Federated Hermes

Federated Hermes, Inc.
[redacted]

April 12, 2021

Ms. Vanessa Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Ms. Ann. E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

U.S. Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Mr. Christopher J. Kirkpatrick, Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Comment Letter of Federated Hermes on President's Working Group Report on Money Market Mutual Funds ("MMFs") (SEC File No. S7-01-21)

Dear Ladies and Gentlemen:

I. Introduction

We are writing on behalf of Federated Hermes, Inc. and its subsidiaries ("Federated Hermes") to provide comments in response to the Report of the President's Working Group on Financial Markets, Overview of Recent Events and Potential Reform Options for Money Market Funds (the "PWG MMF Report") which was issued in December 2020.[1] We would like to state upfront that we acknowledge and endorse the comment letter submitted by The Investment Company Institute ("ICI") on the PWG MMF Report, with very minor differences regarding potential changes to liquid asset requirements.

The PWG MMF Report suggests that the regulation of MMFs be reevaluated in light of financial market events that occurred in the Spring of 2020 during the early part of the COVID-19 pandemic. These troubled times have taught us more about medical care, public health and virology than any of us would have liked. But the newly familiar

[1] The PWG MMF Report is available online at https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf.

maxims of "first, do no harm" and "follow the data" are important in considering further changes to MMF regulation. We support reevaluation and, if warranted by the data, further refinement of MMF regulation. More importantly, we support, where warranted by the data, improvement in market structures to make short-term markets more resilient.

In following the data, we draw very different conclusions than those stated in the PWG MMF Report. We urge policymakers not to further harm financial markets by adopting poorly-conceived changes to MMF regulation. Rather, the U.S. Securities and Exchange Commission (the "SEC") should instead refine certain aspects of the 2014 amendments to Rule 2a-7 under the Investment Company Act of 1940 (the "Investment Company Act")[2] having to do with the implementation of "gates and fees". The creation of an artificial requirement for MMFs to consider the imposition of "gates and fees" linked to conformance with weekly liquid asset requirements created a very real incentive for some shareholders to redeem from prime institutional MMFs ahead of liquidity minimums being reached. The advent of a MMF dropping below the minimum weekly liquidity levels prompting investors' concerns over such a drop triggering gates and fees has become the new "breaking the buck" event.

Federated Hermes has been in business since 1955 and has more than 45 years of experience managing MMFs. During that period, Federated Hermes has participated actively in the money market as it developed over the years.[3] MMFs managed by Federated Hermes in the United States include U.S. government MMFs, municipal MMFs and prime MMFs. As of year-end 2020, slightly over two-thirds of the MMF assets managed by Federated Hermes are U.S. government securities and less than 30% consist of commercial paper and other non-government instruments. Federated Hermes also manages MMFs and other investment funds and accounts in Canada, Europe and Asia. In addition to MMFs, Federated Hermes manages accounts for institutional customers that invest in money market instruments, as well as state government-sponsored local government investment pools ("LGIPs") that invest in money market instruments. In all, Federated Hermes manages more than $400 billion in money market assets, the vast majority of which have ESG integrated into their investment process.

Federated Hermes also manages mutual funds and accounts that invest in equity securities, bonds and other longer-term fixed income instruments. The equity funds and accounts managed by Federated Hermes cover a variety of equity styles, including growth, ESG and impact funds.

MMFs play an important role in the capital markets by providing an efficient means for institutional and retail investors to put short-term cash balances to work at a competitive market rate, providing relatively low-cost short-term financing to creditworthy governments and businesses. MMFs provide investors with a convenient means to access professional management of highly diversified portfolios of high quality short-term instruments. MMFs are much more efficient (and for very large balances,

[2] 17 C.F.R. § 270.2a-7 (2020).

[3] The registration statement for Federated Hermes' Money Market Management fund first became effective on January 16, 1974, making it one of the two longest continuously operating MMFs.

safer) than banks at intermediating between short-term cash investors and short-term government and corporate borrowers.[4] The utility of MMFs to both retail and institutional investors recently received the most sincere and perhaps unintended endorsements from PWG constituent agencies and their proxies in the form of enforcement actions brought by the Office of the Comptroller of the Currency (the "OCC"), the SEC and FINRA against banks, broker-dealers and investment advisers for breaches of fiduciary duties and disclosure obligations to customers by failing to invest customer cash balances at a competitive market yield in institutional MMF share classes and failing to disclose the clear benefits of investing in institutional classes of MMFs and instead investing those balances in bank deposits.[5]

Unlike bank deposits, which pay an administered rate, MMFs provide investors with a market rate of return. This allows a fair and competitive return to investors, rather than potentially-lower non-market rates. This puts smaller investors on par with high-net-worth investors and institutions in terms of access to market-based rates of return on their cash. The benefit to investors of more than $200 billion from these higher returns from MMFs over bank deposits since 1990 is shown in the following chart:

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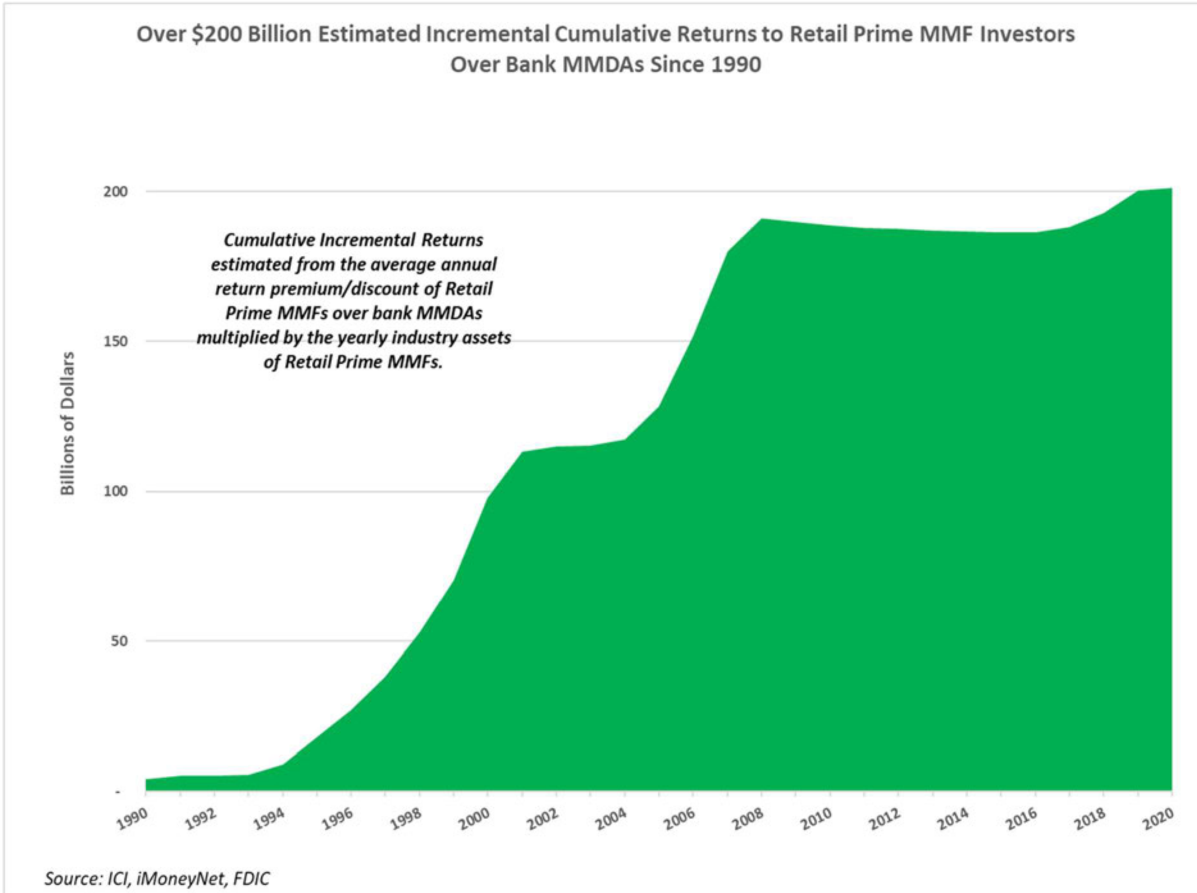
[4] *Compare* ICI, 2020 Investment Company Fact Book at 124 fig.6.5, https://www.ici.org/pdf/2020_factbook.pdf (asset-weighted average expense ratio of MMFs at 0.25% of total assets) *with* Federal Financial Institutions Examination Council Uniform Bank Performance Report, Peer Group Average Report, All Banks in Nation, Summary Ratios, https://cdr ffiec.gov/public/ManageFacsimiles.aspx (non-interest expense ratio average of all U.S. banks ranges over last five quarters from 2.59% to 2.96% of average bank assets) (last visited Mar. 15, 2021) *and* Board of Governors of the Federal Reserve System ("Federal Reserve"), Selected Interest Rates (Daily) - H.15, https://www.federalreserve.gov/releases/h15/ (average one to three month commercial paper rates of 0.06% to 0.10% depending on term and type and bank prime rate at 3.25%) (last visited Mar. 22, 2021).

[5] OCC News Rel. 2020-159, OCC Assesses $250 Million Civil Money Penalty Against JPMorgan Chase Bank, N.A. (Nov. 24, 2020), https://www.occ.gov/news-issuances/news-releases/2020/nr-occ-2020-159.html; Stephanie Avakian, Director, SEC Division of Enforcement, What You Don't Know Can Hurt You, Keynote Remarks at the 2019 SEC Regulation Outside the United States Conference (Nov. 5, 2019), https://www.sec.gov/news/speech/speech-avakian-2019-11-05; Crane Data, FINRA Fallout: More on Sweeps, Fin-Tech Cash Accounts by ignites, FP (Jan. 22, 2020), https://cranedata.com/archives/all-articles/8056/; Clifford E. Kirsch et al., Eversheds Sutherland, Regulators Have Bank Deposit Sweep Programs in Their Sights (Nov. 21, 2019), https://us.eversheds-sutherland.com/mobile/NewsCommentary/Legal-Alerts/227079/Regulators-have-bank-deposit-sweep-programs-in-their-sights.



This comment letter responds to the policy considerations outlined in the PWG MMF Report and recommends regulatory changes and enhancements to improve the resilience of MMFs as well as market structure reform considerations to improve market performance in times of severe stress.

As discussed in more detail below, key points that Federated Hermes wishes to make in this comment letter are:

- MMFs did not cause or exacerbate the turmoil in the financial markets in the Spring of 2020. Playing a role in the markets and reacting to market stresses should not be confused with causing such market stresses.
- MMFs have no "structural vulnerabilities" warranting some of the more significant policy options outlined in the PWG MMF Report, such as capital buffers or holdbacks. The SEC's MMF rule has some flaws related to the linkage of liquid asset compliance to gates and fees, and those should be corrected as discussed below.
- The market turmoil in the Spring of 2020 was created by a global pandemic the likes of which had not been seen for a hundred years and the response by governments around the world to stem the spread of the virus.

- Those actions by governments caused a very fast and very sharp economic downturn in the real economy as people stayed home and stayed away from other people, seeking (understandably) to avoid illness and death.
- The contraction was immediate and particularly hard-hitting in the travel, entertainment, hospitality and in-person retail segments of the economy, leading to an immediate spike in unemployment and sharp drop in sales and income tax revenues to state and local governments.
- That panic and fear in the real economy spilled over into the financial markets as investors sought the safety of cash to prepare for an uncertain future.
- The financial markets turmoil started in the equities markets weeks before it impacted the markets in U.S. treasury securities and corporate bonds, and thereafter commercial paper.
- The financial markets turmoil affected the bond markets and repurchase agreements several days before it affected the commercial paper markets.
- That turmoil affected the commercial paper markets and other high quality short-term markets as documented by 3-month Federal Reserve lending rate/Overnight Index Swap spreads (FRA-OIS spreads) at least a week before outflows started from MMFs.
- MMFs are no longer a dominant player in commercial paper markets and were not in early 2020. Commercial paper is no longer a substantial portion of MMF assets. This is evidenced by the fact the Federal Reserve Bank of Boston included a plethora of high-quality short-term assets as eligible for inclusion in its Money Market Mutual Fund Liquidity Facility on March 18, 2020.
- Commercial paper issued by the industries most disrupted by the COVID-19 pandemic (travel, hospitality, entertainment and in-person retail) are not a significant part of the investment portfolios of MMFs. MMFs did not and could not have caused or materially exacerbated turmoil in the commercial paper markets in the Spring of 2020.
- The very short duration of MMF portfolios as measured by weighted average maturity ("WAM") and weighted average life ("WAL"), particularly as compared to those of banks, evidences the fact that MMFs are not engaged in any significant "maturity transformation" but instead provide cost-effective professionally-managed diversified portfolios of high-quality, short-term securities, which would not be achievable in a separately managed account for most investors.
- The Federal Reserve did not bail out MMFs. It extended fully collateralized credit for a short period of time and as part of a much broader emergency finance program to provide liquidity to credit markets. The Federal Reserve has earned over $185 million in interest, fees and other revenues from its Money Market Mutual Fund Liquidity Facility, with zero incurred or expected losses to the Federal Reserve.[6]

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[6] Periodic Report: Update on Outstanding Lending Facilities Authorized by the Board under Section 13(3) of the Federal Reserve Act (Mar. 10, 2021) at 3, https://www federalreserve.gov/publications/files/pdcf-mmlf-cpff-pmccf-smccf-talf-mlf-ppplf-msnlf-mself-msplf-nonlf-noelf-03-11-21.pdf; *see* letter from Janet L. Yellen, Chair, Federal Reserve, to Sen. Elizabeth Warren (Nov. 30, 2015) at 2,

- MMFs are a useful and efficient capital markets and investment management tool for intermediating between investors of liquid assets and short-term borrowers, and not a threat to the financial system, as documented by the latest round of enforcement actions brought by PWG members and their proxies against banks, broker-dealers and investment advisers for alleged breach of fiduciary duties and disclosure obligations to customers for failing to invest client cash balances in low-fee institutional MMFs and failure to disclose how much better those are than bank sweep deposits.
- The SEC should remove the link between the weekly liquid asset requirement and board consideration of liquidity fees and redemption gates as this has presented a new trigger for redemption for institutional investors that otherwise have no theoretical "incremental incentive" to redeem because of the floating net asset value ("NAV").
- Market structure reforms should be the focus of any reasonable regulatory response, including finding ways to encourage banks and dealers to serve as market makers in times of extraordinary liquidity demand like that caused by the government's response to the pandemic.

II. <u>Background on Assumptions Underlying the PWG MMF Report</u>

<u>MMFs do not create or amplify systemic risk</u>

MMFs do not create or amplify systemic risk. Credit markets have undergone many disruptions over the years and have experienced illiquidity many times before MMFs were created in 1974. The market disruptions of Spring 2020 occurred even though prime institutional MMFs after 2016 were a shadow of their former size, and market disruptions will inevitably occur again regardless of whether MMFs exist. Congress created the Federal Reserve in 1913 to provide liquidity (not bail outs) to the credit markets and it does that well. The Federal Reserve will still need to provide liquidity in the credit markets if MMFs cease to exist. The data presented in the PWG MMF Report overstates the size and timing of MMF redemptions in 2020 and the role of MMFs in the market events of 2008[7] and 2020[8] and, to that extent, perpetuates a false narrative of what really happened. Thus, it cannot be the basis of any legitimate

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https://www.federalreserve.gov/foia/files/warren-letter-20151130.pdf ("Yellen Letter") (noting that providing central bank liquidity to markets during times of unusual financial stress prevents or mitigates extraordinary pressures in financial markets that would otherwise have severe adverse consequences for American households and businesses and the U.S. economy).

[7] *Compare* PWG MMF Report, *supra* note 1, at 4 *with* Martha L. Cochran, David F. Freeman & Helen Mayer Clark, *Money Market Fund Reform: SEC Rulemaking in the FSOC Era*, 2015 Colum. Bus. L. Rev. 861.

[8] *Compare* PWG MMF Report, *supra* note 1, at 11-18 *with* ICI, Report of the COVID-19 Market Impact Working Group, Experiences of US Money Market Funds During the COVID-19 Crisis (Nov. 2020) at 12-16, https://www.ici.org/pdf/20_rpt_covid3.pdf ("ICI Report") *and* The Carfang Group, Corporate Treasurer Response to March Market Collapse, Corporate Treasurers Methodically Made Informed Decisions (April 2021), http://www.tinyurl.com/tcg-mmkt-survey ("Carfang Report").

regulatory response. Action taken in reliance on inaccurate data or fallacious assumptions are de facto arbitrary and capricious.[9]

Filling in the Timeline for the 2007-2009 Financial Crisis

The PWG MMF Report describes the events involving the Reserve Primary Fund breaking the buck in September 2008 in isolation, which in and of itself leads to the perpetuation of a false narrative. The Financial Crisis started in mid-2007, not September 2008. The U.S. and global economy and financial system were in free fall for many months before September 2008. Bear Stearns, Northern Rock, American Home Mortgage Corp., New Century Financial, AIG, Ambac, IndyMac, Fannie Mae, Freddie Mac, Countrywide, Lehman Brothers, and Merrill Lynch, to name just the few largest financial firms, failed or were forced by the regulators to merge to avoid liquidation before the Reserve Primary Fund broke a buck. Unless one adopts a non-linear view of time, MMFs certainly did not cause the Financial Crisis. The Financial Crisis caused Lehman to fail. Lehman's failure caused the Reserve Primary Fund to "break a buck." Not the other way around.

But there is much more to the story than that. In 2008, Lehman Brothers was a depository institution holding company and had subsidiary banks, as well as its flagship securities broker-dealer. As documented by the Bankruptcy Trustee's report on Lehman, the SEC and the Federal Reserve knew as early as May 2008 that Lehman Brothers was about to fail, but continued to allow Lehman to issue commercial paper, obfuscating the troubled condition of Lehman through September of 2008.[10] The government knew full well that this would expose investing MMFs (and other investors in the market) to risk of investment losses.

Under the federal securities statutes, commercial paper cannot be issued unless it is "investment grade." The SEC and Federal Reserve knew that the Lehman paper did not meet that standard. Yet on July 15, 2008, the SEC issued a release affirming the financial condition of 19 specific financial institutions, including Lehman, and restricted the short-sales of those companies' stock.[11] The SEC's release labeled as "false rumors" press reports on "unwillingness of key counterparties to deal with certain financial institutions" and that certain "financial institutions are facing liquidity problems." The

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[9] *See* 5 U.S.C. § 706(2)(A) (2018) (requiring courts to set aside agency action found to be arbitrary or capricious); *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (holding that "an agency rule would be arbitrary and capricious if the agency has . . . entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise").

[10] In re Lehman Brothers Holdings Inc., Report of Anton R. Valukas, Examiner, at 1482, 1498-1500 (Mar. 11, 2010), https://jenner.com/lehman/VOLUME%204.pdf (regulators were aware in May/June 2008 Lehman was about to fail).

[11] SEC Press Release 2008-143, SEC Enhances Investor Protections Against Naked Short Selling (Jul. 15, 2008), https://www.sec.gov/news/press/2008/2008-143.htm (SEC labels investor concerns about financial health of Lehman Brothers and 18 other financial firms as "false rumors").

SEC knew that these "false rumors" about Lehman were true and Lehman was near failure.

The minutes of the Federal Open Market Committee meetings in 2008 also document that the Federal Reserve leadership knew that the failure of Lehman was imminent and would cause one or more MMFs to "break the buck."[12] Notwithstanding this, officials at the Federal Reserve Bank of New York and SEC continued to encourage investors to maintain their credit exposure to Lehman. Ultimately, Lehman failed, causing the Reserve Primary Fund to "break the buck" as a result, just as the SEC and Federal Reserve had secretly anticipated for several months.

MMFs were not even close to being the main event of the 2007-2009 Financial Crisis. There were more than 800 MMFs in operation when the 2007-2009 Financial Crisis began. While a few owned Lehman paper when Lehman filed for bankruptcy, only one broke a buck. The others did not. Investors in the one MMF that "broke a buck"– the Reserve Primary Fund – ultimately recovered more than 99 cents a share on their investments, losing less than a penny per share. No government funds were used to bail them out. But the PWG MMF Report addresses the one MMF that broke a buck late in the Financial Crisis in isolation as if MMFs were the cause or the core of the Financial Crisis. This is absurd and profoundly misleading. What is true is that the Lehman bankruptcy caused investors across the board to reduce credit risk in their portfolios as it became clear that they could not rely on the accuracy of publicly available financial information regarding issuers.

The resilience of MMFs stands in contrast to the fragility and repeated bailout of the banking system. Taxpayers (and since the 2010 Dodd-Frank Act amendments limiting bail outs of uninsured depositors, the large depositors) pick up the tab for bank failures. There have been more than 3600 bank failures since 1971 at a cost to the Federal government of over $180 billion.[13] Just since 2010, the year the SEC's 2010 MMF rule amendments (the "2010 Amendments") were adopted, 371 banks have failed at a cost to the U.S. government of over $28 billion.[14] Note that the government lost no money on the AMLF program or the Treasury guaranty program in 2008. In fact, they made money.[15]

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[12] Transcript of Meeting of the Federal Open Market Committee on September 16, 2008 at 4-5, 7, 51, https://www.federalreserve.gov/monetarypolicy/files/FOMC20080916meeting.pdf; Transcript of Meeting of the Federal Open Market Committee on June 24-25, 2008 at 94, 155-156, https://www.federalreserve.gov/monetarypolicy/files/FOMC20080625meeting.pdf (Federal Open Market Committee discussions of failure of Lehman and its likely impact on investor MMFs).

[13] *See* Federal Deposit Insurance Corporation ("FDIC"), Bank Failures & Assistance Data, https://banks.data.fdic.gov/explore/failures (last visited Apr. 11, 2021).

[14] *See id.*

[15] *See* letter from Martin J. Gruenberg, Acting Chairman, FDIC, to Hon. Shelley Moore Capito (Jun. 29, 2012), http://perma.cc/A98V-9YSN; *Busting Through the Folklore About Money Market Funds: The Fact is They Cost Taxpayers Nothing*, Am. Banker (Jan. 19, 2012) at 8; Office of the Inspector Gen., Federal Reserve, The Federal Reserve's Section 13(3) Lending Facilities To Support Overall Market Liquidity: Function, Status, and Risk Management (2010) at 66, http://oig federalreserve.gov/reports/FRS_Lending_Facilities_Report_final-11-23-10_web.pdf.

Filling in the Timeline on the Resilience of MMFs 2010-2019

The 2010 Amendments addressed the issues experienced by MMFs during the Financial Crisis.[16] The 2010 Amendments enhanced MMF liquidity, credit quality, transparency, and regulatory monitoring, thus making MMFs more resilient to large-scale shareholder redemptions and future market turmoil. Among other things, the 2010 Amendments required that a MMF hold at least 10% of its assets in cash or other securities that can be convertible to cash within one day, and 30% of its assets in securities convertible into cash within one week – reforms designed to enable MMFs to meet high levels of redemptions. The amendments also shortened the maturity limits on MMF portfolios in order to limit interest rate risk. Importantly, it also gave MMF boards the right to suspend redemptions under Rule 22e-3.[17]

The 2010 Amendments were highly effective in improving the resiliency of MMFs. A 2012 SEC Staff study concluded that a MMF's amortized cost valuation "closely tracks" the fund's market-based price, generally within one one-hundredth of a penny per share.[18] The SEC's 2012 study found that under the requirements imposed by the 2010 Amendments, the chance was close to zero that a MMF would "break the buck" due to a change in interest rates.[19] The effectiveness of liquidity requirements adopted in 2010 have been market tested. When faced with heavier-than-normal redemptions during the European debt crisis and U.S. debt-ceiling impasse of summer 2011, money market funds were able to meet all redemption requests, and market-based valuations continued to track closely the $1.00 per share price.[20] MMFs weathered yet another period of large redemptions during the debt-ceiling standoff in 2013.[21]

Ignoring this favorable and very concrete data on the effectiveness of the 2010 Amendments, and instead citing an entirely undocumented and theoretical "incremental incentive to redeem" in stable NAV MMFs, the Treasury and Federal Reserve, acting through the Financial Stability Oversight Council ("FSOC"), continued to press for more destructive changes to MMF regulation when none were warranted. The SEC ultimately chose to subject prime and, inexplicably, municipal MMFs to a new range of restrictions, including a floating NAV calculated to hundredths of a penny and mandatory consideration of gates and fees if required liquidity thresholds were not maintained.[22] These requirements, which were adopted as part of the 2014 amendments to the MMF rules (the "2014 Amendments"), went into effect in October 2016. The 2014

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[16] Money Market Fund Reform, 75 Fed. Reg. 10060, 10061 (Mar. 4, 2010).
[17] 17 C.F.R. at § 270.22e-3.
[18] Division of Risk, Strategy, and Financial Innovation, SEC, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher at 83 (Nov. 30, 2012), https://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf ("When portfolio durations are limited to a maximum of 60 and 90 days, amortized cost closely tracks the shadow NAV.").
[19] *Id.* at 29 tbl.2 (finding that under Rule 2a-7's requirement that money market funds not exceed a weighted average maturity of sixty days, the possibility of a money market fund breaking a buck due to a change in interest rates is nearly zero percent).
[20] *Id.* at 34 tbl.3.
[21] Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47736, 47746 (Aug. 14, 2014) ("2014 Adopting Release").
[22] 2014 Adopting Release.

Amendments also adopted a number of seemingly less onerous requirements, including enhanced transparency to investors and reporting to the SEC.

Ironically, the October 2016 implementation of the SEC's 2014 Amendments – which were adopted on the theory that the 2010 Amendments might not be effective enough to address large scale investor redemptions from MMFs – proved that the 2010 Amendments were indeed up to the task. In the months before the October 2016 implementation of the SEC's 2014 Amendments, non-government MMFs were operating under the 2010 version of Rule 2a-7. The SEC's 2014 Amendments artificially created a $1.3 trillion redemption from MMFs. The massive draw-down from investments in prime and municipal MMFs in September and October 2016 (a larger and more sustained series of redemptions than occurred in the Fall of 2008) in anticipation of the effective date of the SEC's 2014 Amendments confirmed the liquidity requirements imposed by the SEC's 2010 Amendments worked. No MMF became illiquid or "broke a buck" despite redemptions of two-thirds of their shares in two months.[23] The 2010 Amendments worked. Imposing an artificial floating NAV and gates and fees was unnecessary and damaging, exactly as we predicted.[24]

It should also be noted that the dramatic shrinkage in the aggregate asset size of prime MMFs in the Fall of 2016 caused a large widening of the FRA-OIS spread that continued for over a year.[25] The fact that the spread widening continued for so long after prime MMFs shrank and ceased to be a dominant force in the commercial paper markets suggests that they had previously been a stabilizing participant in that market whose absence has been harmful. If one reviews, under the maxim of "first, do no harm," the SEC's 2014/2016 "fix" to MMFs, one would see that it was harmful to the financial markets and should be reconsidered, especially since it was based on a specious causal narrative.

Filling in the Timeline on the Market Events of Spring 2020

The PWG MMF Report suggests that MMFs caused or exacerbated the financial markets turmoil in the Spring of 2020. A closer inspection of the timeline and what actually occurred confirms that MMFs did not cause or exacerbate market turmoil in the Spring of 2020. Unlike the 2007-2009 Financial Crisis, the Spring 2020 financial markets turmoil did not originate in the financial sector. It started with public reaction to the then rapidly-spreading COVID-19 pandemic, the very sharp contraction of the real economy in early March as people stayed home to avoid contracting the illness (the fastest and deepest economic contraction of the U.S. economy within such a short period on record). Through late February 2020, to the public's knowledge, the virus seemed to

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[23] A further irony is that the SEC forced over $1 trillion from prime and municipal MMFs into U.S. government MMFs, concentrating the credit risk of a U.S. government default in every future Congressional debt ceiling stand-off.

[24] *See* letter from Arnold & Porter LLP to SEC on behalf of Federated Investors (May 14, 2014), https://www.sec.gov/comments/s7-03-13/s70313-360.pdf; letter from Arnold & Porter LLP to SEC on behalf of Federated Investors (Jul. 16, 2014), https://www.sec.gov/comments/s7-03-13/s70313-373.pdf.

[25] Michael Gladchun, Loomis Sayles, *Is the Widening LIBOR-OIS Spread Cause for Concern?* (Apr. 2018), https://info.loomissayles.com/is-the-widening-libor-ois-spread-cause-for-concern.

be largely confined to China, Iran and Italy with very limited spread to the United States. But global equity markets began to drop on February 20, 2020. At this same time oil prices dropped dramatically.

During the last week of February and the first week of March 2020, there were growing public reports of limited spread of the virus within the United States, particularly in Seattle and California, and the news was filled with reports on the spread of the virus on cruise ships and increasing public health warnings about handwashing and avoiding close contact with others. Organizations began postponing large gatherings.[26] The second week of March 2020 (the week that began on Sunday, March 8) saw a jump in reported infections and more of cancellations of large events.[27] On Monday, March 9, the stock markets experienced their largest single day drop since 2008 with the Dow index dropping 2,000 points. At this point the volatility expanded into the bond market, which entered a period of extreme volatility starting on March 9, 2020, due in part to margin calls and unwinding of leveraged positions.[28]

The equity markets only deteriorated from there, with further major declines in global equity markets on Thursday, March 12, and on Monday, March 16, global equity markets took a one-day decline of 12-13% which was the largest one-day drop of the period. The equity market slide continued through April 7, 2020. The turmoil also impacted the market for U.S. government securities in the first week of March, which became quite volatile by early in the second week of March 2020, before the impact was felt in other credit markets or the commercial paper market.[29] The SEC closed its headquarters due to a COVID-19 infection among its staff on the ninth floor late on Monday, March 9,[30] and the majority of the SEC's staff has worked remotely since that date.[31]

On March 11, the World Health Organization declared that we were in the midst of a global pandemic and the President made a nationally televised address regarding the

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[26] *See, e,g.*, SEC Press Release 2020-40, EVENT POSTPONED: SEC to Hold National Compliance Outreach Seminar for Investment Companies and Investment Advisers (Feb. 25, 2020), https://www.sec.gov/news/press-release/2020-40 ("Given concerns about coronavirus and out of an abundance of caution, we have decided to postpone the National Compliance Outreach Program Seminar in Washington, D.C. scheduled to take place on April 21, 2020. If appropriate, we will take steps to reschedule this event at a time later this year.").

[27] *See, e,g.*, SEC Press Release 2020-17, EVENT POSTPONED: SEC Announces Conference on Municipal Securities Disclosure (Mar. 9, 2020), https://www.sec.gov/news/press-release/2020-17.

[28] Andreas Schrimpf et al., Bank for International Settlements, *Leverage and Margin Spirals in Fixed Income Markets During the Covid-19 Crisis*, Bulletin No. 2 (Apr. 2, 2020), https://www.bis.org/publ/bisbull02.pdf.

[29] Jeffrey Cheng et al., The Brookings Institution, *How Did COVID-19 Disrupt the Market for U.S. Treasury Debt?* (May 1, 2020), https://www.brookings.edu/blog/up-front/2020/05/01/how-did-covid-19-disrupt-the-market-for-u-s-treasury-debt/.

[30] Rob McLean & Caroline Kelly, *SEC Becomes First Federal Agency to Ask DC Employees to Work from Home over Potential Coronavirus Case*, CNN, Mar. 9. 2020, https://www.cnn.com/2020/03/09/politics/sec-coronavirus-work-from-home/index.html.

[31] SEC, SEC Coronavirus (COVID-19) Response, https://www.sec.gov/sec-coronavirus-covid-19-response (last visited Apr. 11, 2021).

pandemic and announced travel restrictions.[32] "[A]ny doubt that the Covid-19 pandemic was about to shatter daily life ended on March 11. What had been a steadily building crisis exploded in a handful of hours."[33]

For many people, empty streets, offices, stores and churches brought the significance of the pandemic to the top of consciousness. For others, the abrupt cancellation of major sporting events on March 11 and 12, 2020, including all Spring major league sports and the annual "March Madness" college basketball championship series, brought the pandemic home.[34] Suddenly, this pandemic became very real for everyone.

Events in the real world were impacting the economy and the financial markets. By the end of that second week of March 2020, the SEC[35] and federal bank regulators[36]

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[32] David Ingram et al, *'It Felt Like the World was Falling Apart': An Oral History of the Day that Changed America*, NBC News, Mar. 11, 2021, https://www nbcnews.com/news/us-news/-felt-world-was-falling-apart-oral-history-day-changed-america-rcna394 (article on the one-year anniversary of March 11, 2020).
[33] *Id.*
[34] On March 11, the NBA halted its season, followed shortly afterwards by the National Hockey League and Major League Baseball. NBA Press Release, NBA to Suspend Season After Wednesday's Games (Mar. 11, 2020), https://www nba.com/news/nba-suspend-season-following-wednesdays-games; NHL Press Release, NHL to Pause Season Due to Coronavirus (Mar. 12, 2020), https://www nhl.com/news/nhl-coronavirus-to-provide-update-on-concerns/c-316131734; Bill Shaikin & Jorge Castillo, *MLB Suspends Spring Training Indefinitely Because of the COVID-19 Pandemic*, Los Angeles Times, Mar. 12, 2020, https://www.latimes.com/sports/story/2020-03-12/mlb-suspends-spring-training-indefinitely-coronavirus-pandemic; Tyler Kepner, *MLB Pushes Back Opening Day Over Coronavirus Concerns*, N.Y. Times, Mar. 12, 2020, https://www.nytimes.com/2020/03/12/sports/baseball/mlb-season-opening-day-coronavirus html. On March 12, all of the major college basketball conferences terminated their men's championship tournaments (some halfway through the day's games). Kyle Boone & David Cobb, *2020 ACC Tournament Cancelled Amid Coronavirus Pandemic Concerns*, CBS Sports, Mar. 12, 2020, https://www.cbssports.com/college-basketball/news/2020-acc-tournament-canceled-amid-coronavirus-pandemic-concerns/live/; David Cobb & Kyle Boone, *2020 Pac-12 Tournament Canceled Thursday Amid Coronavirus Pandemic Concerns*, CBS Sports, Mar. 12, 2020, https://www.cbssports.com/college-basketball/news/2020-pac-12-tournament-canceled-thursday-amid-coronavirus-pandemic-concerns/live/. On March 13, the NCAA cancelled the basketball national championship tournament for the first time in its history. Kyle Boone, *2020 NCAA Tournament Canceled Due to Growing Threat of Coronavirus Pandemic*, CBS Sports, Mar. 13, 2020, https://www.cbssports.com/college-basketball/news/2020-ncaa-tournament-canceled-due-to-growing-threat-of-coronavirus-pandemic/.
[35] *See, e.g.*, SEC Press Release 2020-62, SEC Staff Provides Guidance to Promote Continued Shareholder Engagement, Including at Virtual Annual Meetings, for Companies and Funds Affected by the Coronavirus Disease 2019 (COVID-19) (Mar. 13, 2020), https://www.sec.gov/news/press-release/2020-62.
[36] *See, e.g.*, OCC Bulletin 2020-13, Pandemic Planning: Updated FFIEC Guidance (Mar. 6, 2020), https://www.occ.gov/news-issuances/bulletins/2020/bulletin-2020-13 html; OCC News Release 2020-30, Agencies Encourage Financial Institutions to Meet Financial Needs of Customers and Members Affected by Coronavirus (Mar. 9, 2020), https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-30.html; OCC Bulletin 2020-15, Pandemic Planning: Working With Customers Affected by Coronavirus and Regulatory Assistance (Mar. 13, 2020), https://www.occ.gov/news-issuances/bulletins/2020/bulletin-2020-15 html; OCC News Release 2020-32, Federal Banking Agencies Encourage Banks to Use Federal Reserve Discount Window (Mar. 16, 2020), https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-32 html; OCC Bulletin 2020-19, Pandemic Planning: Joint Statement on Community Reinvestment Act Consideration for Activities in Response to COVID-19 (Mar. 19, 2020), https://www.occ.gov/news-issuances/bulletins/2020/bulletin-2020-19 html; OCC News Release 2020-39, Agencies Provide Additional Information to Encourage Financial Institutions to Work with Borrowers Affected by COVID-19 (Mar. 22,

had shifted into crisis response mode with temporary relief for businesses dealing with the pandemic.

The turmoil in the commercial paper market and other high-quality short-term markets and its impact on MMFs did not begin until mid-March 2020, weeks after the equity and oil markets had begun to plummet and at least a week after the bond market entered its turbulent period.[37] Blaming these conditions on MMFs does not work, as events in the real world[38] and in other segments of the financial markets occurred before MMFs experienced significant outflows.

According to the PWG MMF Report, prime institutional MMF outflows began on March 12 and peaked on March 17, with the funds losing approximately 30% of their assets over a two-week period.[39] Outflows from tax-exempt MMFs began on March 12 and reached a peak on March 23.[40] According to the PWG MMF Report, this may have adversely affected the municipal bond markets.

The PWG MMF Report points to a widening of FRA-OIS spreads[41] on commercial paper during March 2020 to suggest MMF outflows caused the market turmoil. The FRA-OIS spread is viewed as a proxy for turmoil or risk in the interbank lending markets because it represents the spread between the rate at which the central bank lends and the average rate at which banks lend to one another. The widening of FRA-OIS spreads, however, was widely noted in *early* March 2020 (before outflows from MMF commenced) and was attributed to market concerns over the COVID-19 pandemic. As stated in a March 9, 2020 article on this topic on Bloomberg, "[t]he widening of the FRA-OIS spread -- seen by many as a proxy for risks in the banking sector -- reflects concern that companies will struggle as the new coronavirus exacts its toll on the economy."[42]

As ICI data further documents, OIS spreads widened earlier in March *before* MMFs experienced significant outflows. As the ICI Report stated:

2020), https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-39.html; OCC News Release 2020-42, Agencies Announce Two Actions to Support Lending to Households and Businesses (Mar. 27, 2020), https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-42.html; OCC News Release 2020-48, Federal Agencies Encourage Mortgage Servicers to Work With Struggling Homeowners Affected by COVID-19 (Apr. 3, 2020), https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-48.html.

[37] *See* PWG MMF Report, *supra* note 1, at 13 cht.3.

[38] *Supra* notes 32-34. *See also* Federal Reserve Bank of St. Louis, Timeline of Events Related to the COVID-19 Pandemic, https://fraser.stlouisfed.org/timeline/covid-19-pandemic (detailing months of real world, financial markets and economic turbulence before the Federal Reserve established new lending facilities for money markets) (last visited Apr. 11, 2021).

[39] PWG MMF Report, *supra* note 1, at 13-14.

[40] *Id.* at 13-14.

[41] FRA-OIS spread is the difference between 3-month LIBOR and the federal funds rate.

[42] Alex Harris, *Why It Matters That the FRA-OIS Spread Is Widening*, Bloomberg, Mar. 9, 2020, https://www.bloomberg.com/news/articles/2020-03-09/why-it-matters-that-the-fra-ois-spread-is-widening-quicktake.

the timing of events in March suggests that the collective outflows from both institutional and retail prime money market funds did not trigger the stresses in short-term funding markets. Figure 3.6 shows daily flows of prime money market funds from the beginning of February to the end of April. These are plotted against two measures of market distress. The bid-ask spread on off-the-run Treasuries is a measure of stress in the Treasury bond market, while the FRA-OIS spread is a guide to stress in the interbank lending market. These spreads tend to widen when bond and money markets come under stress. As Figure 3.6 shows, by March 11 these spreads had widened substantially, yet prime money market funds had seen virtually no outflows.

Moreover, if the hypothesis that prime money market funds caused the stresses in the short-term funding markets is correct, there should at least be a positive correlation between flows to these funds and the FRA-OIS spread. In fact, the correlation is *negative* in March. This pattern is most clearly seen between March 13 and 16, when the FRA-OIS spread fell nearly 50 basis points—indicating less market stress—yet outflows from prime money market funds were picking up.[43]

This timing is clearly illustrated in Figure 3.6 of the ICI Report:

FIGURE 3.6

Stresses in Fixed-Income Markets Preceded Outflows from Prime Money Market Funds

Daily, February 3–April 30, 2020

*The off-the-run Treasury spread is calculated using the bid and offer prices on the next most recently issued 10-year US Treasury note.

Note: The off-the-run bid-ask spread on 10-year US Treasury note and the FRA-OIS spread are both shown on the left scale in basis points (bps). Flows to prime money market funds are also shown on the left scale, but in billions of dollars.

Sources: Bloomberg (FRA-OIS spread), iMoneyNet (flows to prime money market funds), and ICI calculations of Bloomberg data (bid-ask spread on off-the-run 10-year US Treasury note)

In addition to the timing being off in the PWG MMF Report, the size of MMFs' commercial paper positions are no longer dominant as a percentage of that market or as a

[43] ICI Report, *supra* note 8, at 14.

portion of prime MMF portfolios.[44] Other even-more-liquid assets currently dominate prime MMF portfolios and are the first to be liquidated to meet redemption requests, ahead of commercial paper. This is reflected in the SEC publication tracking the aggregate portfolio assets of prime MMFs during the Spring of 2020.[45] The following chart shows the holdings by prime MMFs of financial, non-financial and asset-backed commercial paper as at the end of February, March and April 2020 (in billions of dollars):[46]

	Feb. 2020	Mar. 2020	Apr. 2020
Financial CP	209.9	190.3	180.4
Non-Financial CP	162.9	152.1	149.4
Asset-Backed CP	64.4	53.6	55.7

These commercial paper holdings by prime MMFs began to rebound in May 2020.[47] In an aggregate commercial paper market of well over a trillion dollars of outstanding amounts, these changes in MMF holdings were simply not large enough to have had the market impact that the PWG MMF Report implies.

An analysis by The Carfang Group on redemptions of prime MMFs in March 2020 concluded that 23% of sophisticated corporate investors increased their holdings of prime MMFs, 28% maintained their holdings, and only 49% decreased their holdings.[48]

If anything, prime MMFs were a relative stabilizing force in these markets and could have been more of a stabilizing factor had they been larger. Such a conclusion would be consistent with the fact, discussed above, that the 2016 implementation of the 2014 Amendments caused prime MMFs to shrink by nearly two-thirds in asset size and resulted in a substantial widening of the FRA-OIS spread which continued for a year after that asset shift occurred.[49]

The PWG MMF Report attempt to attribute the widening of FRA-OIS spreads in March 2020 to outflows from MMFs (which started over a week later) is simply wrong. As is the conclusion that MMFs or some alleged structural weakness in MMFs caused or exacerbated the market turmoil in the Spring of 2020. The weakness is not in MMFs themselves, but in the ill-conceived linkage of weekly liquid asset thresholds to fees and

[44] *See* Viktoria Baklanova, Isaac Kuznits & Trevor Tatum, SEC Division of Investment Management Analytics Office, Primer: Money Market Funds and the Commercial Paper Market (Nov. 9, 2020) at 1-2, https://www.sec.gov/files/primer-money-market-funds-commercial-paper-market.pdf ("SEC MMF Primer"); ICI Report, *supra* note 8, at 7 fig.3.3; SEC Division of Investment Management Analytics Office, Money Market Funds Statistics, Form N-MFP Data, Period Ending February 2021 (Mar. 16. 2021) at 30 tbl.A11, https://www.sec.gov/files/mmf-statistics-2021-02.pdf ("SEC MMF Data") (MMFs represented 21-22% of investments in the commercial paper market at June 30, 2020 and commercial paper represented 38.8% of prime MMF portfolios as of December 31, 2019).
[45] SEC MMF Data, *supra* note 44, at 30 tbl.A11.
[46] *Id.*
[47] *Id.*
[48] Carfang Report, *supra* note 8, at 1.
[49] *Supra* note 25 and accompanying text.

gates included in the 2014 Amendments, which caused an artificial incentive to redeem shares.

Here is the reality: the COVID-19 pandemic and government reaction to the same drove all of this. The market disruptions in March and April of 2020 were exacerbated by the chaotic and uncoordinated response of governments around the world, including the U.S., to the global pandemic.[50] The disruptions were not "caused" by "structural vulnerabilities" of money market funds. The complaint, for example, of maturity transformation when asserting the structural vulnerability of money market funds – when compared to banks – is like comparing an ice cube to an iceberg; they're both frozen water but are not really the same.

Conditions in the real world affected the markets, not the other way around. And the market impacts were felt first in equities, treasuries and commodities, later in bond markets, then in money markets and subsequently at MMFs. The problem affecting municipal bond markets was that investors quickly realized that without sales tax revenues and income taxes paid in by the workers in the industries most immediately and severely impacted by the pandemic – restaurants, hotels, entertainment and in-person retail – state and local governments might not be able to meet their bond and other payment obligations. Stress to the markets in the timeframe was due to the rational and logical reaction of investors and market participants to the unprecedented and poorly coordinated actions by governments around the world. MMFs, outflows from MMFs and alleged "structural vulnerabilities" in MMFs did not cause or exacerbate the crisis.

Ultimately, Federal Reserve support for the markets helped ease the crisis, but the nature of the shutdowns and the uncertainty about the trajectory of the pandemic and the government responses thereto still meant investors and businesses would look to build up cash and safe assets. In response to the crisis, the Federal Reserve promptly exercised its statutory powers to open emergency credit facilities to provide liquidity to the markets to help reduce the turmoil.[51] These emergency credit facilities included the Primary Dealer Credit Facility (PDCF), the Primary Market Corporate Credit Facility (PMCCF), the Secondary Market Corporate Credit Facility (SMCCF), the Paycheck Protection Program Liquidity Facility (PPPLF), the Commercial Paper Funding Facility (CPFF) (analogous to the AMLF from the 2007-2009 Financial Crisis), the Money Market Mutual Fund Liquidity Facility (MMLF) and the Term Asset-Backed Securities Loan Facility (TALF). The total of these facilities was approximately $2.3 trillion.

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[50] *See, e.g.*, Derek Thompson, *The Pandemic Mistake America Can't Repeat*, The Atlantic (Mar. 17, 2021), https://www.theatlantic.com/ideas/archive/2021/03/the-original-sin-of-americas-covid-19-response/618300/
("The U.S. can use the brutal experience of 2020 to recognize and respond with greater speed and precision to the next dangerous pathogen. In this pandemic, testing was America's original sin.").

[51] *See, e.g.*, Tim Sablik, Federal Reserve Bank of Richmond, *The Fed's Emergency Lending Evolves*, Econ Focus, Second/Third Quarter 2020, https://www.richmondfed.org/publications/research/econ_focus/2020/q2-3/federal_reserve ("Fed Emergency Lending Paper").

Of these facilities, among the smallest and shortest-lived was the CPFF, which was fully paid off with interest. The next smallest was the MMLF, which at its peak reached $53 billion (available not to MMFs but to banks and dealers that purchased portfolio commercial paper and other high-quality short-term assets from MMFs). Notably, neither of these programs lent to MMFs. The CPFF provided financing to issuers of commercial paper, while the MMLF provided financing to banks that purchased commercial paper from MMFs. As such, these facilities provided liquidity to the commercial paper market and issuers of commercial paper, rather than directly to MMFs or other investors in commercial paper. The MMLF was expanded by the Federal Reserve to cover purchases of bank CDs and certain municipal securities when demand for the facility proved to be less than anticipated.[52] At year-end 2020, the outstanding loans under the MMLF stood at $3.7 billion.[53] In comparison, at year-end 2019, the Federal Reserve Banks' aggregate balance sheet totaled approximately $4.2 trillion and grew to approximately $7.4 trillion by year-end 2020.[54]

The aggregate size of the MMLF during the Spring 2020 crisis at its height was about a third of the size of the analogous Federal Reserve credit facility deployed in the Fall of 2008 during the Financial Crisis (which peaked at $152 billion), with the MMLF totaling $53 billion at its peak in April 2020.[55] This facility and its predecessor in 2008 are remarkably similar to a primary purpose for which the Federal Reserve was created by Congress in the Federal Reserve Act of 1913, which was to provide liquidity to the commercial paper market through banks by purchasing commercial paper from the banks at the "discount window."[56] Notably, the Federal Reserve used that authority during the Spanish flu pandemic of 1918-1919 to provide liquidity to banks to allow them to continue lending during that crisis.[57]

The Federal Reserve's CPFF and MMLF are not bailouts,[58] and did not result in any losses to taxpayers. Instead, the Federal Reserve has turned a substantial profit on these facilities, including $43 million in net profits on the CPFF, and $180 million in interest and an additional $130 million in financing facilities fees on the MMLF.[59] In contrast, the "Main Street" Federal Reserve financing facility turned a $2.4 billion loss net of loan loss reserves,[60] and the multi-trillion dollar stimulus packages enacted by

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[52] *See* SEC MMF Primer, *supra* note 44, at 3.
[53] Periodic Report: Update on Outstanding Lending Facilities Authorized by the Board under Section 13(3) of the Federal Reserve Act (Jan. 9, 2021) at 3, https://www.federalreserve.gov/publications/files/pdcf-mmlf-cpff-pmccf-smccf-talf-mlf-ppplf-msnlf-mself-msplf-nonlf-noelf-01-11-21.pdf.
[54] Federal Reserve Banks Combined Financial Statements, As of and for the Years Ended December 31, 2020 and 2019 and Independent Auditors' Report at 3, https://www.federalreserve.gov/aboutthefed/files/combinedfinstmt2020.pdf ("FRB Financial Statements").
[55] ICI Report, *supra* note 8, at 25.
[56] Fed Emergency Lending Paper, *supra* note 52, at 1.
[57] *Id.* at 4.
[58] *See* Yellen Letter, *supra* note 6, at 2.
[59] FRB Financial Statements, *supra* note 55, at 22-23 (MMLF data); Financial Statements: CP Funding Facility II LLC, For the Period from March 30, 2020 to December 31, 2020 and Independent Auditors' Report at 4, https://www federalreserve.gov/aboutthefed/files/cpffllcfinstmt2020.pdf (CPFF data).
[60] *See* Financial Statements: MS Facilities LLC, For the Period from May 18, 2020 to December 31, 2020 and Independent Auditors' Report at 6,

Congress have been grants, forgivable loans and other targeted spending that constitute direct subsidies to small businesses (broadly defined to include many law firms, accounting firms, consulting firms, etc.), religious institutions, private schools, charitable organizations and hard-hit industries such as hotels, medical and airlines, as well as individuals and state and local governments. These include the $2 trillion Coronavirus Aid, Relief, and Economic Security Act, and $484 billion Paycheck Protection Program enacted in March and April 2020, the Consolidated Appropriations Act, 2021 in December 2020 which includes $900 billion in further COVID-19-related stimulus relief and the American Rescue Plan Act of 2021, which passed Congress in March 2021 and added an additional $1.9 trillion in childcare assistance payments, unemployment benefits and $1,400 checks for persons earning under $75,000 per year, among other benefits and funding programs. These should not be confused either in substance or size with the fully secured Federal Reserve credit programs that have largely been repaid in full. In view of the tight conditions to their use, they do not present a moral hazard. The MMLF at peak during its brief period of operations totaled well under one percent of the consolidated assets of the Federal Reserve.

III. PWG MMF Report

Federated Hermes appreciates the opportunity to provide the following comments on each of the potential policy measures for prime and tax-exempt MMFs set forth in the PWG MMF Report, taking into account the assessment criteria in the PWG MMF Report, namely:

- how each reform option would seek to achieve the goals of MMF reform;
- how each reform option would affect short-term funding markets and the MMF sector more broadly; and
- the potential drawbacks, limitations, and challenges specific to each reform option.

A. Removal of Tie between MMF Liquidity and Fee and Gate Thresholds

Federated Hermes supports eliminating the requirement for a fund's board to consider imposing redemption gates and liquidity fees if weekly liquid assets ("WLAs") drop below 30% of the fund's total assets. However, Federated Hermes supports a MMF board being permitted, in its discretion and in accordance with its exercise of its fiduciary duty, to impose liquidity fees or redemption gates when doing so is in the best interests of the fund and its shareholders, without reference to any specific level of liquidity.

Federated Hermes supports the existing MMF daily and weekly liquid asset threshold requirements of 10% and 30%, respectively. We note that if a fund does not satisfy these requirements at any time, the fund is limited to purchasing assets that would cause the percentage of its liquid assets to increase, as required by the 2010 Amendments.

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https://www.federalreserve.gov/aboutthefed/files/msllcfinstmt2020.pdf (showing $2.4 billion loss on municipal securities financing facilities).

As noted in the PWG MMF Report, liquidity fees and redemption gates are intended to give MMF boards tools to stem heavy, and potentially disruptive, redemptions by imposing a fee to reduce shareholders' incentives to redeem or by stopping redemptions altogether for a limited period of time.[61] Under Rule 2a-7, MMF boards have discretion to impose fees or gates when WLAs fall below 30 percent of total assets and generally must impose a fee of 1 percent if WLAs fall below 10 percent, unless the board determines that such a fee would not be in the best interests of the fund or that a lower or higher (up to 2 percent) liquidity fee is in the best interests of the fund.[62]

While the 2014 Amendments to Rule 2a-7 were intended to strengthen MMFs, they in fact made MMFs more susceptible to financial market stress, as evidenced by the experiences of the MMF sector in March 2020.[63] By adding the possibility of a liquidity fee or redemption gate to the WLA threshold, the SEC's 2014 Amendments to Rule 2a-7 created a new bright line trigger event, which could cause investors to redeem heavily as a fund approaches the 30 percent level.

As noted in the PWG MMF Report, in March 2020, the link between a fund's WLA and the permissive imposition of liquidity fees and redemption gates had the effect of incentivizing preemptive investor redemptions as funds approached the relevant WLA threshold.[64] Note that these investor redemptions occurred as MMFs approached the WLA threshold where liquidity fees and redemption gates were ***permissible*** (i.e., when WLAs fall below 30%) rather than the WLA threshold where liquidity fees are ***required*** (i.e., when WLAs fall below 10%).

An analysis by The Carfang Group on redemptions of prime MMFs in March 2020 concluded that 23% of sophisticated corporate investors increased their holdings of prime MMFs, 28% maintained their holdings, and only 49% decreased their holdings.[65] The analysis noted that 87% of investors that decreased their prime MMF holdings mentioned the potential of redemption hurdles as a factor in their decision.[66]

By coupling the option to impose liquidity fees or redemption gates with the 30 percent WLA requirement, the SEC's 2014 reforms negatively affected the benefits of this substantial liquidity buffer. As a result of these changes, the 30 percent WLA buffer became a floor that accelerated shareholder redemptions due to uncertainty about the imposition of liquidity fees or redemption gates. To be a true buffer, the WLA requirement should be an extra source of liquidity in times of stress rather than a potential source of instability.[67]

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[61] PWG MMF Report, *supra* note 1, at 22.
[62] 17 C.F.R. at § 270.2a-7.
[63] *See* ICI Report, *supra* note 8, at 30-37.
[64] PWG MMF Report, *supra* note 1, at 23.
[65] Carfang Report, *supra* note 8, at 1.
[66] *Id.* at 2.
[67] ICI Report, *supra* note 8, at 37.

A potential regulatory enhancement could include enhanced Know Your Customer ("KYC") tools, such as amending Rule 22c-2 of the Investment Company Act[68] to require MMFs to enter into agreements with intermediaries to provide shareholder information. This would equip MMFs even better to plan for sufficient portfolio liquidity to meet anticipated redemptions above and beyond the 10% daily and 30% weekly liquid asset minimums.

B. Reform of Conditions for Imposing Redemption Gates

In light of the recent experience of MMFs with the redemption gates and liquidity fees requirement from the 2014 Amendments to Rule 2a-7, it is clear that reform of the conditions for imposing redemption gates should be seriously considered by policymakers.

As discussed earlier, the data from March 2020 strongly suggests that tying permissible redemption gates to a fund's WLA does not strengthen MMFs as intended but rather subjects them to increased redemptions when a MMF approaches the permissible threshold.[69]

As noted earlier, Federated Hermes supports a MMF board being permitted to impose liquidity fees or redemption gates when doing so is in the best interests of the fund, without reference to any specific level of liquidity. The right to redeem should not be restricted unless there is a reasonable prospect that shareholders would benefit from the restriction. Federated Hermes cannot conceive of any formulation of a nondiscretionary liquidity fee or suspension of redemptions that would not run the risk of needlessly restricting shareholder redemptions or incenting the very redemption activity we're trying to avoid. As a fund's board is charged with safeguarding the interests of its shareholders, it is appropriate for the board to make this determination, without prior notice to or approval from the SEC.[70]

C. Minimum Balance at Risk

Federated Hermes opposes any redemption restriction that would impair investor liquidity when liquidity is readily available within the MMF, such as minimum balance at risk ("MBR").

Throughout the 40-year history of MMFs, investors have benefited from the convenience, liquidity, and stability of these funds. Individual or retail investors use MMFs as savings vehicles to amass money for future investments or purchases; as transaction accounts; and as stable-value investments in their retirement or other investment portfolios. Institutional investors – which include corporations of all sizes, state and local governments, securities lending operations, bank trust departments, sweep

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[68] 17 C.F.R. at § 270.22c-2.
[69] *See* PWG MMF Report, *supra* note 1, at 23; ICI Report, *supra* note 8, at 30-37.
[70] Letter from Federated Investors, Inc. to SEC (Sept. 16, 2013) at 8, https://www.sec.gov/comments/s7-03-13/s70313-130.pdf.

programs, securities brokers, and investment managers – use MMFs as a cost-effective way to manage and diversify credit risk, while providing same-day liquidity with market-based yields.[71]

An MBR (or a holdback variant of the same basic concept) would eliminate the very liquidity of MMFs that has been central to their widespread use in a variety of applications, including corporate payroll processing, escrow balances, storing corporate and institutional operating cash balances, pension and employee benefit plan processing, and holding broker-dealer customer cash balances. A holdback requirement would also limit the utility of MMF shares as collateral and lead to ever-higher collateral requirements when MMF shares serve as collateral.

Same-day settlement of the entirety of a transaction amount is a crucial feature of MMFs that underpins their widespread use to hold short-term cash balances. Imposition of an MBR or holdback requirement—no matter the amount—for any number of days would destroy the ability of companies and individuals to use MMFs as a liquid investment that can be readily redeployed, on a same-day basis, towards other uses. The net result of an MBR or holdback requirement would be to make MMFs impractical to hold the large, short-term cash balances used in transaction processing systems across a wide variety of businesses and applications. This, in turn, will result in many existing institutional investors choosing not to continue to invest in MMFs if such requirements are imposed.[72]

Furthermore, while the PWG MMF Report justifies an MBR on the basis that it could reduce the vulnerability of MMFs to redemptions,[73] Federated Hermes notes that an MBR would not remove the risk of large scale redemptions from MMFs, and, if adopted, could even precipitate redemptions.[74] As noted in the PWG MMF Report,[75] an MBR also poses several significant implementation and administration challenges that significantly complicate its potential effectiveness.[76]

D. MMF Liquidity Management Changes

Federated Hermes strongly supports the 2010 Amendments that require MMFs to be subject to daily and weekly liquid asset requirements and the daily disclosure of a MMF's compliance with such requirements, and the requirement that MMFs have a process for anticipating investor redemptions and hold additional liquid assets above and beyond these daily and weekly liquid asset thresholds in order to meet the anticipated outflows. These requirements have worked remarkably well as documented above. Moreover, Federated Hermes believes that *most* of the amendments to MMF regulation

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[71] Letter from ICI to SEC (Jun. 20, 2012) at 7, https://www.sec.gov/comments/4-619/4619-200.pdf.
[72] Letter from Arnold & Porter LLP to SEC (Aug. 9, 2012) at 14-23, https://www.sec.gov/comments/4-619/4619-222.pdf ("A&P Aug. 9, 2012 Letter"); letter from Federated Investors, Inc. to SEC (Mar. 16, 2012), https://www.sec.gov/comments/4-619/4619-140.pdf ("Federated Mar. 16, 2012 Letter").
[73] PWG MMF Report, *supra* note 1, at 25.
[74] *See* A&P Aug. 9, 2012 Letter, *supra* note 73, at 11-14, 23-27.
[75] *See* PWG MMF Report, *supra* note 1, at 25-26.
[76] *See* A&P Aug. 9, 2012 Letter, *supra* note 73, at 14-23; Federated Mar. 16, 2012 Letter, *supra* note 73.

that the SEC adopted in the 2014 Amendments also worked well (except for imposing a floating NAV requirement on institutional prime and municipal MMFs and linking mandatory consideration of gates and fees in institutional and retail prime and municipal MMFs to threshold liquidity levels). Federated Hermes does not support adding additional detail and tiers to the existing liquid asset requirements (such as adding a bi-weekly liquid asset requirement) as this would, as a practical matter, simply result in an increase in the weekly liquid asset holdings of MMFs and would unnecessarily tie the hands of MMF portfolio managers and limit their flexibility in how they structure the maturities of the portfolios to address current market conditions and anticipated client redemptions. It may also artificially reduce the spread between prime and government MMFs, thus making prime MMFs less attractive to investors, shrinking the prime MMF industry and increasing the cost of funding to issuers in the prime money markets. We support the proposal to de-link the consideration of imposing gates or fees by the board of a MMF from compliance with portfolio liquidity levels. The linkage has had the unintended consequence of creating a redemption incentive for some shareholders as a MMF approaches the minimum required liquid asset levels.

E. Countercyclical Weekly Liquid Asset Requirements

As discussed above, the linkage of gates and fees to weekly liquid asset requirements in the 2014 Amendments to Rule 2a-7 created an artificial and unnecessary incentive for some institutional shareholders of prime MMFs to redeem as the threshold is approached. For that reason we believe that imposition of gates and fees should be de-linked from weekly liquid asset standards. When regulatory liquidity thresholds are de-linked from consideration of gates and fees, there will be no need for countercyclical liquid asset requirements. By delinking the requirements, the incentive is removed and the purpose behind allowing lower liquidity in times of stress is no longer necessary or appropriate. Therefore, Federated Hermes does not support a countercyclical weekly liquid asset requirement.

F. Floating NAVs for All Prime and Tax-Exempt MMFs

As noted in the PWG MMF Report, following the 2014 Amendments to Rule 2a-7, institutional prime and institutional tax-exempt MMFs are required to price their shares using a floating NAV, which attempts to reflects the market value of the fund's investments and any changes in that value, thus reducing the risk of an adverse signaling effect from "breaking the buck".[77] However, retail prime and retail tax-exempt MMFs are allowed to use a stable NAV.[78]

While the PWG MMF Report suggests that requiring a floating NAV for retail prime MMFs and retail tax-exempt MMFs could eliminate or diminish the importance of a stable NAV for spurring investor redemptions,[79] redemption data from March 2020 shows that institutional prime MMFs that had floating NAVs still experienced increased

[77] PWG MMF Report, *supra* note 1, at 6.
[78] *Id.* at 28.
[79] *See id.* at 20, 28.

redemptions.[80] Indeed, floating NAV MMFs had more redemptions than their stable NAV counterparts.[81] *There is no evidence that floating NAVs stop redemptions*. It would be far more appropriate, and based on data, to remove floating NAV requirements from institutional prime and tax-exempt MMFs than to impose them on retail funds.

As noted in the PWG MMF Report, floating NAVs could result in a reduction in the size of retail prime and retail tax-exempt MMF sectors by making retail MMF shares less cash-like, which could reduce investor demand.[82] This is exactly what happened to institutional prime MMFs following the 2014 Amendments to Rule 2a-7; in the run up to the compliance date of the 2014 Amendments, $740 billion left institutional prime MMFs with a nearly one-for-one increase in the assets of government MMFs.[83] Floating NAV prime MMFs' assets never recovered. This segment of prime MMFs is about one-third of its former size, and floating NAV tax-exempt MMFs are about one-tenth of their previous size.

Federated Hermes strongly opposes a floating NAV requirement for retail prime and tax-exempt MMFs because, as the SEC believed in 2014, and as the PWG MMF Report acknowledges, retail MMF investors tend not to redeem their shares in a crisis. By dividing prime and tax-exempt MMFs into separate retail and institutional series, this effect has been even more clearly documented by the data on MMF outflows in the Spring of 2020. Retail investors largely left their prime and tax-exempt balances in place. In the Spring of 2020, institutional prime MMFs were subject to floating NAVs and this category of MMFs experienced outflows. Retail prime MMFs were not subject to floating NAVs and this category of MMFs did not experience significant outflows. This demonstrates that floating NAVs – which arguably eliminate the theoretical "first mover" advantage – did not stem outflows and retail MMFs did not experience material outflows in a financial crisis. All that floating NAVs for institutional prime and tax-exempt MMFs accomplished was to shrink their size. Why, then, would any rational policymaker amend Rule 2a-7 to impose floating NAVs on retail prime MMFs? It would be an ineffective (and potentially harmful) solution to a non-existent problem. Remember, first, do no harm.

We also note that the movement of MMF investors from prime MMFs to federally-insured bank deposits and U.S. government MMFs in 2016 as a result of the 2014 Amendments to Rule 2a-7 shifted trillions of dollars of private funding from prime borrowers to federally-guaranteed bank deposits and to the U.S. government itself. This effectively crowded private borrowers out of the market and shrunk the available pool of commercial paper funding for corporate and municipal government borrowers, thereby increasing the costs of commercial paper funding.

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[80] *Id.* at 29.
[81] *Id.* at 14-15.
[82] *Id.* at 29.
[83] ICI Report, *supra* note 8, at 28.

With this in mind:[84]

- A floating NAV would do nothing to advance the regulatory goal of reducing or eliminating large scale redemptions from a MMF.

- A floating NAV would only serve to tell investors something they already know – that MMF shares' valuations may fluctuate slightly – and would not affect investor behavior in times of stress.

- The potential for a "first-mover advantage," upon which the floating NAV proposal is based, cannot develop under Rule 2a-7 unless the precepts of the rule are not followed.

- A floating NAV will not produce "mark-to-market" prices for MMF portfolio instruments or for MMF shares. Instead, it will generate time-consuming and costly processes to derive market-based "good faith opinions" from pricing vendors of the valuation of MMF portfolio instruments, from which to calculate the required MMF NAVs. It would, however, preclude their use as cash sweep vehicles and force investors into deposit products or government funds.

- To the extent "market-based" valuations have an informational value for investors – principally to demonstrate that the underlying portfolio instruments and the MMF's underlying "market-based" NAV fluctuate in value – investors already have access to this information for MMFs.[85]

- A floating NAV would impose significant daily operational burdens on MMF users, intermediaries and MMFs. It could significantly impair the utility of prime MMFs and tax-exempt MMFs as cash management tools and lead to significant and disruptive disintermediation. The potential imposition of liquidity fees and redemption gates has already facilitated the movement by most intermediaries to government MMFs, crowding out other issuers from cost-effective short-term financing.

- Floating NAVs would substantially impair the utility of the product and shrink the assets of retail prime MMFs and retail tax-exempt MMFs.

- A floating NAV for retail prime MMFs and retail tax-exempt MMFs would contract the market for, and raise the cost of, short-term public and private debt financing while potentially destabilizing those markets.

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[84] *See generally* letter from Arnold & Porter LLP to SEC (Sept. 13, 2013), https://www.sec.gov/comments/s7-03-13/s70313-123.pdf; letter from Arnold & Porter LLP to SEC (Nov. 2, 2012), https://www.sec.gov/comments/4-619/4619-274.pdf.

[85] Based on Federated Hermes' review of floating NAVs for institutional prime MMFs managed by Federated Hermes and other asset managers since the effectiveness of the 2014 Amendments, floating NAVs for such MMFs are stable approximately 90% of the time and deviate very little from $1.00.

- A floating NAV for retail prime MMFs and retail tax-exempt MMFs would leave government MMFs as the only viable stable-value cash management vehicle for retail investors, which would promote the ability of the federal government to borrow at the expense of state and local governments and private issuers by funneling additional assets into government MMFs.

- A floating NAV for retail prime MMFs and retail tax-exempt MMFs could also force current retail prime MMFs and retail tax-exempt MMFs users to less regulated and less transparent products such as bank "short-term investment funds" and private "liquidity funds."

- A floating NAV for retail prime MMFs and retail tax-exempt MMFs would also accelerate the flow of assets to "Too Big to Fail" banks, further concentrating risk in that sector.

- A floating NAV for retail prime MMFs and retail tax-exempt MMFs would also cause confusion for individual investors when preparing their income tax filings, even if the IRS grants the same relief to retail MMFs as it did to institutional MMFs in 2016.[86]

G. Swing Pricing Requirement

As noted in the PWG MMF Report, while certain U.S. mutual funds (but not MMFs) are allowed to adopt an optional swing pricing framework, U.S. mutual funds have not implemented swing pricing because it would require substantial reconfiguration of current distribution and order-processing practices.[87] With respect to MMFs, imposing "swing pricing" will destroy their utility. MMFs would be effectively gone, but the potential for illiquidity and volatility in the commercial paper markets would remain. Market stresses predate the invention of MMFs as documented by the financial crises that led to adoption of the Federal Reserve Act of 1913 and the commercial paper crisis triggered by the collapse of Penn Central in 1970, to cite but a few pre-MMF era examples.

Moreover, because a MMF stands ready to create and redeem its shares at the applicable NAV throughout the trading day, the fund would not necessarily know whether net redemptions exceeded the swing pricing threshold until the end of the trading day. As a result of not knowing whether the swing pricing threshold had been exceeded until the end of the trading day, swing pricing would eliminate the existing ability of MMFs to price their shares on an intraday basis.

Furthermore, because MMFs provide same-day settlement even for redemptions that occur up until the close of trading, on a day when net redemptions exceed the swing pricing threshold (e.g., there is an abnormal amount of net redemptions), the fund may not know its liquidity costs as a result of the redemptions until it is able to sell the

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[86] *See* 26 C.F.R. § 1.446-7 (2020); IRS Rev. Proc. 2016-39, https://www.irs.gov/pub/irs-drop/rp-16-39.pdf.
[87] PWG MMF Report, *supra* note 1, at 29-30.

underlying prime and tax-exempt securities on the following trading day. Accordingly, swing pricing is not compatible with same-day settlement of MMFs. The ability to impose liquidity fees to prevent material dilution or other unfair results is functionally equivalent to swing pricing and exponentially easier.

In addition to the increase in risks to the financial system that would be caused by the *lengthening* of the settlement cycle for MMFs (e.g., counterparty and credit risks), the inability of investors to have same-day liquidity from MMFs, even in normal market conditions, would destroy the ability of companies and individuals to use MMFs as a liquid investment that can be readily redeployed, on a same-day basis, towards other uses.[88] We note that, in the case of French-domiciled MMFs, which are permitted to use swing pricing, no French-domiciled MMFs use swing pricing because swing pricing is not compatible with a key tenet of MMFs: providing investors with access to their cash on an intraday basis.

H. Capital Buffer Requirements

Most significantly, a capital buffer would not have the desired effect of reducing redemptions. A capital buffer does not prevent large scale redemptions or stop them once they have begun. Liquidity, available cash to pay investors, is what prevents or resolves large scale redemptions.[89] Capital buffers do not serve a purpose in an investment product such as MMFs where the investor bears the risk of loss of a portion of its investment.

While Federated Hermes acknowledges that capital buffers could in theory allow a MMF to incur small trading losses without breaking a dollar and that it is possible that small trading losses could help to avoid later and more significant credit losses, Federated Hermes believes that both the enormous cost and the marginal utility of capital buffers does not come close to justifying the adverse costs to shareholders and financial markets.

The concept of establishing a capital buffer has been put forward as a means of absorbing portfolio credit losses without a decline in share value. The options for a capital buffer include a slow build-up of capital through retained earnings, purchase of a new subordinated class of equity by the fund manager or sale of subordinated equity to third party investors. Any of these options would be a departure from the concept of what a mutual fund fundamentally is – a mutually-owned pool of equity owned by shareholders, who share equally in the profits or losses of the fund. In its place, there would be created a two-tiered equity structure, introducing a form of leverage into MMFs for the first time.[90]

Due to the very low yields on money market investments that have persisted over a period of more than a decade and are likely to continue for the foreseeable future,

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[88] *See supra* note 73 and accompanying text.
[89] Letter from Arnold & Porter LLP to SEC (Jun. 1, 2012) at 24, https://www.sec.gov/comments/4-619/4619-190.pdf ("A&P Jun. 1, 2012 Letter").
[90] *Id.*

currently there is insufficient portfolio yield to generate returns that could be used to create a meaningful capital buffer through retained earnings. In the current rate environment, a subordinated capital layer would take many years to build up to any significant level through retained earnings, will cause adverse tax consequences to the MMF and its investors, and further reduce yields in an already very-low yield environment. If provided by the investment manager, it would be expensive for the manager to provide and would be difficult or impossible to finance. It is doubtful that third-party investors would be willing to purchase subordinated capital of a MMF under economic terms that would make sense for the main shareholders of the MMF. The subordinated class of investors would expect a yield on their more risky class commensurate with that risk, which would be a further reduction to yields to the other investors.[91]

Adding subordinated debt or equity would also turn a rather simple product—the MMF—into a considerably more complex offering. Also, small funds and small fund complexes would likely find it difficult and costly to issue and roll over subordinated securities, resulting in industry consolidation and raising a barrier to entrants. Furthermore, the approach potentially would create competing interests between the subordinated and senior investors, such as the subordinated investors' desire to avoid losses and senior investors' desire for the fund to take greater risks to boost fund yields. The concept of raising capital through subordinated securities raises a number of additional issues that precludes the use of this structure.[92]

The Investment Company Act is designed to preclude use of leverage by registered funds in the form of classes of equity of different seniority and limits the use of leverage in the form of borrowings in order to protect fund investors and limit the systemic impact that the leverage in funds would add to the markets. This proposal would go against that bedrock principle in the Investment Company Act and add leverage to MMFs through creation of subordinated equity classes. This would increase, not decrease, the potential risk posed by MMFs.

Capital buffers will drive most shareholders out of MMFs and into banks or alternative (often unregulated) cash products by making it impractical for shareholders to use the funds for cash management or by taking away the advantages of using MMFs.[93]

I. Required Liquidity Exchange Bank Membership

The Dodd-Frank Act and actions by the federal bank regulators has improved bank capital levels. Bank affiliate transaction restrictions, however, preclude banks from playing a meaningful role in providing liquidity to MMFs that are sponsored or advised by the bank or its affiliates. While Federated Hermes and the broader MMF industry had been supportive of creating a liquidity exchange bank and similar proposals in the past,

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[91] *Id.*
[92] *See* letter from ICI to SEC (May 16, 2012), https://www.sec.gov/comments/4-619/4619-177.pdf.
[93] *See* A&P Jun. 1, 2012 Letter, *supra* note 93, at 24.

these ideas have since been studied in detail and determined to be untenable.[94] Further, Federated Hermes believes that designing, organizing and capitalizing a captive liquidity bank will be difficult to accomplish under the best of circumstances.[95] Banking and tax regulations make this even more difficult insofar as they do not allow for the unique purpose of the bank and the extremely limited risks that would be posed by its activities.[96]

In addition, this proposal is financially untenable. As noted in the PWG MMF Report, the bank would need significant capital to both be in a position to provide meaningful liquidity for MMFs in stress events and be seen as a credible liquidity backstop. Building adequate capacity from MMF income could take decades, particularly in a low interest rate environment.[97] As noted in a 2010 study conducted by the ICI, a liquidity exchange facility would require an initial equity contribution of $350 million, which, assuming 5% leverage, would allow for $7 billion in lending capacity, which could potentially increase to approximately $23 billion over three years.[98] Given current yields and fee waivers in the MMF market, this is simply not feasible.

J. New Requirements Governing Sponsor Support

Federated Hermes supports restriction of sponsor support of MMFs. The implication of tacit sponsor support by banks of their funds has created moral hazards for bank-sponsored funds that has required special disclosures. Imposing this support as a requirement would make the situation far worse. This possibility of support would create the risk of expansion of contagion from bank-sponsored funds to the affiliated banking organizations. If sponsor support is required, banks would need to include funds on their balance sheets and hold regulatory capital against the funds' assets.

MMF shares are investments. Sponsor support should not be assumed or relied upon by investors or required by regulatory policy. In limited, extraordinary circumstances, a sponsor may voluntarily choose to provide support to a MMF in several ways, such as, for example, through purchase by the sponsor of an illiquid or troubled security out of a fund's portfolio. While sponsor support has provided benefits for fund investors, some have referred to incidences of sponsor support of MMFs as a risk, because of the perceived danger that investors may rely on such support when it in fact is not guaranteed.[99]

The problem with every proposed form of sponsor support for MMFs is that it pushes MMFs farther in the wrong direction. Investors and their advisors understand from the disclosures that MMFs are not riskless and hope that a fund sponsor might absorb some amount of loss to protect its franchise. If they doubted that, the Reserve

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[94] *See id.*; letter from ICI to SEC (Jan. 10, 2011) at 23-31, https://www.sec.gov/comments/4-619/4619-49.pdf ("ICI Jan. 10, 2011 Letter").
[95] *See* A&P Jun. 1, 2012 Letter, *supra* note 93, at 35; ICI Jan. 10, 2011 Letter, *supra* note 98, at 23-31.
[96] A&P Jun. 1, 2012 Letter, *supra* note 93, at 35.
[97] PWG MMF Report, *supra* note 1, at 32-33.
[98] ICI, Liquidity Exchange Facility (Jan. 10, 2011) at 17, https://www.ici.org/pdf/11_sec_pwg_deck.pdf.
[99] A&P Jun. 1, 2012 Letter, *supra* note 93, at 14.

Primary Fund episode disabused them of the notion. Sponsor support would raise investor expectations and give credence to a view that money market funds are somehow "guaranteed." It seems evident that raising investor expectations of a guarantee will only make it harder to avoid government support during financial crisis, as shareholders will justifiably claim that they had been assured by federal regulations that the funds would be guaranteed. The ever-increasing demands made on federal deposit insurance during each banking crisis provide ample evidence of this phenomenon.[100] This proposal would give an unfair advantage to bank sponsors of MMFs who use their "too big to fail" status as a competitive advantage to attract investors to manage their assets.

Federated Hermes believes that investors should not make decisions based upon the potential for sponsor support, but instead should consider the quality of the investment portfolio of the MMF and the experience of the investment manager. The assumption that investors do not understand that MMFs have investment risks is simply incorrect.[101] Disclosures on MMF prospectuses in the U.S. are required to make clear that:

> An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund.[102]

As with capital buffers, mandatory sponsor support would increase investor expectations that MMFs are protected or guaranteed against loss and increase systemic risk. The approach would be anti-competitive because it would provide big banks and the very largest asset managers with a built-in advantage and regulatory barriers to entry in the MMF and cash management business. Additionally, fears that sponsors cannot maintain required capital could prompt massive shareholder redemptions. This would serve not to reduce the risk of large-scale shareholder redemptions, but rather to shift the trigger for a shareholder redemption from a "fear of portfolio default" to a "lack of capital event."[103]

A major reason for the additional returns MMFs provide shareholders is their low cost. Shareholders do not pay sponsors to maintain capital and the competitive environment of MMFs will not allow associated price increases to compensate for increased costs. Requiring any meaningful amount of sponsor capital would result in a return on equity below any rational economic incentive.[104]

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[100] Letter from Federated Investors, Inc. to SEC (May 19, 2011) at 7, https://www.sec.gov/comments/4-619/4619-101.pdf
[101] A&P Jun. 1, 2012 Letter, *supra* note 93, at 14-15.
[102] *See, e.g.*, 17 C.F.R. at § 230.482(b)(4).
[103] Letter from Federated Investors, Inc. to SEC (May 6, 2011) at 3, https://www.sec.gov/comments/4-619/4619-98.pdf.
[104] *Id.*

Regulated capital requirements make sense for banks and insurance companies, but do not make sense for MMFs. Unlike banks and insurance companies, sponsors do not have an equity stake in MMFs. MMFs are owned directly by shareholders.[105]

We note that there is a belief among Federal Reserve officials that the MMLF "bailed out" a number of foreign issuers in the U.S. commercial paper markets, raising the question of why U.S. taxpayers were supporting foreign banks. The Federal Reserve more directly has supported foreign banks and to a much larger dollar amount (both in the 2007-2009 Financial Crisis and in the Spring of 2020) by extraordinarily large lines of credit to the European Central Bank.[106] What the MMLF did (successfully) was to fulfill the statutory role of the Federal Reserve to provide liquidity to short-term U.S. credit markets when needed in a crisis. That benefits the domestic market and all of its participants, including non-U.S. banks that are active in U.S. credit markets and the businesses and state and local governments that borrow in these markets.

It should be remembered that providing central bank liquidity to markets during times of unusual financial stress prevents or mitigates extraordinary pressures in financial markets that would otherwise have severe adverse consequences for American households and businesses and the U.S. economy.[107] The provision of such liquidity does not represent a bailout.[108] Rather, any such central bank liquidity is provided with the end goal of supporting the real economy.[109]

IV. Market Structure Reform Alternatives

It is widely understood that the root cause of the market dislocations in March 2020 were not the activities of financial firms. The root cause was an economic shock to the system that sharply reduced price discovery across all markets. A contagion then ensued in which market participants could not be confident of asset values, no bids were available, or bid/ask spreads widened dramatically. Federated Hermes intends to submit a second comment letter detailing the reforms to regulation and market structure that would more effectively respond to such causal factors now and in the future.

Key findings of this letter will include: (i) in a rapidly evolving contagion, the Federal Reserve's toolkit is calibrated to intervening in an already-raging crisis, not preventing it from taking hold; (ii) in this regard, the reforms to Federal Reserve Act

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[105] *Id.* at 3-4.
[106] *See* Randal K. Quarles, Vice Chair for Supervision, Federal Reserve, *What Happened? What Have We Learned From It? Lessons from COVID-19 Stress on the Financial System* (Oct. 15, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20201015a htm (describing lines of credit and facilities for foreign central banks in COVID-19 crisis); Federal Reserve Bank of New York, Central Bank Swap Arrangements, https://www newyorkfed.org/markets/international-market-operations/central-bank-swap-arrangements (describing swap facilities put in place for foreign central banks in March 2020) (last visited Apr. 11, 2021).
[107] Yellen Letter, *supra* note 6, at 2.
[108] *See id.*
[109] *Id.*

Section 13(3) enacted by the Dodd-Frank Act have weakened the Federal Reserve's emergency response abilities; (iii) following the 2007-2009 Financial Crisis and Dodd-Frank Act reforms, the Federal Reserve substantially increased regulation of banks and bank broker-dealers in a manner that knowingly impaired their market-making capabilities; (iv) the Federal Reserve's programs for high-quality short-term debt including commercial paper were directed to primary issuance (the CPFF) and MMFs (the MMLF), but not to the secondary market generally, which if implemented would have met the needs of MMFs, as well as the needs of other holders, the damage to whom in March 2020 has been unmeasured and unaddressed; and (v) the structure of the high-quality short-term debt market itself is antiquated: an electronic venue allowing multiple broker-dealers to make markets in an array of issues (not just their own programs) would materially improve liquidity and transparency in the market.

V. Conclusion

Thank you for the opportunity to comment on the PWG MMF Report. As we have outlined, policy decisions based on inaccurate assumptions and false narratives as to the underlying cause and effect of market events inevitably leads to poor regulatory policy and unintended consequences. The market disruptions in March and April of 2020 were in no way "caused" by MMFs and do not demonstrate that MMFs have "structural weaknesses" that need to be addressed through additional regulation. The disruptions were caused by the logical and rational reaction of investors to the wholly unprecedented actions taken by governments around the world to try to slow the spread of the pandemic. In such circumstances some investors will seek safety and build cash because quite literally they cannot predict what's going to happen next. The role of central bankers and regulators in that event was first and foremost to assure the markets that they would provide liquidity and/or regulatory relief as necessary to restore confidence in the operation of the markets. The measures taken were not bailouts, particularly not in terms of the relief provided to the short-term liquidity markets, and were wholly consistent with the Dodd-Frank Act and the statutorily-intended role of the Federal Reserve.

In the wake of the Financial Crisis, efforts were made by the SEC and the U.S. mutual fund industry to take steps to enhance the resilience of money market funds. The 2010 Amendments to Rule 2a-7 incorporated a number of significant and helpful changes to enhance transparency and provide tools for MMF boards to respond more effectively to exogenous market events. Unfortunately, FSOC decided to push for additional regulation, proposing some of the very reforms articulated in the recent PWG MMF Report. The SEC rightly rejected many of those proposals, as many of them would have destroyed either the utility of the product or the economic feasibility of offering the product. Unfortunately, the SEC nonetheless embarked on additional rulemaking that in retrospect appears to have adversely impacted the role of money market funds in the prime commercial paper and municipal money markets by requiring a floating NAV for funds offered to institutional investors. Ironically, the 2014 Amendments also created a new "trigger" for potential large-scale redemptions by tying the 30% weekly liquid asset test to mandatory board consideration of liquidity fees and redemptions gates. Query whether markets would have been better served by leaving money market fund reform at the 2010 Amendments and addressing systemic risk at the firm level. Let's remember to "first, do no harm" in further amending MMF regulations.

We look forward to an opportunity to discuss this important subject further with you and would be happy to respond to any questions you might have.

Sincerely,

/s/ J. Christopher Donahue
J. Christopher Donahue
Chairman, CEO & President

/s/ Deborah Cunningham
Deborah Cunningham, CFA
Executive Vice President, Chief Investment Officer of Global Liquidity Markets and Senior Portfolio Manager

cc: The Honorable Gary Gensler, Professor of the Practice of Global Economics and Management, MIT Sloan School of Management
The Honorable Allison Herren Lee, Acting Chair, SEC
The Honorable Hester M. Pierce, Commissioner, SEC
The Honorable Elad L. Roisman, Commissioner, SEC
The Honorable Caroline A. Crenshaw, Commissioner, SEC
Ms. Sarah G. ten Siethoff, Acting Director, SEC Division of Investment Management
The Honorable Jerome H. Powell, Chair, Federal Reserve
The Honorable Randal K. Quarles, Vice Chair for Supervision, Federal Reserve
The Honorable Janet L. Yellen, Secretary of the Treasury