April 12, 2021

Securities and Exchange Commission
Attn: Vanessa A. Countryman, Secretary
100 F Street NE
Washington, DC 20549-1090

Re: Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report, File No. S7-01-21

Thank you for the opportunity to comment on potential reform measures for money market funds, as highlighted in the December 2020 report of the President's Working Group on Financial Markets (PWG Report). The authors of this letter are Samuel Hanson, Professor of Business Administration at Harvard Business School, David Scharfstein, Edmund Cogswell Converse Professor of Finance and Banking at Harvard Business School, and Adi Sunderam, Professor of Business Administration at Harvard Business School. We write in our individual capacities as financial economists, not on behalf of Harvard or any other organizations with which we are affiliated.[1]

**Background.** In 2014, after several years of study, the SEC approved new regulations for prime money market funds (MMFs), which were implemented in 2016. These new regulations were intended to prevent sudden and mass redemptions from MMFs of the sort that occurred in September 2008 during the height of global financial crisis. The goal of these reforms was not just to protect investors but also to protect the broader financial system given the important role that prime MMFs played in funding large global financial institutions. The SEC's new 2014 regulations included the introduction of floating net asset values (floating NAVs) for prime institutional MMFs, as well as liquidity fees and redemption gates for all prime funds.

On September 17, 2013, in response to a request for comments on the proposed rule, we submitted a letter to the SEC arguing that the proposed reforms were inadequate. We quote from our 2013 letter:

> *We think that the floating net asset value (NAV) alternative would not be a significant improvement over the status quo and that it would not meet the SEC's goals of "address[ing] the heightened incentives shareholders have to redeem shares in times of financial stress" and "improv[ing] the transparency of money market fund risks through more visible valuation and pricing methods." Moreover, we believe that liquidity fees and redemption gates could actually exacerbate the incentive for shareholders to redeem shares ("run") during a period of financial stress, and could thus be a step back relative to the status quo.*

Both of these concerns proved to be correct in March 2020, when there was another run on prime institutional MMFs due to the financial stresses triggered by the onset of COVID-19. As noted in the PWG Report, prime institutional MMFs experienced redemptions equal to 30% of total assets

[1] David Scharfstein is a director of M&T Bank Corporation. The views presented here are his personal views and he is not representing the views of M&T Bank Corporation.

between March 11 and March 24, 2020, including three consecutive days where redemptions exceeded 5%. Neither floating NAVs nor liquidity fees and gates helped prevent this run on prime institutional funds. As in 2008, the 2020 run on MMFs was only stopped after an extraordinary intervention by the Federal Reserve and the U.S. Treasury.

As we noted in our 2013 letter, because the assets held by prime money market funds—commercial paper, certificates of deposits, repurchase agreements—have limited secondary market liquidity, it is difficult to mark them to market, particularly during periods of financial distress. This means that the NAV of a prime MMF cannot float in any meaningful sense. During periods of market-wide distress, it is in investors' interest to redeem early, before concerns about the quality or liquidity of a prime fund's assets can be reflected in its NAV. Getting out early allows investors to avoid taking even small losses. Thus, as demonstrated in March 2020, prime MMFs are vulnerable to runs even if their NAVs are nominally floating.

In our 2013 letter, we also argued that redemption gates and liquidity fees would not forestall incipient runs but instead would accelerate them because institutional investors would preemptively withdraw if they feared that prime MMFs were about to impose gates or fees. Recent research by Federal Reserve Board economists supports this view: funds whose liquidity levels were closer to the threshold that would allow them to impose gates and fees experienced larger redemptions in March 2020.[2]

The events of 2008 and 2020 show that modest reforms, some of which are outlined in the PWG Report, will not meaningfully enhance the stability of prime MMFs. The core problem is that prime MMFs use risky and illiquid assets to back liabilities (MMF shares) that investors take to be safe and liquid and that they treat as close substitutes for bank deposits and other "cash-like" instruments. It has been long understood that mismatches in safety and liquidity between their assets and liabilities leave financial institutions vulnerable to runs that can threaten the stability of the broader financial system. Regulators use a combination of capital and liquidity requirements to reduce the financial stability risks posed by these mismatches at banks and other institutions.

A similar approach, consisting of two parts, should be used to regulate prime MMFs. First, as we argued in our 2013 letters to the SEC and the Financial Stability Oversight Council, as well as in research published in the *IMF Economic Review*, regulators should require prime MMFs to have some form of loss-absorbing capital.[3] Properly calibrated, capital regulations of this sort would substantially reduce the risk of loss to prime MMF investors, reducing their incentives to run as well as their incentive to chase yield. Second, regulators should require prime MMFs to hold a much larger share of their assets in truly liquid assets such as Treasury bills.

**Capital.** Capital serves two functions. First, it provides a layer of protection for ordinary MMF investors. This protection reduces their concern with losses on MMF assets and thus their incentive to run during periods of market turmoil. Second, capital reduces the incentive for prime

[2] Lei Li, Yi Li, Marco Macchiavelli, and Xing Zhou (2020), "Liquidity Restrictions, Runs, and Central Bank Interventions: Evidence from Money Market Funds," working paper.

[3] Hanson, Samuel G., David S. Scharfstein, and Adi Sunderam (2015). "An Evaluation of Money Market Fund Reform Proposals." *IMF Economic Review* 63(4), 984-1023.

MMFs to take on excessive risk in normal times. By taking on additional risk, prime MMF managers are able to offer higher yields, attract more assets, and earn greater fees.[4] Capital forces prime MMFs that take more risk to bear some of the costs of doing so, reducing their incentives to take risk in the first place.

There are a number of ways to implement a capital regime for prime MMFs. We discuss several alternatives in our paper in the *IMF Economic Review*, which the PWG Report referenced. A first approach would be for prime MMFs to issue a subordinated share class that would absorb losses before ordinary MMF shareholders. In exchange for bearing potential losses, the subordinated shareholders—longer-term investors who are willing to bear losses—would be paid a premium over the yield on the assets in the MMF in normal times. We estimate that for a well-diversified portfolio of MMF assets, a subordinated share class of 3 to 4% of assets would fully protect ordinary shareholders from losses with a high degree of confidence. Furthermore, we estimate that the cost of this loss protection for ordinary MMF shareholders would be small—a reduction in yield on the order of 5 basis points (0.05%). The resulting structure would be similar to those found in securitizations, which often use contractual loss-absorption by junior tranches to provide the safety desired by investors in more senior tranches.

Another way to implement a capital regime would be to require MMFs to buy capital protection from a regulated banking institution. For a fee, a bank would commit to buying an MMF's assets at par at the fund's request. Regulators would require the bank to hold capital and liquidity against this purchase commitment. The Federal Reserve and the U.S. Treasury facilitated such purchases through Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) in 2008 and the Money Market Mutual Fund Liquidity Facility (MMLF) in 2020 at no cost to money market fund investors. In this proposal, MMF investors would be required to pay private entities in advance for protection rather than getting it for free from the government after the fact.

There are many other ways to implement a loss-absorbing capital regime for prime MMFs. Regardless of the details, in our view, the next round of reforms should include some capital-like mechanism to protect ordinary shareholders in prime MMFs from losses. Absent such a policy, it is almost inevitable that during future periods of financial market turmoil there will be runs on prime MMFs and U.S. policymakers will again feel compelled to provide support to them.

**Liquidity.** While MMFs already face liquidity regulation, the requirements they face should be strengthened. The 2010 money market fund reforms required prime MMFs to increase the share of their portfolios invested in assets that the SEC deemed liquid on a daily or weekly basis. We believe two changes to these requirements are needed. First, the required quantity of liquid assets should be increased. As we saw in March 2020, redemptions over the course of a day or week can be very large. Second, the definition of liquid assets should be narrowed. Commercial paper maturing within five business days qualifies as a weekly liquid asset under current rules. However, given the difficulty of selling such private credit instruments on the secondary market, they are not suited to meeting large, rapid redemptions of the kind we saw in March 2020.

[4] Marcin Kacperczyk and Philipp Schnabl (2013), "How Safe are Money Market Funds," *Quarterly Journal of Economics* 128(3), 1073-1122.

Therefore, the definition of liquid assets should be refined to include only overnight credit instruments and assets for which there is a deep and liquid secondary market, such as Treasury bills.

**Costs of reform.** Sponsors of prime MMFs will likely argue that requiring prime funds to have loss-absorbing capital and to hold more Treasury securities will lower prime MMF yields and hence the demand for prime MMFs. We do not disagree. But we do not think the broader consequences of such a policy will be problematic. Investors who need safety and liquidity can meet those needs through safer Treasury and government MMFs. And, issuers of financial instruments typically held by prime MMFs will find other sources of financing. This is exactly what happened in 2016 after the implementation of the SEC's 2014 reforms. Assets under management of prime MMFs declined, yet commercial paper outstanding was essentially unaffected.

**Conclusion.** Prior to the last round of reforms in 2013, we argued that the proposed reforms would not prevent future runs and that SEC should require prime MMFs to have some form of loss-absorbing capital. We again make the case for capital regulation of prime MMFs paired with more robust liquidity regulations.

The prime MMF industry has required extraordinary government support twice in the last 13 years. This recent history shows that the existing regulatory regime for prime MMFs is inadequate. In the absence of serious structural reform, history is likely to repeat itself, with more investor runs and more government support when they happen.

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