

April 14, 2021

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

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

Dear Ms. Countryman:

CFA Institute¹ is writing in response to the aforementioned request for comment (“Request”).² CFA Institute speaks on behalf of its members and advocates for investor protection and market integrity before standard setters, regulatory authorities, and legislative bodies worldwide. We focus on issues affecting the profession of financial analysis and investment management, education and competencies for investment professionals, and on issues of fairness, transparency, and accountability of global financial markets.

The Securities and Exchange Commission (“SEC” or “Commission”) seeks comment on potential money market fund reform measures presented in the December 2020 Report of the President's Working Group on Financial Markets (“PWG Report”).³ That report analyzed the market stresses in March 2020 and presented a series of policy options to improve the resilience of money market mutual funds (“MMFs”) and broader short-term funding markets.⁴

¹ CFA Institute is a global, not-for-profit professional association of more than 178,000 members, as well as 157 member societies around the world. Members include investment analysts, advisers, portfolio managers, and other investment professionals. CFA Institute administers the Chartered Financial Analyst® (CFA®) Program.

² Securities and Exchange Commission, Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report, 86 Fed. Reg. 8,938 (Feb. 10, 2021) (“Request”).

³ The PWG was chaired by the Secretary of the Treasury and included the Chairs of the Board of Governors of the Federal Reserve System, the SEC, and the Commodity Futures Trading Commission. The PWG Report is attached as an Appendix to the Request and is also available at <https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf> (“PWG Report”).

⁴ The policy options presented in the PWG Report would seek to:

- 1) Internalize liquidity costs of investors' redemptions, particularly in stress periods.
- 2) Decouple regulatory thresholds from consequences such as gates, fees, or a sudden drop in NAV.
- 3) Improve MMFs' ability to use available liquidity in times of stress.
- 4) Commit private resources ex ante to enable MMFs to withstand liquidity stress or a credit crisis.
- 5) Further improve liquidity and portfolio risk management. Changes to liquidity management requirements could include raising required liquid-asset buffers.
- 6) Clarify that MMF investors, rather than taxpayers, bear market risks.

Id. at 20-21.

We welcome the renewed focus on financial stability. The Request asks commenters to address 1) structural vulnerabilities of MMFs that can contribute to stress in short-term funding markets and 2) the goal of eliminating government interventions.⁵

Executive Summary

Since the start of the Global Financial Crisis (GFC), the SEC has adopted two sets of MMF reforms, and the Federal Reserve has intervened twice to support MMFs. Several of the policy options under consideration today date from 2012 to 2015. There is a reason for the repeated recurrence of the same questions, the same policy options, and the same need for reform. MMFs have a key structural vulnerability: they offer a bank-like product akin to bank deposits, yet without the safeguards of banks.⁶ Specifically, MMFs have no capital, no insurance, no access to Federal Reserve liquidity and no legal requirements for support from sponsors or parent companies.⁷

MMFs offer attractive features to investors, including the perception of safety and liquidity, convenience, and competitive returns. These benefits, however, derive in part from favorable regulatory treatment (no regulatory capital requirements) and implicit government support in times of crisis (which lowers MMFs' costs of funding). As a result, some of the risks and economic costs of MMFs are shifted, or externalized, onto short-term funding markets, the real economy, and taxpayers in the form of Fed rescues.

These externalities surface in times of economic shock, as they did during the GFC of 2008 and most recently during the coronavirus pandemic and resulting economic shutdown of March 2020. As the Systemic Risk Council notes in its comment letter, “[W]here runs and forced sales of assets occur, they inflict costs on the economy given the role of money funds and other similar funds in short-term financing markets.”⁸ Absent further changes, these externalities will reappear along with more Federal Reserve rescues.

To address these vulnerabilities, reforms should internalize the costs to MMF sponsors and investors. Specifically, the Commission should require these funds to institute capital buffers and a mechanism called a minimum balance at risk (MBR). In addition, the Commission should amend certain previous

⁵ See Request *supra* footnote 2 at 5 (“Commenters should address the effectiveness of the measures in: 1) addressing structural vulnerabilities of MMFs that can contribute to stress in short-term funding markets and 2) improving the resilience and functioning of short-term funding markets; and 3) reducing the likelihood that official sector interventions will be needed to prevent or halt future money market fund runs.”).

⁶ Regulations require MMFs to hold high levels of safe and liquid assets. Nonetheless, these and other regulatory requirements do not compensate for the absence of loss-absorbing capital or explicit government backing.

⁷ The Systemic Risk Council made this point in its Comment Letter to the Financial Stability Oversight Council on its Proposed Recommendations Regarding Money Market Mutual Fund Reform (“SRC Comment Letter to FSOC”) (Jan. 18, 2013).

⁸ Sir Paul Tucker, the Systemic Risk Council, Comment Letter to the SEC (“SRC Comment Letter to SEC 2021”) (April 12, 2021). For further detail, see also Samuel G. Hanson, David S. Scharfstein and Adi Sunderam, IMF Economic Review Vol. 63, No. 4, “An Evaluation of Money Market Fund Reform Proposals,” (“Hanson”) (2015) at 995, available at <https://www.jstor.org/stable/24738130> (“The fact that MMF investors can redeem their funds immediately gives them strong protections if the MMF gets in trouble. However, it also means that the full economic costs of MMF risk-taking and runs may not be borne by MMF investors in isolation. Some of these costs can be borne by other parts of the financial system and economy. Specifically, runs on MMFs may destabilize the financial system and trigger a broader credit crunch.”).

reforms that have resulted in unintended consequences and perverse incentives. Liquidity thresholds should be delinked from redemption gates and liquidity fees to keep them from precipitating a run. The Commission also should adopt countercyclical measures to encourage MMFs to draw on their most liquid assets, instead of hoarding them, in times of stress. In addition, the requirement for a floating Net Asset Value (NAV) should be extended to all MMFs, including government and retail MMFs.

The Need to Break the Cycle of Reforms, Runs, and Fed Intervention

This Request represents the third time in little more than a decade that the SEC has considered reforms to make MMFs more resilient. In the span of 12 years, we have witnessed not one but two Federal Reserve interventions to support MMFs. And many of the policy options presented in this public consultation are repeats from 2012 to 2015.⁹

There is a reason that the same issues and proposals – prompted by the same need for further reform — keep recurring. MMFs have a key structural vulnerability: they are marketed, sold, and accepted as a bank-like product akin to a bank account, yet without the safeguards of banks.¹⁰ Specifically, MMFs have no capital reserve requirements, no deposit insurance protection, no access to Federal Reserve liquidity, and no legal requirements for support from sponsors or parent companies.¹¹

In normal times these attributes work to MMFs' competitive advantage: they are perceived as safe, liquid and convenient, yet are unencumbered by banking regulations such as capital requirements and leverage ratios. In times of economic shock, however, their non-bank attributes make MMFs particularly vulnerable to runs. The perception of safety has a binary, all-or-nothing quality to it: perceptions can swing suddenly from safe to unsafe at the mere suggestion that something may be amiss.¹² Economists call safe assets information-insensitive. But when a shock suddenly makes such assets information-sensitive, the abrupt change can have a cliff-like quality that precipitates a run.¹³

⁹ See, e.g., Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform (“FSOC Proposed Recommendations”) (November 2012); See Hanson *supra* footnote 8; and Patrick E. McCabe, Marco Cipriani, Michael Holscher, and Antoine Martin, “The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds,” Brookings Papers on Economic Activity (Spring 2013).

¹⁰ As noted earlier (*supra* footnote 6), regulations requiring MMFs to hold high levels of safe and liquid assets do not compensate for the absence of loss-absorbing capital or explicit government backing.

¹¹ See SRC Comment Letter to FSOC, *supra* footnote 7.

¹² See Hanson *supra* footnote 8 at 993 (“According to this view, risk-averse investors treat assets that are classified as “safe” in a qualitatively different way than they treat assets that are classified as “slightly risky.” As a result, panic-driven runs can occur when investors reclassify an asset from “safe” to “slightly risky.” This mechanism naturally generates runs on MMFs, which are designed to be regarded as “safe” by investors in normal times. However, in times of financial stress, investors can quickly change their opinions if an MMF suffers losses, or has portfolio holdings that expose it to significant risk of loss.”).

¹³ See Bengt Holmstrom, Understanding the Role of Debt in the Financial System, BIS Working Papers No 479, Bank for International Settlements, at 25 (“[T] there is a danger in the logic of money markets: if their liquidity relies on no or few questions being asked, how will one deal with the systemic risks that build up because of too little information and the weak incentives to be concerned about panics. I think the answer will have to rest on over-collateralisation, stress tests and other forms of monitoring banks and bank-like institutions.”).

In this, MMFs differ sharply from other investment vehicles, such as equity mutual funds, that are expected to fluctuate in value.¹⁴ In 2012, the Financial Stability Oversight Council (FSOC) described a combination of features that make MMFs particularly vulnerable to runs and how the contagion can spread to the financial system. These attributes include:

1. The absence of loss-absorption capacity
2. A first-mover advantage to redeem that makes it rational for investors to redeem at the first sign of potential trouble
3. The likelihood that a run on a single MMF can spread quickly to others, because of correlated holdings
4. The high risk of contagion because of the sizable and highly interconnected ties between MMFs and the rest of financial system.¹⁵

MMFs are not unique in presenting potential market, credit and maturity transformation risks. Nor are MMFs the only type of pooled investment vehicles to lack loss-absorbing capital. MMFs stand out, however, in 1) their vulnerability to runs and 2) the impact of those runs on short-term funding markets and the real economy.¹⁶

The economic costs of MMF runs have a wide range of impacts, from the domestic to the global. For example, a run on MMFs can affect firms that issue commercial paper to fund operating costs.¹⁷ States and municipalities that rely on municipal bond can experience higher borrowing costs and reduced credit availability.¹⁸ And in global markets, stresses can spread to large non-U.S. banks that rely on dollar financing.¹⁹

MMFs invest about \$250 billion in commercial paper, or about 21% of the market; \$950 billion in repurchase agreements (repos); and \$540 billion in short-term securities issued by Federal Home Loan Banks (FHLB).²⁰

MMFs present regulators with a choice of two basic policy approaches: a market-based approach, emphasizing disclosures and market discipline; or a bank-like approach, requiring some form of loss-

¹⁴ See, e.g., SRC Comment Letter to SEC 2021 *supra* footnote 8 (listing a combination of attributes that distinguish MMFs from other types of mutual funds, such as equity mutual funds).

¹⁵ See FSOC Proposed Recommendations *supra* footnote 9 at 70. See Hanson *supra* footnote 8 at 1006 (“These run incentives exist to some extent in all mutual funds holding illiquid assets but there are a few reasons to believe that the problem could be more severe with MMFs.”).

¹⁶ See Hanson *supra* footnote 8 at 1006 (observing that troubled MMFs, compared with other types of mutual funds, may present greater risks of runs, fire sales, contagion to other MMFs, and disruption of primary capital market activity).

¹⁷ Moreover, runs on MMFs are likely to be more disruptive to the real economy than runs on other types of mutual funds, because firms rely on short-term credit markets to finance working capital necessary for ongoing operations. Unlike long-term capital financing, these operating needs cannot be delayed in times of distressed markets. See Hanson *supra* footnote 8 at 1007.

¹⁸ See SEC staff report, “U.S. Credit Markets Interconnectedness and the Effects of COVID-19 Economic Shock,” (October 2020) (“SEC Staff Interconnectedness Report”), at 27 available at https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf (highlighting “the interconnection between the municipalities, banks, and MMFs and the role adverse shocks can have on this segment of the market.”).

¹⁹ See, e.g., Hanson *supra* footnote 8 at 987-990.

²⁰ See SEC Staff Interconnectedness Report *supra* footnote 18 at 25.

absorbing capital. In its 2010 and 2014 reforms, the SEC generally selected the market-based approach. Notwithstanding these actions, the market stresses of March 2020 – and the emergency Fed intervention to support MMFs – clearly have demonstrated the inadequacy of previous reforms.

In the words of two preeminent experts on financial markets, “The Covid crisis confirmed the view of many critics that gates, fees, and maturity limits on assets are inadequate responses to the funding vulnerabilities, and consequent contribution to systemic risk, of money market mutual funds.”²¹

Moreover, the latest Fed intervention has simply reinforced the rational expectation and moral hazard among MMF investors and sponsors to expect future bailouts in times of stress. To break this cycle, or at least reduce its likelihood, the SEC, in coordination with FSOC and other regulators as appropriate, must directly address the structural fragilities of MMFs.

The Real-Life Stress Test of March 2020: Lessons Learned

The Run on MMFs

In 2013, as the SEC considered reforms involving gates, liquidity fees and a floating NAV for certain institutional MMFs, one scholar presciently warned:

Ultimately the stability of MMFs depends upon implicit guarantees and other support by their sponsors, and, in extremis, the willingness of the Federal Reserve to take credit risk to avoid a massive run among MMFs... **To be blunt, the SEC proposal relies on a future Federal Reserve bailout to protect the stability of the MMF sector.**²² [Emphasis added.]

That is exactly what happened in March 2020, when the economy partially shut down in response to the novel coronavirus pandemic. Over the two-week period from March 11 to 24, net redemptions from publicly offered institutional prime funds totaled 30% (about \$100 billion) of the funds’ assets.²³ Retail withdrawals began to follow suit, though at a lesser level. By the end of March, investors had withdrawn a total of \$160 billion, or about 15% of assets, from US prime money market funds.²⁴ Clearly, the events of March 2020 served as a real-life stress test for MMFs and the previous regulatory reforms adopted by the SEC.

Although some (though not all) of the reforms represented improvements, they were not enough to stop a run on MMFs or prevent Fed intervention. On the positive side, MMFs in March 2020 had more short-term, or highly liquid, assets in 2020 than in 2008.²⁵ Moreover, the size of prime MMFs, though still considerable, was significantly smaller in 2020 than in 2008. The 2014 reforms, implemented in 2016, had precipitated a sizeable migration of institutional assets from prime MMFs to government MMFs. As

²¹ Andrew Metrick and Daniel K. Tarullo, *Congruent Financial Regulation*, Brookings Papers on Economic Activity, BPEA Conference Drafts (March 11, 2021) at 6.

²² Jeffrey N. Gordon, *Comment Letter to the SEC on Money Market Reform* (Nov. 17, 2013).

²³ See PWG Report at 14 and SEC Staff Interconnectedness Report *supra* footnote 18 at 25.

²⁴ Bank for International Settlements, *Annual Economic Report* (“BIS Annual Report”), (June 2020) at 10.

²⁵ See the Investment Company Institute (ICI), *Experiences of US Money Market Funds During the COVID-19 Crisis*, Report of the COVID-19 Market Impact Working Group (“ICI Report”) (November 2020) at 27, available at www.ici.org/pdf/20_rpt_covid3.pdf (“Simply put, there were substantially fewer dollars in prime money market funds to flow out. In this respect, the SEC’s 2014 reforms did indeed make prime money market funds more resilient to financial market shocks.”).

a result, publicly offered institutional prime MMFs in March 2020 had less than one-fourth the assets as in September 2008. The size of outflows (in dollar amount, though not in percentage terms) also was smaller than in 2008.²⁶

On the other hand, one particular reform of 2014 appears to have had the perverse effect of encouraging or accelerating a run on MMFs. This reform gave the boards of all prime and tax-exempt MMFs the option, but not the requirement, to impose liquidity fees, redemption gates,²⁷ or both, if the weekly liquid assets (“WLA”) fell below 30%. At the time the Commission adopted this rule, critics – including at least one commissioner – argued that gates or fees would only encourage runs.²⁸ A gate, for instance, will stop runs *ex post*, but will encourage runs *ex ante*. The events of March 2020 bore this out. Institutional investors appeared to accelerate outflows once weekly liquid assets fell below 35% and approached the 30% threshold.²⁹ Thus, the 30% threshold served as a magnet for a run. For this reason, we favor decoupling the WAL threshold with any options for MMF board to impose gates or liquidity fees.

The Impact

MMFs were not the only funds to experience heavy outflows or asset sales in March 2020.³⁰ Nonetheless, several authoritative reports have singled out the impact of the MMFs on short-term funding markets. For example, the Bank for International Settlements (BIS) offered this assessment of the impact of large-scale withdrawals from US prime MMFs:

This had large knock-on effects on crucial funding markets, particularly on that for commercial paper, where prime money market funds are key investors. As a result, funding costs in these markets soared and issuance dropped. The disruptions reverberated globally, given that non-US firms and banks rely heavily on these markets, contributing to a global shortage of US dollar liquidity.³¹

The BIS Report goes on to say:

A key initiative would be an effective extension of the regulatory perimeter to the non-bank, capital market segment, such as asset management. Strains in this sector, notably runs on money market funds, have played a first-order role in this crisis, as they already had during the GFC.³²

²⁶ See, e.g., PWG Report *supra* footnote 3 at 14; and ICI Report *supra* footnote 25 at 29.

²⁷ Such fees were capped at 2%. The gates would stop redemptions for up to ten business days. See PWG Report *supra* footnote 3 at 8.

²⁸ Statement of Commissioner Kara M. Stein (July 23, 2014). Likewise, experts made the same argument in 2015. See Sheila Bair, The Systemic Risk Council, Comment Letter to the SEC on Proposed Rule Regarding Money Market Funds (Sept. 16, 2103) and Hanson *supra* footnote 8 at 1009.

²⁹ See ICI Report *supra* footnote 25 at 30, available at www.ici.org/pdf/20_rpt_covid3.pdf; SEC Staff Interconnectedness Report *supra* footnote 18 at 26.

³⁰ For example, short-term investment funds operated by banks and ultra-short corporate bond mutual funds also experienced outflows in March 2020—just as ultrashort bond funds in the U.S. and floating NAV MMFs in Europe suffered runs during the GFC. See Hanson *supra* footnote 8 at 1006; BIS Annual Report *supra* footnote 24 at 16; and PWG Report *supra* footnote 3 at 16.

³¹ *Id.* BIS Annual Report at 40.

³² *Id.* BIS Annual Report at 57.

Similarly, reports by the SEC's Division of Economic and Risk Analysis³³ ("DERA") and the PWG³⁴ also noted the impact of MMFs on short-term funding markets. Meanwhile, the Investment Company Institute, the trade association for the mutual fund and ETF industry, disputes the view that institutional and retail MMF outflows triggered the stresses in short-term funding markets.³⁵

To the extent that the 2014 reforms improved the liquidity of MMFs and reduced the size of non-government MMFs, the measures may have limited the damage in March 2020. Nonetheless, the impact of MMF runs on short-term funding markets and the real economy were significant enough to prompt Federal Reserve intervention. This, in our view, is the key lesson learned from the real-life stress test of March 2020.

Internalize Costs

As it currently stands, once an internal or external shock precipitates a run on MMFs, the Fed has little choice but to intervene. The alternative would be to watch credit markets freeze up and liquidity in the real economy come to a grinding halt, as we witnessed in 2008. The resulting economic disruptions would be of unacceptable proportions.

To avoid a repeat of such situations, it is time for the SEC to adopt requirements that will internalize costs for MMF sponsors and investors. We support a combination of two requirements: a capital buffer plus a minimum balance at risk (MBR).

Capital Buffers

A capital buffer would offer an MMF some protection from loss caused, for example, by the default of a major asset. In its 2012 report, FSOC suggested that an MMF be permitted to use any funding method to build its capital buffer, and it presented three ways in particular: from sponsor support, with assets going into an escrow account; capital market issuance of subordinated, non-redeemable equity shares; or through retained earnings.³⁶ FSOC also suggested that the size of the required buffer be tiered based on the riskiness of the MMF's assets.³⁷ Other experts have in the past estimated that subordinate MMF shares would have default risk comparable to an A-rated or BBB-rated long-term bond issued by a financial firm.³⁸

³³ See SEC Staff Interconnectedness Report *supra* footnote 18 at 26 ("Conditions in short-term funding markets deteriorated rapidly in the second week of March.... Stress among prime MMFs likely contributed to these problems, as funds reduced their holdings of CP and CDs.").

³⁴ See PWG Report *supra* footnote 3 at 16-17 ("Prime and tax-exempt MMFs were not the sole contributors to the pressures in short-term funding markets. However, it appears that MMF actions were particularly significant relative to market size.").

³⁵ See ICI Report *supra* footnote 29 at 14.

³⁶ See FSOC Proposed Recommendations *supra* footnote 9 at 39-40.

³⁷ *Id.* at 39.

³⁸ See Hanson *supra* footnote 8 at 1002.

How much of a buffer would be appropriate? Some experts have suggested a 3% buffer, which might be in line with the MMF's maximum investment in any single asset.³⁹ This would enable an MMF to absorb a 100% loss resulting from the default of its single largest asset.

In calibrating the size of a buffer, the SEC should consider the commercial impact on MMFs. We would urge a reasoned approach that balances liquidity risk management protections with the economic viability of such fund products.

Whatever the level of a capital buffer, it would be insufficient by itself to prevent all runs. But that is not its purpose. Instead, its purpose is to provide enough loss-absorbing capacity to deter runs in certain deteriorating circumstances, such as market fluctuations or a limited credit event. As long as the capital buffer is perceived as adequate to meet those limited circumstances, it should have a deterrent effect.⁴⁰

Minimum Balance at Risk (MBR)

Because a capital buffer alone cannot stop all runs, it should be combined with additional measures to better ensure that costs are internalized. The Commission should consider a strong form of an MBR, which would 1) delay redemption of a portion of the amount of an investor's withdrawal and 2) make the delayed portion (called the MBR) first in line to absorb any losses that the MMF suffers during the delay interval.

In 2012, the FSOC presented this version of an MBR:

The NAV buffer would be paired with a requirement that 3% of a shareholder's highest account value in excess of \$100,000 during the previous 30 days — a minimum balance at risk (MBR) — be made available for redemption on a delayed basis. Most redemptions would be unaffected by this requirement, but redemptions of an investor's MBR itself would be delayed for 30 days. In the event that an MMF suffers losses that exceed its NAV buffer, the losses would be borne first by the MBRs of shareholders who have recently redeemed, creating a disincentive to redeem and providing protection for shareholders who remain in the fund. These requirements would not apply to Treasury MMFs, and the MBR requirement would not apply to investors with account balances below \$100,000.⁴¹

By serving as a speed bump on a portion of redemptions, MBRs directly address the perception of MMF investments as perfectly liquid. And by subjecting the MBR portion to the risk of first loss, the measure provides investors with a disincentive to run. The MBR will internalize a portion of the investor's cost to

³⁹ *Id.* at 986 (“For a well-diversified portfolio, we estimate that MMFs should hold a capital buffer of 3-4% against unsecured paper issued by global financial institutions, the primary asset held by MMFs. For more concentrated portfolios, we estimate that the amount of capital should be considerably higher. At a minimum, for an MMF to be able to survive a default by at least one portfolio firm, the buffer must be larger than the funds' maximum firm exposure.”). Since this paper was published in 2015, the Commission should reexamine whether these estimates would remain valid for MMFs today. *See also* SRC Comment Letter to FSOC *supra* footnote 7 (though preferring other reforms, suggesting that if the SEC were to require a buffer, that it be set at 3% or higher).

⁴⁰ *Id.* Hanson at 999 (“By reducing the *ex ante* probability that investors suffer a major loss in the first place and weakening run incentives following modest MMF losses, capital may decrease the probability of system-wide runs.”).

⁴¹ *See* FSOC Proposed Recommendations *supra* footnote 9 at 38.

redeem in times of distress. Thus, the MBR counteracts the current first-mover advantage that otherwise makes it rational for investors to run at the first hint of potential trouble.⁴²

We acknowledge that the deterrent effect of the MBR would be limited. In times of great stress, the incentive to run could outweigh the disincentive of the MBR.⁴³ Nonetheless, an MBR in combination with a properly calibrated capital buffer would provide a new and meaningful level of deterrence against a run.

As an added benefit, the internalized costs stemming from a capital buffer and an MBR could foster market discipline to manage risks appropriately. Both investors and sponsors would have incentives to insist on prudent MMF management of risks, which could counteract pressures to reach for yield.⁴⁴

It is possible that measures such as an MBR or capital buffer could make MMFs appear less attractive to some investors. But investors must accept the reality that, in times of stress, MMF investments are not as safe as bank deposits. So, too, must sponsors and investors bear more of the risks and costs of MMFs. Regulations must make this clear if we are to prevent future Fed bailouts.

Would a combination of a capital buffer and an MBR drive a substantial number of investors to move from prime MMFs to government MMFs? That could happen if investors came to perceive the relative safety of government MMFs as more attractive upon consideration of internalized costs. We would not necessarily view such a move negatively. The problem now is that investors count on implicit Fed bailouts to render investments safe even in times of a run. If a migration to government or Treasury MMFs addressed that problem, it might ultimately serve as an attractive private market solution to avoiding future bailouts.

In sum, both a subordinated capital buffer and an MBR provide loss-absorbing capital to the MMF. The capital buffer provides *ex ante* capital from sponsors, investors in subordinated shares, or the fund's retained earnings. The MBR would provide *ex post* capital from redeeming investors. Both measures have a deterrent effect on runs. And both measures internalize costs that are now externalized on short-term funding markets, taxpayers, and the real economy.

Other Measures to Improve MMF Resilience

Counter-Cyclical Measures

As noted above, the link between the 30% WAL threshold and optional gates and liquidity fees appeared to exacerbate the run on MMFs in March 2020. For this reason, we favor decoupling the WAL threshold from such gates and fees.

The 30% WAL threshold was meant to ensure that MMFs had highly liquid assets available to sell to meet heavy redemptions. Yet the threshold appeared to have the opposite effect. MMFs appeared to avoid selling their most liquid assets to keep from falling below the 30% threshold. Thus, the threshold

⁴² See PWG Report *supra* footnote 3 at 25.

⁴³ Suppose, for example, that 3% of an investor's investment were subject to the MBR. It would still be rational to redeem shares and accept a potential loss of that 3%, if an investor believed that the NAV would fall even more than 3% in the delayed interval. See Hanson *supra* footnote 8 at 986.

⁴⁴ See Hanson *supra* footnote 8 at 1003.

appeared to serve as a disincentive for the very sales it was meant to facilitate. Therefore, we see merit in a countercyclical WAL threshold that would be temporarily lowered in times of stress.

A similar dynamic could play out if MMFs were required to hold a capital buffer equal to a fixed percentage of assets. In times of distress, MMFs might choose to reduce their assets to satisfy the fixed capital requirement. Therefore, should the Commission choose to require a capital buffer, it should also consider provisions to relax the buffer temporarily in times of stress.⁴⁵

In sum, countercyclical measures could address potential unintended consequences engendered by a WAL or fixed capital buffer. We note, however, that countercyclical reforms would not in themselves address the structural issues that call for capital requirements to start with.

Beyond those measures, reforms should also transition to a floating NAV for all MMFs.

Floating NAV

The SEC's 2014 reform required a floating NAV for institutional prime and tax-exempt MMFs while allowing a fixed NAV for institutional government funds (and retail MMFs of all kinds). Yet, as the March 2020 experience showed, a floating NAV will not necessarily prevent or stop a run.⁴⁶ The first-mover advantage still serves as an incentive for investors to run.

Nonetheless, the floating NAV offers decisive advantages over a fixed NAV. By removing the accounting fiction of a stable dollar even when the NAV deviates from \$1.0000, a floating NAV makes the valuation of fund assets more accurate. CFA Institute has long advocated for fair-value reporting for financial reporting and with regard to financial instruments. We believe it provides investors with a more accurate picture of an entity's financial condition.⁴⁷ In addition, the enhanced transparency can better align investors' expectations with the risks of portfolio holdings.

Furthermore, we have long held the belief that activities, instruments and/or services should be regulated in a manner similar to all other activities that are similar in nature.⁴⁸ The 2014 reform departs from that principle, and it shows how disparate treatment of the NAV has led to unintended consequences and new risks to financial stability.

In 2013, the Systemic Risk Council accurately warned of the unintended consequences that would flow from disparate regulations, requiring a floating NAV for certain funds while permitting a fixed NAV for others: "This is a perverse incentive: one that creates a potential for significant maturity mismatch and interest rate risk in the Government and the GSEs [government-sponsored entities]."⁴⁹

That is just what happened following the SEC's 2014 reforms. The disparate treatment of NAVs has led indirectly to increasing reliance of the Federal Home Loan Bank (FHLB) system on MMFs as a source of

⁴⁵ *Id.* at 1002.

⁴⁶ See PWG Report *supra* footnote 3 at 29 ("Institutional prime MMFs with floating NAVs still experienced runs in March; floating NAVs do not prevent runs.").

⁴⁷ See Kurt N. Schacht and Linda L. Rittenhouse, CFA Institute Comment Letter to the SEC on Money Market Fund Reform and Amendments to Form PF ("CFA Institute Comment Letter to SEC 2013") (Sept. 19, 2013).

⁴⁸ *Id.*

⁴⁹ See SRC Comment Letter to the SEC on Proposed Rule Regarding Money Market Funds (September 16, 2013).

short-term funding.⁵⁰ Though this did not become a stress point in March 2020,⁵¹ the links between the FHLB system, the largest U.S. banks, and MMFs have resulted in new risks to the U.S. financial system. Both the SEC's DERA⁵² and the Office of Financial Research⁵³ have called attention to this new and unintended vulnerability.

For these reasons, we recommend that the Commission extend the floating NAV to all MMFs, including government and retail MMFs.⁵⁴

Conclusion

In normal times, MMFs offer attractive benefits to their users: they are perceived as safe, liquid, and convenient, and they offer competitive returns compared to interest rates on bank deposits. Under the surface, however, MMFs also have structural weaknesses: they can be vulnerable to runs, yet they have no loss-absorbing capital or explicit support from sponsors or the government. In times of stress MMFs can impose significant costs on short-term funding markets, the real economy and, ultimately, the taxpayers in a forced government bailout. Unfortunately, these vulnerabilities and external costs become manifest with each succeeding Fed intervention. It is time to internalize these costs through a combination of a required capital buffer and an MBR.

In addition, the Commission should redress the unintended consequences of certain previous reforms. In particular, future reforms should delink liquidity thresholds from gates and fees; introduce countercyclical liquidity measures to make MMFs more resilient in times of stress; and extend the floating NAV requirement to all MMFs.

Put simply, there should no longer be a free lunch in the MMF industry. MMF investment risks and costs properly inure to the fund investor and sponsor, and not the taxpayer. Until regulations make that clear, we fear that some future crisis will prompt yet another round of Federal Reserve support and will rekindle the same policy debate over MMF reforms.

⁵⁰ The disparate treatment of the NAV precipitated a significant migration of institutional investments from prime and tax-exempt MMFs to government funds. That development in turn significantly boosted the demand by government MMFs for eligible short-term government and agency debt, according to an analysis published by the Office of Financial Research. The Federal Home Loan Bank stepped in to meet this demand by issuing more of the sought-after securities. See Kenekwue Anadu and Viktoria Baklanova, "The Intersection of U.S. Money Market Reforms, Bank Liquidity Requirements, and the Federal Home Loan Bank System," OFR Working Paper 17-05 ("OFR Working Paper"), (Oct. 31, 2017). See also SEC Staff Interconnectedness Report *supra* footnote 18 at 27 ("After the 2008 GFC and the various money market and banking sector reforms that followed, the FHLB system has become increasingly dependent on MMFs as a source of short-term funding.").

⁵¹ See SEC Staff Interconnectedness Report *supra* footnote 18 at 27.

⁵² *Id.* at 27 ("Regulators and market participants should remain focused on this interconnection between banks, FHLB, MMF and STFM more generally, as an area for potential future market risks.").

⁵³ See OFR Working Paper *supra* footnote 50 at 20 ("The FHLBanks are increasingly serving as a link between money market funds and the largest U.S. banks, and this link may generate new unintended vulnerabilities to the U.S. financial system.").

⁵⁴ In our 2013 comment letter to the SEC, we supported requiring a floating NAV for institutional MMFs and expressed the hope that the industry would eventually move to a floating NAV for all funds. That private ordering has not happened. Therefore, we now recommend that the SEC require a floating NAV for all MMFs, including government and retail funds. See CFA Institute Comment Letter to SEC 2013 *supra* footnote 47.

CFA Institute Comment Letter to SEC

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On behalf of CFA Institute, we thank you for your consideration and welcome the opportunity to discuss our letter with you. Please do not hesitate to contact us.

Sincerely,

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