Comment letter re: Money Market Funds

Dear Securities and Exchange Commission:

The SEC has requested comments in response to its Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report [Release No. IC-34188; File No. S7-01-21].

One of us is a lawyer and law professor and has written extensively on financial regulation or administrative law. The other is a law professor who is an expert on mutual funds. We have no financial or other relationship with money market funds or their competitors. We appreciate the opportunity to submit these comments for your consideration. Our comment follows.

David Zaring

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William Birdthistle

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Comment In Response to Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report [Release No. IC-34188; File No. S7-01-21], available at https://www.sec.gov/rules/other/2021/ic-34188.pdf.

One of us is a law professor at the Wharton School and an expert in financial regulation and administrative law. The other is a professor at Chicago-Kent School of Law and an expert on mutual fund. We submit this comment of our own accord and not as the representative of any interested party.

David Zaring has written over fifty articles on administrative law and financial regulation, and have just published a monograph on *The Globalized Governance of Finance*, that considers the international scheme for ensuring that banks are adequately capitalized in detail. He is one of the twenty most cited scholars of administrative law, and ten most cited in financial regulation in particular. Before entering the academy and winning tenure at Wharton, he served as a litigator in the Federal Programs Branch of the Department of Justice, where he defended, among other things, administrative law cases brought against government agencies.

William Birdthistle is Professor of Law at Chicago-Kent College of Law, where he specializes in investment funds and corporate law. He is the author of Empire of the Fund: The Way We Save Now (Oxford University Press, 2016) and co-editor of The Research Handbook on the Regulation of Mutual Funds (Edward Elgar, forthcoming 2017).

Birdthistle is a graduate of Harvard Law School, where he served as managing editor of the Harvard Law Review. He received his B.A. summa cum laude in English and psychology from Duke University in 1995. Following law school, Birdthistle clerked for Judge Diarmuid F. O'Scannlain of the US Court of Appeals for the Ninth Circuit.

In this comment letter, we will make two points and three proposals. *First*, money market funds have needed to be rescued by the Fed and Treasury Department twice in the last 13 years, once in the financial crisis and again during the current COVID crisis. Two bailouts in just more than a decade is evidence of instability. The Securities and Exchange Commission, the Financial Stability Oversight Council, and perhaps another regulator should regulate money market funds as if they were comprised of risky financial institutions. Risky financial institutions are subject to a variety of regulation designed to ensure their resiliency; similar precautions should be adopted with regards to money market funds. *Second*, the SEC and other regulators should consider adopting three particular regulatory approaches to increase the resiliency of money market funds:

1. The net asset value for all money market funds should float, which will decrease the size of the sector, though not eliminate the possibility of a run on money market funds.
2. Money market fund sponsors should be required to hold capital sufficient to ensure that the sponsor can serve as a source of strength for funds subject to redemptions or declines in asset prices.
3. The industry, perhaps at the prompting of its regulators, should consider adopting a systemic emergency insurance fund.

1. Money Market Funds Have Required Two Rescues Too Many

Money market funds may be thought of as shadow banks which are regulated by the SEC. Like banks, they use demand deposits to finance assets that are liquid, but typically less liquid then typical demand deposits.[1] This means that money markets, just as banks do, work by exploiting a mismatch in maturities. It also makes them potentially subject to runs – which creates market risk.

There is another way that money market funds work like banks. In the last financial crisis, money market funds, like banks, had to be rescued; and now, in the current COIVD crisis, they, unlike banks, have had to be rescued once again. In both cases, the Fed and Treasury organized the rescue.[2]

Despite this, the SEC has moved slowly to regulate the asset class, and the changes that were implemented only resulted in partial reform. By 2016, after some encouragement by the Financial Stability Oversight Council, the commission adopted a number of reforms. Redemption gates were introduced, as were liquidity requirements.[3]

But the agency exempted many money market funds from the central reform imposed in 2016 – floating asset values that treated the funds, entirely appropriately, as if the assets they invested in could rise or fall in value. While money market funds invested in non-governmental bonds were required to let their net asset value float, those invested in governmental bonds did not.[4] The SEC also distinguished between "institutional" and "retail" money market funds, requiring institutional funds to adopt a floating net asset value while retail funds were allowed to retain a constant net asset value.[5]

2. One Potential Solution: Let Asset Values For All Money Market Funds Float

The SEC and other regulators should consider whether it makes sense to let *any* money market funds fix their net asset values. As Jill Fisch and Eric Roiter have observed, "Money market funds can maintain a $1.000 share price only under limited conditions."[6]

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[1] For discussion, see Lance Pan, *Liquidity in Question – What Do We Do with Prime Money Market Funds?*, Capital Advisers Group, July 9, 2020, https://www.capitaladvisors.com/wp-content/uploads/2020/07/Liquidity-in-Question-What-Do-We-Do-with-Prime-Money-Market-Funds.pdf.

[2] Sarah O'Brien, *The Fed is propping up money market funds. Here's what that means for investors*, CNBC Personal Finance, March 20, 2020, https://www.cnbc.com/2020/03/19/the-fed-props-up-money-market-funds-what-that-means-for-investors.html.

[33] In particular, money market funds must maintain daily liquidity of 10% and weekly liquidity of 30% of total assets under management (https://www.sec.gov/files/rsfi-wp2014-01.pdf.

[4] Jeff Benjamin, *Fund companies, investors move to avoid new fees and restrictions,* Investment News https://www.investmentnews.com/money-market-funds-scramble-ahead-of-secs-floating-nav-rule-68768.

[5] Viktoria Baklanova and Daniel Stemp, *Reference Guide to the OFR's U.S. Money Market Fund Monitor*, Office of Financial Research Brief Series, July 10, 2016, https://www.financialresearch.gov/briefs/files/OFRbr_2016-07_Money-Market-Fund-Monitor.pdf.

[6] Jill Fisch and Eric Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy,* August 25, 2011, University of Pennsylvania Institute for Law and Economics (citing from Institutional Cash Distributors, LLC, *ICD Commentary: Operational and Accounting Issues with the Floating NAV and the Impact on Money Market Funds,* July 2013, available at https://www.sec.gov/comments/s7-03-13/s70313-40.pdf).

The agency should be under no misapprehensions about the likely effect of this development, to be sure. As Fisch and Roiter have put it, a "required floating NAV would eliminate the fundamental attraction of money market funds for investors."[7]

Moreover, the partly floating environment of money market funds did not prevent them from needing a rescue in 2020. But to the extent that investors left floating net asset value funds for fixed (and fictional) net asset value funds, requiring every fund to allow its net asset value to float would address a problem and more accurately price the asset class.

3. A Second Potential Solution: Require Sponsors To Hold Capital To Rescue The Funds

The SEC, FSOC, and, if necessary, an experienced safety and soundness regulator should regulate the asset class as if it was comprised of risky financial institutions, which it manifestly is. Other risky financial institutions have capital requirements that are far in excess of anything required of money market funds the SEC has substituted liquidity requirements for capital buffers. But sponsors could be required to hold capital against the funds, and be required to serve as a source of strength for a fund if redemptions or a decline in asset values taxed the fund. Capital buffer requirements have been suggested in the Presidential Working Group Report on Financial Markets: Overview of Recent Events and Potential Reform Options for Money Market Funds, and we think the SEC and other regulators should give them strong consideration.[8]

To be sure, additional regulation that resembles banking regulation "would place significant burdens on money market funds, which would have to raise capital and set aside reserves, as well as on the U.S. government in that it would be guaranteeing and supervising many trillions more in assets in the financial system."[9] But a record of bailouts makes this cost one that the government is already paying. As for the funds, they appear to be deserving of some additional capital burdens after their performance in the past two financial crises.

4. A Third Option: Industry-Run Emergency Insurance for Money Market Funds

Observers have considered whether financial institutions in other contexts ought to develop emergency insurance funds.[10] We think it is time to extend that consideration to the money market fund industry. No such insurance, which might reassure investors inclined to run, currently exists. Instead, brokers who advertise money market funds disclaim that funds are "not insured or guaranteed" by the Federal Deposit Insurance Corporation or any other entity.[11] Moreover, brokers make clear that the "fund's sponsor has no legal obligation to provide financial support to the fund," and that investors "should not expect that the sponsor will provide

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[7] *Id.*
[8] Available at https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf.
[9] Mark Perlow, *Money Market Funds-Preserving Systemic Benefits, Minimizing Systemic Risks*, 8 BERKELEY BUS. L.J. 74, 94-95 (2011).
[10] *See* Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund, 28 YALE J. ON REG. 151, 155 (2011) ("The initial fund should be $1 trillion, indexed to an appropriate measure of financial sector growth. The Fund should be partly pre-funded by risk-adjusted fees charged to large or systemically important financial firms.").
[11] *See, e.g.*, *Manage Your Cash Investments*, VANGUARD, https://investor.vanguard.com/investing/cash-investments

financial support to the fund at any time."[12] Nor does not appear to be any government or industry-run insurance for funds in Canada[13] or the United Kingdom.[14]

But legal scholars have called upon the industry to create some kind of insurance program in the wake of repeated failures. William A. Birdthistle's *Breaking Bucks in Money Market Funds* suggests that fund sponsors either (1) self-insure or (2) come together as an industry to collectively insure.[15] Self-insurance would require fund sponsors and advisors of money market funds to "intervene[] to purchase at full value portfolio securities whose values had declined precipitously and threatened to break the buck. In essence, the advisors paid money out of their own pockets to insure the loss and to make fund investors whole."[16] Collective insurance would follow the banking industry and require funds to "pay into a common pool that would rescue any fund that failed."[17] Funds would "pay insurance premia, the cost of which would in turn be passed through to all investors in those funds."[18]

To be sure, mandating collective insurance, like all these regulatory proposals, could lead to more risk-taking by the funds. In *Money Market Funds—Preserving Systemic Benefits, Minimizing Systemic Risks*, Mark Perlow cautions that requiring Money market funds to agree to an industry-run insurance scheme could "shift fund managers' incentives away from conservative management and create moral hazard."[19]

For the scheme to work, the collective insurance would have to be "priced properly" to "prevent…tilting the regulatory playing field towards funds and away from banks."[20] But it can work. Collective industry-insurance programs are currently active in the car insurance industry, for example.[21]

Thank you.

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[12] *Id*.
[13] *See Money Market Funds Are Not Guaranteed*, MONEY SENSE CANADA, https://www.moneysense.ca/columns/money-market-funds-are-not-guaranteed/#:~:text=But%20since%20money%20market%20funds,thinking%20of%20them%20that%20way.
[14] *See Sterling Money Market Funds*, BANK OF ENGLAND, https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2004/sterling-money-market-funds.pdf.
[15] William A. Birdthistle, *Breaking Bucks in Money Market Funds,* 2010 WIS. L. REV. 1155, 1198-1200 (2010).
[16] *Id*.
[17] *Id*.
[18] *Id*.
[19] Mark Perlow, *Money Market Funds-Preserving Systemic Benefits, Minimizing Systemic Risks*, 8 BERKELEY BUS. L.J. 74, 94-95 (2011).
[20] *Id*.
[21] *See The Role of Collective Pricing In Auto Insurance*, FEDERAL TRADE COMMISSION, https://www.ftc.gov/sites/default/files/documents/reports/role-collective-pricing-auto-insurance/231950.pdf.