the Fed? The FSOC has struggled to

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codified at 12 U.S.C. § 5325(a)(1)). For ease of reference, these firms will be referred to as SIFIs.

[25] *Id.* §113(a)(1) (to be codified at 12 U.S.C. § 5323(a)(1)).

[26] *Id.* §§ 113(a)(2)(A)-(B), (I)-(J) (to be codified at 12 U.S.C. §§ 5323(a)(2)(A)-(B), (I)-(J)).

[27] *Id.* § 113(a)(2)(C) (to be codified at 12 U.S.C. § 5323(a)(2)(C)).

[28] *Id.* § 113(a)(2)(F) (to be codified at 12 U.S.C. § 5323(a)(2)(F)).

[29] *Id.* § 113(a)(2)(H) (to be codified at 12 U.S.C. § 5323(a)(2)(H)).

[30] *Id.* § 113(a)(2)(K) (to be codified at 12 U.S.C. § 5323(a)(2)(K)). Another factor merely repeats an earlier formulation ("nature, scope, size, scale, concentration, interconnectedness, and mix of . . . activities"). *Id.* § 113(a)(2)(G) (to be codified at 12 U.S.C. § 5323(a)(2)(G)).

[31] These are (i) the importance of a firm as a source of credit for households, businesses, and state and local governments, and (ii) the importance of a firm as a source of credit for low-income, minority or underserved communities. *Id.* §§ 113(a)(2)(D)-(E) (to be codified at 12 U.S.C. §§ 5323(a)(2)(D)-(E)).

provide answers. Its first attempt took the form of an "advance notice of proposed rulemaking" in late 2010 seeking public comment on what quantitative measures might apply, and how statutory terms might be elaborated, including "material financial distress," "financial stability," and the systemic risk factors set forth in the statute.[32] The FSOC then proposed the contours of a rule in January 2011 that by and large paraphrased the operative statutory criteria, failing to set forth any quantitative metrics that might govern the process of SIFI designation ("January Proposal").[33] The January Proposal suggested that the FSOC would look to six criteria when considering whether a nonbank financial company poses systemic risk. All derive explicitly from the Dodd-Frank Act: interconnectedness, size, leverage, liquidity risk, the existing authority of a separate financial regulatory agency, and "substitutability."[34] The last factor considers whether market participants can readily turn to other providers of financial services if a particular nonbank company becomes distressed or fails.[35]

Finally, in October 2011, the FSOC came out with a revised proposal that contains quantitative measures,[36] and, in the process, answered some questions and raised others. The FSOC imports into its proposed rule the six criteria drawn from the statute and announced in its earlier proposal.[37] The FSOC goes on to suggest a

[32] Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653, 61,655 (proposed Oct. 6, 2010) (to be codified at 12 C.F.R. ch. 13).
[33] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4555 (proposed Jan. 26, 2011) (to be codified at 12 C.F.R. pt. 1310).
[34] *Id*. at 4560.
[35] In the FSOC's view, these six criteria essentially restate (and condense) the ten factors contained in the statute. *Id*. For example, the FSOC asserts that three of its criteria (size, interconnectedness and lack of substitutes) subsume the statutory factor relating to "the extent to which assets are managed rather than owned by the company." *Id*. This certainly is not self-evident, as the statutory factor quite clearly appears intended to militate *against* SIFI status rather than for it.
[36] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64,264, 64,280 (proposed Oct. 18, 2011) (to be codified at 12 C.F.R. pt. 1310).
[37] The FSOC explains that three factors deal with whether a firm would have a major impact on the financial markets if it were to encounter

three-stage winnowing process. The first stage asks, essentially, is a firm big enough to care about? There is more than one measure of bigness, but the starting point is whether consolidated assets exceed $50 billion. This is simple enough for, say, a stand-alone insurance company. But what about a money market fund that is but one of many mutual funds managed by the same investment adviser? The FSOC indicates that the $50 billion threshold can be reached by adding up the assets of some or all of the money market funds (and other mutual funds) that happen to be managed by the same investment adviser, so long as "their investments are identical or highly similar."[38] The FSOC provides no further guidance on this critical question.

Money market funds are subject, under SEC rules, to strict standards relating to diversification, credit quality and average maturity. But in terms of types of money market funds, there are essentially only four—those whose portfolios hold (1) only securities issued or guaranteed by the U.S. government, (2) only tax-exempt municipal securities, (3) only commercial paper and other short-term debt of highly creditworthy corporations and other private sector issuers or (4) a mix of U.S. government and corporate short-term debt. Does this suggest that a large fund complex with a number of legally separate money market funds investing, say, in investment grade corporate debt will be treated as a single entity for purposes of the $50 billion threshold? Or, will the FSOC try to identify the extent to which two or more sister money market funds happen to hold short-term debt of the same corporate issuers? If the former, this suggests that consolidation will be the norm, at least for funds falling within any one of the four categories. If the latter, this would be a rapidly moving target at which the FSOC would take aim, as SEC rules require that money market funds hold short-term debt with an average maturity of no greater than sixty days.[39]

However the $50 billion threshold is computed, it is a necessary but not sufficient condition. The FSOC, in the first stage, would consider whether any one of five other thresholds is crossed. These relate to credit default swaps outstanding, derivative liabilities, loans and bonds outstanding, leverage ratio and short-term debt

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financial distress (size, substitutability and interconnectedness), and three deal with whether a firm is vulnerable to financial distress (leverage, liquidity risk and existing regulatory authority). *Id.* at 64,268.

[38] *Id*. at 64,281 n.12.

[39] 17 C.F.R. § 270.2a-7(c)(2)(ii) (2010).

ratio.[40] How could any of these possibly ensnare any money market fund? The answer is: only by ignoring the nature of money market funds and their capital structure. Money market funds, like all mutual funds, are investment pools. Those who invest in them hold equity claims, proportionate ownership interests in the investment pool.[41]

Treating money market funds as potential SIFIs posing systemic risk would thus distort the essential character of money market funds, treating equity as debt and shareholders as creditors—precisely the wrong direction to take. This is why none of the FSOC's five "first stage" thresholds can properly apply to money market funds. These funds have no bonds and exceedingly little or no loans outstanding,[42] essentially no leverage and hence little debt (other than accrued management fees and other expenses). Some money market funds might engage, to a limited extent, in derivatives (chiefly for hedging purposes), but these funds are not sellers of credit default swaps. As earlier explained, it is therefore simply incorrect to view a money market fund's shares as "debt." A redeeming money market fund shareholder, like any other mutual fund shareholder, has an equity claim, a right to receive an amount approximately equal to his or her proportionate ownership of the fund's net assets, not total assets. This proportionate interest might well be $1 per share or, as shareholders of the Reserve Primary Fund

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[40] The metrics that apply to these triggers are as follows: (1) credit default swaps (at least $30 billion for which the nonbank company is the "reference entity," a status that *excludes* the company as a contractual party to the swap), (2) derivative liabilities (at least $3.5 billion on a net basis), (3) loans and bonds outstanding (at least $20 billion), and (4) leverage ratio (a minimum leverage ratio of consolidated assets to equity of fifteen to one). Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. at 64,281-82.

[41] Fisch & Roiter, *supra* note 9 (manuscript at 3, 5).

[42] Section 18(f) of the Investment Company Act of 1940 places stringent limits on borrowing by mutual funds, including money market funds. *See generally* Investment Company Act of 1940 § 18(f), 15 U.S.C. § 80a-18(f)(1) (2006). These funds can borrow only from a bank and, in so doing, must have total assets with a value of at least three hundred percent of its total bank loans. *Id.* Stated otherwise, because mutual funds have exceedingly few other liabilities (essentially management fees and amounts owed on pending redemptions), a money market fund, immediately after obtaining a bank loan, must, in effect, have $2 of equity for every $1 of bank borrowing. In practice, money market funds engage in very little borrowing from banks.

learned, something less than that. But if a money market fund pays out, say 99 or 98 cents per share, the fund has not defaulted on any debt nor breached any contractual payment obligation.

For this reason, no money market fund should, under normal circumstances, proceed beyond the first stage of the FSOC's proposed winnowing process—unless, of course, the FSOC decides, in an individual case, to chart a new course. And the FSOC, in its proposal, has reserved for itself this discretion.[43] For the time being, then, money market funds face considerable uncertainty over whether the FSOC will designate any of them as SIFIs.

III. The Fed's "Enhanced Supervision" of SIFIs

Dodd-Frank's second step enlists our nation's central bank, the Fed, to carry out "enhanced supervision" of nonbank financial firms designated as SIFIs, and instructs the Fed to impose standards on SIFIs that are "more stringent" than those imposed on financial firms not designated as SIFIs.[44] In doing so, the Fed is to draw upon an expanded arsenal of rules and standards *designed for banks and bank holding companies*. Some of these the Fed must apply to SIFIs; others are left to the Fed's discretion. As to the former, the Fed is directed to impose on SIFIs (1) risk-based capital requirements, (2) leverage limits, (3) liquidity requirements, (4) overall risk management requirements, (5) resolution plan and credit exposure report requirements and (6) concentration limits.[45] In addition, the Fed may impose (1) a contingent capital requirement, (2) enhanced

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[43] *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. at 64,282 ("[B]ecause the uniform quantitative thresholds may not capture all of the potential ways in which a nonbank financial company could pose a threat to financial stability, the [FSOC] may, in limited cases, initially evaluate nonbank financial companies in Stage 1 based on other firm-specific qualitative or quantitative factors, such as substitutability and existing regulatory scrutiny.").

[44] *See* Dodd-Frank Act, Pub. L. 111-203, § 165(a)(1), 124 Stat. 1376, 1423 (2010) (to be codified at 12 U.S.C. § 5365(a)(1)) (requiring that the Fed establish rules for enhanced supervision that are "more stringent than the standards and requirements applicable to nonbank financial companies . . . that do not present similar risks to the financial stability of the United States").

[45] *Id*. § 165(b)(1)(A) (to be codified at 12 U.S.C. § 5365(b)(1)(A)).

public disclosure rules, (3) limits on short-term debt and (4) any other prudential standard it deems appropriate.[46]

The Fed, however, is given discretion in how, and to what extent, it exercises its enhanced supervisory authority. Importantly, the Fed, in consultation with the FSOC, may decide to refrain from imposing risk-based capital requirements and leverage limits, upon determining that these requirements "are not appropriate for a company subject to more stringent prudential standards because of the activities of such company (such as investment company activities or assets under management) or structure, in which case, the [Fed] shall apply other standards that result in similarly stringent risk controls."[47] As we have seen, money market funds are subject to *far more stringent* limits on leverage than banks, for which the risk-based capital and leverage limits were designed.[48] If, as a formal matter, the Fed must do something to comply with this statutory requirement, it could simply incorporate by reference the leverage limits placed on money market funds under the Investment Company Act and the provisions of Rule 2a-7.

Further, and more broadly, the Dodd-Frank Act empowers the Fed to alter the terms of *any* of the enhanced prudential standards for a SIFI, by taking into account factors such as extent of leverage, extent of off-balance sheet exposures, the degree to which the company is supervised by a different primary regulator, and the amount and types of liabilities of the company.[49] All of these factors strongly militate against imposing bank-like regulation upon money market funds, which are comprehensively supervised by the SEC. The Act makes this especially clear by empowering the Fed to take into account "any predominant line of business of [a] company, including assets under management or other activities *for which particular standards may not be appropriate*."[50]

In light of this discretion, the Fed should refrain from imposing a superfluous layer of regulation on money market funds. A superior approach would be to adopt rules that reserve the right to require money market funds to provide information and reports to the Fed, particularly during turbulent financial market conditions. The

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[46] *Id*. § 165(b)(1)(B) (to be codified at 12 U.S.C. § 5365(b)(1)(B)).
[47] *Id.* § 165(b)(1)(A)(i) (to be codified at 12 U.S.C. § 5365(b)(1)(A)(i)).
[48] *Supra* note 42 and accompanying text.
[49] Dodd-Frank Act § 165(b)(3) (to be codified at 12 U.S.C. § 5365(b)(3)).
[50] *Id.* § 165(b)(3)(D) (emphasis added) (to be codified at 12 U.S.C. § 5365(b)(3)(D)).

Fed could better allocate its time and resources overseeing other types of SIFIs that have no primary federal regulator and, with respect to money market funds, consulting with—and deferring to—its fellow FSOC member, the SEC.