



# BANKING LEGISLATION & POLICY

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## HIGHLIGHTS

This issue contains detailed information on the following:

- [SEC Approves Rule Allowing Money Market Fund Share Prices to Float](#), including:
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- [Federal Reserve, FDIC Demand That 11 Large Banks Must Take Meaningful Action on Their Resolution Plans](#), including:
  - [Timeline of Living Wills Submitted by First-Wave Companies](#)
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- [Federal Reserve, FDIC Release Additional Guidance for Smaller Banks Filing Second Resolution Plans](#)

In addition, it summarizes [other notable legislative, regulatory, and judicial developments that occurred during the third quarter of 2014](#).

### SEC Approves Rule Allowing Money Market Fund Share Prices to Float

On July 23, 2014, the Securities and Exchange Commission (SEC) voted 3–2 to approve a [new rule](#) that would require institutional nongovernmental money market fund share prices to float from their original \$1.00 constant share price. Amending the rules that govern money market funds under the Investment Company Act of 1940, the final rule is designed to address money market funds' susceptibility to heavy redemptions in times of

stress.<sup>1</sup> In addition, the final rule seeks to improve their ability to manage and mitigate potential

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<sup>1</sup> Money market funds, also called money market mutual funds or money funds, are a type of mutual fund registered by the SEC under the Investment Company Act of 1940 and governed pursuant to rule 2a-7 under that act. These funds typically pay dividends that reflect prevailing short-term interest rates, are redeemable on demand, and seek to maintain a stable net asset value of usually \$1.00 per share.

contagion from such redemptions as well as increase the transparency of their risks.

### ***Recent Background of Money Market Funds***

The new rule comes in the wake of the recent financial crisis of 2007–2009. On September 16, 2008, the day after Lehman Brothers Holdings Inc. announced its bankruptcy, the Reserve Fund announced that its Primary Fund would “break the buck” and price its securities at \$0.97 per share instead of \$1.00 per share. Even though the Reserve Primary Fund held only 1.2 percent of its assets in Lehman Brothers commercial paper, when combined with turbulence in the market for financial sector securities and investors’ fears of losing their money, investors withdrew so much money from the Reserve Primary Fund that it had to lower its share price to meet the high demand. This action threatened a run on other money market funds and a freeze in the market for commercial paper.

Therefore, the U.S. Department of the Treasury announced a temporary guarantee program that money market funds had the option to join. Similar to how the FDIC insures deposits in banks, the Treasury Department would allow money market funds access to the assets of its Exchange Stabilization Fund for a fee. That way, if a participating money market fund was about to “break the buck,” the Treasury could provide that fund with enough liquidity to maintain its constant price of \$1.00 per share.

To prevent this type of crisis in the future, the SEC adopted a number of [amendments](#) to rule 2a-7 of the Investment Company Act of 1940 that were designed to make money market funds more resilient by reducing the interest rate, credit, and liquidity risks of fund asset portfolios. These amendments included features such as requiring money market funds to maintain liquidity buffers and decreasing the maximum weighted average

maturities of fund portfolios from 90 to 60 days. However, after further study, the SEC determined that additional regulation was needed to prevent runs on money market funds and approved this new final rule in response to those concerns.

### ***Liquidity Fees and Redemption Gates***

The new amendments enable money market funds to impose liquidity fees and redemption gates in times of stress to stem heavy redemptions from investors. As a result, a money market fund may impose a liquidity fee of up to 2 percent or temporarily suspend redemptions for up to 10 business days in a 90-day period if a fund’s weekly liquid assets fall below 30 percent of its total assets and the fund’s directors approve of such a decision.<sup>2</sup> In addition, a money market fund will be required to impose a liquidity fee of up to 1 percent on all redemptions if its weekly liquid assets fall below 10 percent of its total assets, unless the fund’s directors do not believe such a fee is in the best interests of the fund.

Only government money market funds, or money market funds that invest at least 99.5 percent of their total assets in cash, government securities, and/or repurchase agreements collateralized by cash or government securities, are exempt from charging any mandatory liquidity fees.

### ***Floating Net Asset Value***

Under the new rule, institutional prime money market funds will have to sell and redeem their shares using a floating net asset value (NAV) based on the current market-based value of the securities in their underlying portfolio rounded to the fourth decimal place. Institutional prime money market funds are money market funds designed to cater to institutional investors that invest in a variety of

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<sup>2</sup> Weekly liquid assets include cash, U.S. Treasury securities, certain other government securities with maturities of no more than 60 days, and securities that convert into cash within five business days.

short-term debt obligations issued by banks and corporations, as well as repurchase agreements and asset-backed commercial paper. These funds will have to round prices and transact in fund shares to four decimal places in the case of a fund with a \$1.00 target share price.

Government money mutual funds and retail money market funds are exempt from this floating NAV requirement. Retail money market funds are money market funds that have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.

#### *Disclosure Requirements*

Under the new rule, money market funds have to improve the transparency of their operations and risks by disclosing on their websites the levels of their daily and weekly liquid assets, net shareholder inflows or outflows, and market-based NAVs per share.<sup>3</sup> In addition, these funds will have to disclose the fact that they may impose liquidity fees or redemption gates on investors as well as any use of affiliate sponsor support.

Money market funds will now be required to promptly disclose certain events on a new Form N-CR, such as when a fund has to start charging liquidity fees or temporarily suspend investor redemptions. Money market funds will also be required to report on this new form any portfolio security defaults, any time they have received sponsor or fund affiliate support in the past 10 years, or — for retail and government money market funds — any time their market-based NAV falls below \$0.9975 per share.

The final rule also eliminates the previous 60-day reporting delay and requires money market funds

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<sup>3</sup> Daily liquid assets include cash, U.S. Treasury securities, securities that convert into cash within one business day, and receivables scheduled to be paid within one business day.

to report monthly to the SEC. To monitor whether substantial assets switch from money market funds to private liquidity funds because of this regulation, the final rule amends Form PF by forcing liquidity fund advisers managing at least \$1 billion in combined money market fund and liquidity fund assets to report substantially the same portfolio information that registered money market funds have to report on Form N-MFP.<sup>4</sup>

#### *Diversification Requirements*

The new regulation seeks to increase the diversification of money market fund portfolios by requiring money market funds to treat certain entities affiliated with each other as single issuers of securities. Therefore, money market funds have to aggregate their exposure to affiliated entities to prevent them from investing more than 5 percent of their assets in these related entities.

Except for tax-exempt money market funds, the final rule removes the “25 percent basket” under which a single institution could guarantee up to 25 percent of the value of securities held in a money market fund’s portfolio. Instead, no single institution can guarantee more than 10 percent of a money market fund’s assets. For tax-exempt money market funds, the “25 percent basket” will be reduced to a “15 percent basket,” so an institution can guarantee up to 15 percent of the value of securities held in a money market fund’s portfolio.

Lastly, the new regulation states that a money market fund has to treat a sponsor of asset-backed securities issued by special purpose entities as a guarantor of the asset-backed securities. Unless the fund’s board of directors can determine that the

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<sup>4</sup> The SEC considers private liquidity funds as essentially unregistered money market funds, as the SEC defines private liquidity funds to be any private fund that seeks to generate income by investing in a portfolio of short-term obligations to maintain a stable NAV per share for investors.

fund is not relying upon the sponsor's financial strength or its willingness to provide liquidity, credit, or other support to decide the asset-backed security's quality or liquidity, money market funds will have to make sure that they invest no more than 10 percent of their assets in these sponsors.

### ***Stress Test Requirements***

The final rule enhances the stress test requirements on money market funds first approved by the SEC in 2010. Regardless of whether a money market fund has a floating NAV, the SEC requires money market funds to stress test their ability to maintain weekly liquid assets of at least 10 percent.

Money market funds will also have to minimize principal volatility in response to certain specified hypothetical stress scenarios, such as increases in the level of short-term interest rates. Even for money market funds with floating NAVs, the SEC requires the funds to avoid excessive deviations from the present NAV to prevent investor fears of a fund's possible insolvency.

### ***Implementation Date***

The liquidity fee and redemption gate amendments, as well as the floating NAV mandate, will become effective on October 14, 2016. The compliance date for the new Form N-CR requirements is on July 14, 2015, while the compliance date for the new disclosure, diversification, and stress test requirements is on April 16, 2016. In addition, the adjustments to Forms PF and N-MFP will become effective on April 16, 2016.

### **Federal Reserve, FDIC Demand That 11 Large Banks Must Take Meaningful Action on Their Resolution Plans**

On August 5, 2014, the Board of Governors of the Federal Reserve System and the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) [ordered](#) that 11 large banking organizations

must take meaningful and immediate action to improve their resolution plans by the middle of 2015. Under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), these regulators require banking organizations with total consolidated assets of at least \$50 billion and nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve periodically to submit living wills on how these institutions will be dissolved in the event of material financial distress or failure of the company.<sup>5</sup>

### ***Timeline of Living Wills Submitted by First-Wave Companies***

To enforce this section of the Dodd-Frank Act, in October 2011, the Federal Reserve and the FDIC [decided](#) to implement the act's provisions on a staggered basis. Therefore, only those institutions with more than \$250 billion in nonbank assets had to file their first resolution plans with the two agencies by July 1, 2012. As of that time, 11 large banking organizations met these criteria.<sup>6</sup>

After reviewing the July 2012 resolution plans, the two agencies released additional guidance in April 2013 updating the obstacles that these companies should take into consideration when making their next resolution plans. With this new information in mind, all 11 large banking organizations submitted new living wills to the two regulators in October 2013.

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<sup>5</sup> For more information on Section 165 of the Dodd-Frank Act, see [Banking Legislation & Policy, Volume 29, Number 2](#).

<sup>6</sup> These 11 large banking organizations are Bank of America, Bank of New York Mellon, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corporation, and UBS.

### *Issues to Address for 2015 Living Wills*

While the Federal Reserve and the FDIC did notice some improvements between the first and second resolution plans, such as improvements in the narratives describing what these institutions would do in the case of bankruptcy, the two agencies identified several common features in the living wills' shortcomings. Most resolution plans included assumptions deemed by the two regulators as unrealistic or inadequately supported, such as the behavior of customers and counterparties during times of crisis. In addition, the two regulators felt that most living wills did not make the necessary organizational changes to ensure the orderly resolution of the troubled company.

As a result, the Federal Reserve and the FDIC required all 11 large banking organizations to take more steps to improve their resolvability for the resolution plans due by July 1, 2015. These actions include developing a holding company structure that supports resolvability, establishing a rational and less complex legal structure taking into account the best alignment of a firm's legal entities and business lines, and amending a firm's financial contracts to allow for a stay of early termination rights of external counterparties triggered by insolvency proceedings. In addition, a large banking organization should be able to provide continued support for critical operations throughout the resolution process as well as maintain the ability to produce reliable information in a timely manner.

### **Federal Reserve, FDIC Release Additional Guidance for Smaller Banks Filing Second Resolution Plans**

On August 15, 2014, the Board of Governors of the Federal Reserve System and the Board of Directors of the FDIC issued [additional guidance](#) to banking organizations filing their second resolution plans, which were due by December 31, 2014. As part of the two agencies' staggered process to implement Section 165 of the Dodd-Frank Act, U.S. bank holding companies with less than \$100 billion in total nonbank assets and foreign-based firms with less than \$100 billion in U.S. nonbank assets had to file their first living wills by December 31, 2013.

Following the review of the initial resolution plans, the Federal Reserve and the FDIC stated that out of the 117 banking organizations set to file their second living wills, the 31 most advanced of these banking organizations will have to file a full resolution plan taking into account potential obstacles to resolvability identified by the two regulators. Meanwhile, 25 firms with less complex U.S. operations are allowed to submit tailored resolution plans focusing on the nonbanking operations of the institution and can either use the model template released by the two agencies or the same guidelines from last year. The remaining 61 firms with limited U.S. operations will only have to focus their resolution plans on material changes to their original living wills as well as actions taken to strengthen the effectiveness of their original plans.

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## **Federal Regulation**

### ***Federal Reserve System***

#### *Federal Banking Regulators Finalize Liquidity Coverage Ratio*

On September 3, 2014, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) approved a [final version](#) of the liquidity coverage ratio (LCR) that would strengthen the liquidity positions of large financial institutions. The LCR, which requires large and internationally active banking organizations to hold enough high-quality, liquid assets (HQLA) to satisfy its

projected net cash outflows during a 30-day stress period, remains largely unchanged from when it was originally proposed in October 2013.<sup>7</sup> Impacted financial institutions are still expected to be fully compliant with the LCR by January 1, 2017.

Most of the changes from the original proposal are adjustments in response to comments from the public, such as making changes to the range of corporate debt and equity securities included in the definition of the HQLA. However, unlike the original proposal, the LCR requirement will not apply to nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) as systemically important. Instead, the Federal Reserve plans to apply enhanced prudential liquidity standards to these particular firms by issuing a specifically tailored LCR requirement for each systemically important nonbank financial institution following an evaluation of the institution's business model, capital structure, and risk profile.

#### *Federal Banking Regulators Finalize Changes to Supplementary Leverage Ratio*

Also on September 3, 2014, the Federal Reserve, the FDIC, and the OCC approved a [final rule](#) that would modify the definition of the denominator of the supplementary leverage ratio requirement. The final rule remains largely unchanged from when it was first proposed in April 2014.<sup>8</sup> As a result, the changes seek to better capture a banking organization's on- and off-balance-sheet exposures in a manner consistent with recent changes agreed to by the Basel Committee on Banking Supervision. The new version of the supplementary leverage ratio will be effective on January 1, 2018.

#### *Regulators Propose Margin Requirements for Swap Dealers*

On September 3, 2014, the Federal Reserve, the Farm Credit Administration, the FDIC, the Federal Housing Finance Agency, and the OCC proposed a [new rule](#) that would establish minimum margin requirements for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the proposal would establish minimum requirements for the exchange of initial and variation margin between covered swap entities and their counterparts to noncleared swaps and noncleared security-based swaps.<sup>9</sup> The five federal agencies accepted comments on this proposal until November 24, 2014.

The amount of margin that would be required under the proposed new rules would vary based on the relative risk of the counterparty and of the noncleared swap or noncleared security-based swap. [Originally proposed](#) in April 2011, the new proposal does include some modifications in light of comments received from the public, such as an expansion of the types of collateral eligible to be posted as initial margin.

The five federal regulators consulted with both the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) in developing this updated proposal. Later that month, on September 17, 2014, the CFTC also released [revised collateral rules](#) about proposed margin requirements for

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<sup>7</sup> To read more about the original LCR requirement, see [Banking Legislation & Policy, Volume 32, Number 4](#).

<sup>8</sup> To read more about the proposed changes to the supplementary leverage ratio's denominator, see [Banking Legislation & Policy, Volume 33, Number 1](#).

<sup>9</sup> A covered swap entity is an entity dealing in swaps that is regulated by one of the five aforementioned federal agencies involved with issuing this proposal.

uncleared swaps for swap dealers and major swap participants that largely resembled the five federal regulators' requirements.

### ***Financial Stability Oversight Council***

#### *FSOC Designates MetLife as Systemically Important*

On September 4, 2014, the FSOC determined that the insurer MetLife Inc. should be [designated](#) as systemically important. Therefore, MetLife would be subject to stricter supervision by the Federal Reserve Board, such as facing enhanced capital requirements. MetLife would join American International Group, Inc., GE Capital Corporation, and Prudential Financial, Inc. as the fourth nonbank financial institution to receive such a distinction.

However, the insurer did not agree with this decision and challenged the council's ruling. On October 6, 2014, the FSOC decided to [hear](#) MetLife's challenge to its systemically important designation and held a hearing on November 3. The FSOC has 60 days to reexamine MetLife's designation before the council has to confirm or overturn its original determination.

### ***Office of the Comptroller of the Currency***

#### *OCC Finalizes Guidelines for Its Heightened Expectations of Large Banks*

On September 2, 2014, the OCC approved [final guidelines](#) that would strengthen the governance and risk management practices of large financial institutions. The new rule generally remains unchanged from when it was proposed in January 2014 except to provide additional clarity and to avoid imposing managerial responsibilities on board members of large financial institutions.<sup>10</sup>

The final guidelines state that covered institutions should establish and adhere to a written risk governance framework to manage and control its risk-taking activities as well as provide minimum standards for the large bank's board of directors to oversee that risk governance framework. Covered institutions would include insured national banks, insured federal savings associations, and insured federal branches of foreign banks with at least \$50 billion in total consolidated assets. In addition, the final guidelines would also apply to any OCC-regulated firm with less than \$50 billion in average total consolidated assets if that firm's parent company controls at least one other covered institution.

### ***Federal Deposit Insurance Corporation***

#### *FDIC Changes Deposit Insurance Calculations to Reflect New Capital Standards*

On November 18, 2014, the FDIC approved a [final rule](#) that would update the FDIC's risk-based deposit insurance assessment system to take into account the new requirements imposed by the U.S. Basel III capital standards. Approved in July 2013, the U.S. Basel III capital standards strengthened capital requirements on U.S. banks consistent with the changes approved by the Basel III accord and required by the Dodd-Frank Act.<sup>11</sup> The final rule was effective on January 1, 2015, the date on which the U.S. Basel III capital standards went into effect.

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<sup>10</sup> For more information on the original OCC risk management proposal, see [Banking Legislation & Policy, Volume 33, Number 1](#).

<sup>11</sup> For more information on the final version of the U.S. Basel III capital standards, see [Banking Legislation & Policy, Volume 32, Number 2](#).

The final rule, originally proposed on July 15, 2014, revises the capital ratios and ratio thresholds in the small institution system to the new prompt corrective action capital ratios and ratio thresholds in the U.S. Basel III capital standards.<sup>12</sup> Also, under the final rule, the assessment base calculation conforms to the new asset risk weights using the standardized approach from the U.S. Basel III capital standards while allowing for the deduction of certain low risk, liquid securitizations. In addition, institutions with more than \$1 billion in total assets must measure counterparty exposure for assessment purposes using the Basel III standardized approach credit equivalent amount for derivatives and the Basel III standardized approach exposure amount for securities financing transactions.

### ***Securities and Exchange Commission***

#### ***SEC Adopts Credit Rating Agency, Asset-Backed Security Reform Rules***

On August 27, 2014, the SEC approved new [requirements](#) for credit agencies that would enhance governance, protect against conflicts of interest, and increase transparency to improve the quality of credit ratings and increase credit rating agency accountability. Originally proposed in May 2011, the SEC approved the final restrictions in a 3–2 vote.<sup>13</sup> As a result, the SEC will require credit rating agencies registered with the SEC as nationally recognized statistical rating organizations (NRSROs) to report on internal controls, guard against conflicts of interest, and publicly disclose the methodologies used in determining a credit rating. In addition, NRSROs will have to improve upon the public disclosure of how their credit ratings perform and develop the professional standards necessary for accurate credit analysis, such as requiring that at least one individual with at least three years of experience in performing credit analysis participates in the determination of a credit rating. The new requirements are effective on January 1, 2015.

On August 27, 2014, the SEC also unanimously approved [revisions](#) to rules governing the disclosure, reporting, and offering process for asset-backed securities. Originally proposed in April 2011 and revised in July 2011, the final rules will require loan-level disclosure for certain assets, such as residential and commercial mortgages and automobile loans.<sup>14</sup> In addition, the final rules will expand disclosures about the parties involved in a transaction as well as give investors more time to review and consider a securitization offering.

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<sup>12</sup> The FDIC generally considers small institutions to be institutions with less than \$10 billion in assets.

<sup>13</sup> To read about the original May 2011 proposal, see [Banking Legislation & Policy, Volume 30, Number 2](#).

<sup>14</sup> For more information on the proposals regarding asset-backed securities, see [Banking Legislation & Policy, Volume 30, Number 3](#).