

June 1, 2021

United States Securities and Exchange Commission
100 F St NE
Washington, DC 20549

Board of Governors of the Federal Reserve System
Constitution Ave NW &, 20th St NW
Washington, DC 20551

United States Treasury Department
1500 Pennsylvania Avenue NW
Washington, DC 20220

Re: Comment Letter Of Federated Hermes, Inc. On Structural Reforms To Mitigate Systemic Risk And The Root Causes Of The Liquidity Crisis Of March 2020 (SEC File No. S7-01-21)

Dear Ladies and Gentlemen:

I am writing on behalf of Federated Hermes, Inc. and its subsidiaries (“Federated Hermes”), to provide additional comments in response to the Report of the President’s Working Group on Financial Markets, Overview of Recent Events and Potential Reform Options Report on Money Market Funds (the “PWG MMF Report”) which was issued in December 2020.¹ Federated Hermes has already provided detailed comments that respond to the specific policy options identified in the PWG MMF Report (the “First Federated Hermes Comment Letter”) and are incorporated and restated herein by reference.²

In this comment Federated Hermes recommends structural reforms that address the root causes of the failure of critical funding markets in March 2020 and the consequent systematic

¹ President’s Working Group on Financial Markets, *Overview of Recent Events and Potential Reform Options for Money Market Funds* (Dec. 2020), available at <https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf> (“PWG MMF Report”).

² See the First Federated Hermes, Comment Letter, (Apr. 12, 2021), available at <https://www.sec.gov/comments/s7-01-21/s70121-8662821-235311.pdf> (“Federated Hermes First Comment Letter”).

risks. We propose: (i) considerations relating to the Federal Reserve (“Fed”) posture for providing liquidity in stressed markets, as well as reforms to promote market-making in stressed conditions;³ (ii) amendments to rule 2a-7; (iii) reforms to the short-term market structure itself that could improve liquidity in times of stress; and (iv) considerations for balancing the SEC’s statutory mandate with liquidity and financial stability concerns.

Federated Hermes has been in the investment management 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.⁴ Federated Hermes currently manages over \$400 billion in money market assets including registered domestic and offshore funds, private funds and state government-sponsored local government investment pools (“LGIPs”) that invest in money market instruments. MMFs managed by Federated Hermes in the United States include U.S. government MMFs, municipal MMFs and prime MMFs. As of year-end 2020, over two-thirds of the MMF assets managed by Federated Hermes were 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. Federated Hermes also manages mutual funds and accounts that invest in equity securities, bonds and other longer-term fixed income instruments. The equity and fixed income funds and accounts managed by Federated Hermes cover a variety of styles, including ESG and impact funds.

I. Executive Summary

1. Considerations For The Fed To Provide Liquidity And Promote Market-Making In Stressed Market Conditions

At its inception in 1913, the Fed’s original mission was to increase the money supply to support a growing economy, help develop the commercial paper market – and even more importantly, to quickly supply liquidity to the economy to avert a panic. These objectives were to be achieved, or facilitated, through use of the discount window (then Section 13(2)) of the Federal Reserve Act (“FRA”) that could be responsive to the real time needs of the economy.

The challenge today is that the discount window has fallen into disuse as a result of an associated stigma; and the Fed’s predominant means of injecting liquidity in a crisis is the emergency lending power established in 1932 (FRA Section 13(3)). However, this tool is calibrated to deal with an already existing crisis, not prevent it. Thus, an origin of the problem lies in the construction of the relevant lending powers as emergency measures and not tools that can react in real time.⁵ For example, under Dodd Frank Act⁶ Section 1101, the Fed’s

³ To be clear, there inevitably will be events that are of systemic and catastrophic nature such that additional or extraordinary interventions by central banks will still be necessary.

⁴ 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.

⁵ Various scholars have pointed out the relative weakness of the Fed’s crisis response capabilities compared with other central banks. See, e.g., Ben Bernanke, *Liquidity Provision by the Federal Reserve* (May 13, 2008) available at <https://www.federalreserve.gov/newsevents/speech/bernanke20080513.htm>.

⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 11-203 (July 2010).

emergency lending authority is no longer discretionary and independent of the Administration. Approval of the Secretary of the Treasury, with related documentation is, required. Similarly, after the 2008 financial crisis, the Fed introduced a broad array of capital, leverage and liquidity constraints on banks that have enabled them to withstand severe economic conditions. But those constraints have also curtailed a bank's ability to fulfill market-making objectives in the stressed markets experienced in March 2020, thus limiting liquidity when it is most needed.

Importantly, on March 15, 2020, the Fed announced constructive measures to encourage use of the discount window to stem the crisis, and additional measures to promote market-making by bank broker-dealers. On April 1, 2020 the Fed announced temporary amendments to the Supplementary Leverage Ratio ("SLR"). However, these actions came weeks into the crisis and unnecessary damage had already been done. We recommend that the Fed make the amendments to the discount window permanent; and that the Fed critically examine and amend regulations that have curtailed market-making, including the SLR. In addition, the Dodd Frank Act ("DFA") Section 1105 defines the concept of a Liquidity Event, which broadly characterizes the conditions in February and March 2020. We recommend that the Fed consider the *timely* designation of a Liquidity Event, or similar concept, as: (i) a means of alerting banks to respond to the real time needs of the markets by using these facilities; and (ii), a potential threshold for temporary waiver of regulations that may hinder market-making.

2. Reforms To Rule 2a-7

The credit quality and liquidity levels of prime and tax exempt MMFs met or exceeded regulatory requirements during March 2020. Outflows from these funds in March 2020 resulted in significant part from 2014 MMF reforms that linked the 30% weekly liquid asset ("WLA") test to board action on fees or gates. The Fed predicted this would trigger redemptions – and it did. We recommend that the SEC delink the WLA test from required board action while continuing to empower (and obligate) MMF boards to take actions on fees and/or gates that are in the best interest of shareholders. We believe that an objective review of the data from and the events of March 2020 would result in the conclusion that no other reforms are necessary or appropriate.

3. Reforms To The Short-Term Money Market Structure

The commercial paper ("CP") market is unnecessarily fragmented. Today non-financial corporate CP is traded on several electronic platforms (e.g., TradeWeb and Boom). However, a large volume of the CP market is bank paper, where only the issuing bank makes a market. This comes at the expense of liquidity in the market, and ultimately, financial stability. The Fed and SEC should take steps necessary to broaden bank CP market-making just as the market for non-financial CP has evolved over time. Additionally, a further expansion of electronic venues would be to enable investors, issuers and broker/dealers to all view and post bids and offers – an "all to all" platform. We urge the SEC and Fed to convene a working group of private market stakeholders to arrive at a model that provides greater transparency and liquidity, particularly in periods of market stress. Recent examples of on-going dialogs between the industry with the Fed include, particularly since 2007 – 2009, frequent NY Fed inquiries on market conditions, the increased usage of cleared repo (through FICC) as opposed to bilateral settlement to reduce the

risk of collateral fire sale, and a dialog on the Fed’s reverse repo facility – particularly on mechanics of the program.

4. Considerations For Balancing The SEC’s Statutory Mandate With Liquidity And Financial Stability Concerns

The SEC succinctly states its mission:

For more than 85 years since our founding at the height of the Great Depression, we have stayed true to our mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.⁷

Prime and tax-exempt money market funds (“MMFs”) have been among the most successful financial products in history providing investors with over \$200 billion in returns in excess of bank deposit rates while significantly lowering borrowing costs for corporations and municipalities.⁸ Just two MMFs have ever “broken the buck”, with zero cost to taxpayers, and investors recovering over 96% percent of their principal in one case and over 99% of their principal in the other.⁹ Over this same period, over 3,600 federally insured depositories have failed costing taxpayers over \$180 billion,¹⁰ which should provide some helpful perspective for those who assert that it’s MMFs that have “structural vulnerabilities” or needed “taxpayer bailouts”.

To be clear, we understand that mitigating the on-set of and preventing the damage from a financial crisis are daunting responsibilities that requires constant vigilance. It is understandable that one response of the Fed would be to advance macroprudential regulation to enable banks or other financial institutions to withstand significant, even catastrophic, events without Fed intervention. However, there is a point at which this imposes too great a cost on business and the economy; and the Fed must ultimately step in to address a true crisis. This is particularly relevant in light of the Fed’s current realization that the discount window is an essential near-real time tool for providing liquidity and preventing panic conditions; and that banking reforms that limit market-making in stressed conditions can be re-examined.¹¹

⁷ SEC, *What We Do*, available at <https://www.sec.gov/about/what-we-do> (last visited May 27, 2021).

⁸ See Federated Hermes First Comment Letter at 4.

⁹ See Cochran, Freeman, Clark, Money Market Fund Reform: SEC Rulemaking in the FSOC Era, 2015 COLUM. BUS. L. REV. 861 (2015) at 884-885.

¹⁰ See Federal Deposit Insurance Corporation (“FDIC”), Bank Failures & Assistance Data, available at <https://banks.data.fdic.gov/explore/failures> (last visited May 27, 2021).

¹¹ The Administrative Procedure Act requires a cost/benefit assessment of proposed regulations. The Fed appears to suggest that a “benefit” of ending prime MMFs would be to reduce the Fed’s need to fulfill its statutory mandate to provide liquidity in the secondary CP markets in a financial crisis. There are several problems with that. First, eliminating MMFs will not reduce the need for the Fed to provide liquidity in the CP markets in a crisis or the size of that need. This need existed for many decades before the invention of MMFs, was shown in 2020 not to have been in any way reduced by the massive drawback after 2016 of MMFs as participants in the CP market, and will continue unabated if MMFs cease to exist. Second, the government incurred no losses on either the 2008 Treasury Guarantee program or the MMLF, but instead made a large profit in both cases. These facts also demonstrate that prime MMFs did not create or amplify systemic risk in March 2020, but instead that the money markets as a whole (meaning the markets for the underlying credit instruments themselves) are subject to periodic liquidity issues of the

Nonetheless, as happened after the 2008 crisis, it is likely that the SEC will be pressured to adopt a financial stability mandate that would ultimately come at the expense of its actual statutory mandate; and, among other things, lead to reforms to 2a-7 in excess of what is required. We believe that any SEC action must *remain true* to its statutory mandate of investor protection, efficiency and capital formation. Successful execution of this mandate is what has created the foundation of financial stability in the US capital markets; and it should not be diluted to mitigate the risk of another agency failing to timely fulfill its own statutory mandate.¹²

There is however an overlap of the SEC's mandate with financial stability: liquidity, which is essential for orderly markets. Within the SEC, the Division of Trading and Markets particularly has this responsibility. The SEC's regulation of fixed income markets, including alternative trading systems (ATS, or electronic venues), has promoted market efficiency and lowered trading costs in normal periods, but this has not necessarily translated to improved liquidity in turbulent periods. The SEC's Division of Investment Management has taken steps to enhance the liquidity risk management of mutual funds generally,¹³ and MMFs in particular,¹⁴ in recent years. We suggest that the SEC focus greater attention on regulations that can enhance liquidity in fixed income and short-term markets in crisis periods. More generally, we recommend that the Division of Trading and Markets undertake a thorough review of money markets to identify additional means of improving liquidity during stressed market periods.

II. The Federal Reserve Act: Origin, Purpose and Evolution

1. The Panics Of 1893 And 1907: The Birth Of The Federal Reserve System

After the FRA enactment in 1913, Section 13(2) (that corresponds to today's discount window enacted in the 1930s, Section 10B), was the mechanism that the authors of the Act intended to serve as the means for developing the commercial paper market,¹⁵ expanding credit and the money supply to support a growing economy; and extending liquidity to avert panics, such as those of 1893 and 1907, that had severely damaging effects. It was envisioned that

sort the Fed was established in 1913 to address by injecting liquidity into those markets through credit-worthy borrowers on secured terms. It should also be noted that an associated cost of achieving the alleged benefit of ending prime MMFs could be an unreasonable interference with the SEC's own statutory mandate and a potentially damaging precedent.

¹² The SEC's mandate should change only by statute. History shows that excessive outside pressure to go beyond its mandate, particularly in FSOC's pressure on 2014 MMF reforms, hobbles prime institutional MMFs..

¹³ See SEC Rule 22e-4, 17 C.F.R. 270.22e-4; SEC-IM, Risk Management in Changing Fixed Income Market Conditions, Guidance Update 2014-01 (Jan 2014) *available at* <https://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf>.

¹⁴ See 2010 and 2014 amendments to SEC Rule 2a-7 *available at* <https://www.sec.gov/rules/final/2010/rule2a-7amendments.pdf>.

¹⁵ Howard Hackley, Lending functions of Federal Reserve banks: A history (1973) at 9 (emphasis added). "As Hackley notes, "one of the basic purposes of the original Federal Reserve Act, as stated in its preamble, was "to afford means of discounting commercial paper" *Id.* The Senate Banking and Currency Committee referred to the necessity of "establishing an open market for liquid commercial bills, by providing through the reserve banks a constant and un-failing market for such bills at a steady rate of interest". *Id.* at 10.

member banks could obtain loans from the discount window, based on sound collateral presented by businesses, to achieve these objectives. Senator Robert Owen, a principal author of the FRA summarized the most significant purpose of the Act as follows:

It should always be kept in mind that ... the main object to be attained ... is the *prevention* of panic, the protection of our commerce, the stability of business conditions, and the maintenance in active operation of the productive energies of the nation which is the question of vital importance.¹⁶

2. The Continuing Evolution Of The FRA During The Depression Years

In the Great Depression, Congress and President Hoover believed that additional lending authority was necessary to finance the recovery. In 1932, the Fed board member Charles Hamlin privately lobbied Senator Carter Glass to prevent such powers from going to another entity. While Hamlin's specific recommendation has been lost to history, the result was Section 13(3) as enacted as Glass's amendment to the Emergency Relief and Reconstruction Act of 1932. Section 13(3) was further amended over time and substantially amended by the DFA. Other banking legislation, enacted particularly in 1932 – 1935 and subsequent years, broadened the application of the discount window with the insertion of Section 10(b) (now Section 10B).¹⁷ These amendments broadened the class of paper that could be discounted (including paper having financial asset collateral) and made the window available in normal, rather than only stressed, periods. There is no restriction on the use of loan proceeds. The required soundness of the collateral was modified by giving Reserve Banks latitude to accept paper that was "secured to the satisfaction of such Reserve Bank." Also, however, the Reserve Banks were under no obligation to provide discount window loans.

The essential difference between current Section 10B and current 13(3) is that 10B describes the discount window available to member banks. Section 13(3) provides for direct lending to individuals, partnerships and corporations, (intermediated through a member bank). . The 13(3) requirement of "unusual and exigent circumstances" was not defined in the Emergency Relief and Reconstruction Act, but it was presumed to imply emergency circumstances.¹⁸ A key difference therefore is that the discount window can be reactive in near real time to the needs of bank customers, while 13(3) requires that the Fed recognize and establish an emergency facility. Neither Sections 10B nor 13(3) permitted the Fed to purchase assets from banks or other eligible counterparties; they were to operate solely through lending.

Remarkably, after its legislative success in 1932, the Fed used 13(3) sparingly during 1932 – 1936, extending 123 loans totaling \$1.5 million, and not again until 2008. Similarly, the discount window fell into disuse, particularly after the Fed increased the use of open market operations to expand the money supply. One can see in this evolution an underlying caution,

¹⁶ *See id.* at 84.

¹⁷ The Banking Act of 1932, The Emergency Banking Act of 1933, the Banking Act of 1935, the Monetary Control Act of 1980, and the FDIC Improvement Act of 1991. The Monetary Control Act required that all depositories hold reserves.

¹⁸ *See id.* at 121.

even reluctance of the Fed to use either the discount window or Section 13(3) in the manner that Congress originally intended.

3. The Financial Crisis Of 2008

While the use of Section 13(3) powers was successful in stemming the 2008 financial crisis from creating a still greater contraction, it is quite clear that the market began its descent long before the Fed took emergency actions: there was no immediacy or proactiveness to *prevent* the panic. The actions eventually taken under Section 13(3) are credited with forestalling a still worse recession, however, there is broad consensus that the Fed exceeded its authority in the creation of special purpose vehicles that purchased assets from the private sector, thus doing indirectly what 13(3) prohibited directly. In reaction to this perceived overreach of authority, Sections 1101 – 1103 of the DFA curtailed Fed’s 13(3) powers, including its ability to act independently: it now required permission of the Treasury to employ emergency lending as well as strict congressional oversight.

Moreover, contrary to an original purpose, the discount window was not employed as a responsive mechanism for injecting liquidity into markets. By this point, the discount window had fallen into disuse and no longer served an original purpose of helping to avert financial crises.¹⁹ Indeed, there was now a stigma associated with using the window, proactively created by the Fed in earlier years, as it was deemed to be the avenue of troubled member banks. It essentially became another emergency lending facility.

From the late 1920s, the DW gradually fell into disuse as the Fed began to take a dim view of DW borrowing and adopted a stance against the practice. The Fed observed that banks were becoming [habitual borrowers from the DW](#), and it was concerned that an overreliance on DW borrowings would weaken banks and make them more prone to failure. Moreover, the Fed had switched to open market operations as its primary tool for conducting monetary policy. Accordingly, it viewed the DW as playing a more subordinate role by providing [limited amounts of short-term credit](#) to banks, to meet emergency needs, for example.²⁰

The Fed did take steps to increase use of the discount window with administrative changes made in 2003 that created the Primary Credit Facility. Banks in healthy financial conditions no longer had to demonstrate that they had exhausted all other means of borrowing; and there were no restrictions on the use of loan proceeds, in contrast to earlier practices.²¹ Nonetheless, the stigma remained and was most recently reinforced by DFA’s requirement that discount window loans to member banks be made public after a two-year lag.²²

¹⁹ In particular, it was no longer used as a means whereby member banks proactively went to their district Reserve Bank to obtain credit against sound collateral when faced with real time liquidity needs of their customers.

²⁰ See Oliver Armantier, *et al.*, *History of Discount Window Stigma*, Liberty Street Economics (Aug. 10, 2015) available at <https://libertystreeteconomics.newyorkfed.org/2015/08/history-of-discount-window-stigma.html> (last visited May 27, 2021).

²¹ <https://libertystreeteconomics.newyorkfed.org/2015/08/history-of-discount-window-stigma.html>, <https://www.newyorkfed.org/aboutthefed/fedpoint/fed18.html>

²² <https://www.federalreserve.gov/newsevents/speech/fischer20160210a.htm>

4. Post Financial Crisis Capital Market Regulation

In the years after the 2008 financial crisis, Federal regulators embarked on an ambitious reform program targeting two sectors in particular, that were perceived as prone to systemic risk: the banking system and money market funds.

Banking Regulation In an array of new regulations, banks – particularly the largest that carried the greatest systemic risk – experienced much higher capital requirements as well as the requirement to meet a host of new tests including: the Liquidity Coverage Ratio (“LCR”), the Net Stable Funding Ratio (“NSFR”), the Supplementary Leverage Ratio (“SLR”), the Comprehensive Capital Analysis and Review (“CCAR”) that annually stress tests banks to validate resilience against adverse economic events; as well as the Volker Rule, enacted by Section 619 of the DFA, that prohibited financial institutions that have a federal backstop and their affiliated firms from engaging in proprietary trading. It was well understood by regulators that these new requirements in aggregate would have a damaging impact on market liquidity due to a pronounced decline in market-making by bank affiliated broker-dealers.²³

It is also concerning that banking regulators, in such a focus on the stress tests for banks, did not concern themselves with stress testing the impact of the many new regulations imposed on markets or the banks.²⁴ In a noteworthy exchange, Jamie Dimon asked Ben Bernanke whether anyone had analyzed the combined effect of all the new regulations. Bernanke responded:

“To answer your question, nobody’s looked at it in detail because the impact is too complicated to quantify,” Bernanke said. “I can’t pretend that anybody really has.”²⁵

²³ For example, the Bank for International Settlements commented:

Dealers have continued to lower their market-making capacity and willingness in many jurisdictions, focusing on activities that require less capital. Demand for market-making services, in turn, continues to grow given the expansion of primary bond markets and increased bond holdings by market participants who rely on dealers’ immediacy services (e.g. asset managers). ... The impact of diverging trends in liquidity supply and demand differs across bond markets. For ... markets, such as those for off-the-run sovereign bonds and corporate bonds, there is evidence of bifurcation, with liquidity deteriorating most in those market segments that have historically been less deep than others. In these segments, the reduction in dealers’ market-making capacity seems to have had a greater impact on liquidity, given the limited availability of substitutes to their services.

Bank for International Settlements, *Fixed income market liquidity* (Jan. 2016), available at <https://www.bis.org/publ/cgfs55.pdf> at 1.

²⁴ With some 500 economists working in the Federal Reserve System, this would have been a reasonable initiative to undertake.

²⁵ Shirley Gao, *Reform Reading: JPMorgan’s Jamie Dimon Complains Dodd-Frank Is Hurting Economy*, Public Integrity (June 8, 2011) available at <https://publicintegrity.org/inequality-poverty->

The failure to address the interaction of these new regulations, as well as their interaction with monetary policy, in both normal and stressed market conditions, has reduced the ability of the banking system to perform their essential roles, especially in a crisis. In particular, the SLR is the ratio of bank Tier 1 Capital (common equity plus certain other loss absorbing assets such as preferred equity shares) to its non-risk weighted balance sheet assets and off-balance sheet exposures (especially derivatives). The required level for the largest banks is 5% at the holding company level and 6% at the bank level. As we will discuss, this limits the ability of banks to acquire lower yielding assets and impedes market-making in high quality short term (“HQST”) paper.²⁶

Money Market Fund Regulation Although the 2010 money market fund (MMF) reforms substantially improved the resiliency of MMFs, the Fed and the Financial Stability Oversight Council (“FSOC”) continued to believe that prime funds in particular possessed bank-like run risk, and continued to pressure the SEC to further regulate MMFs, prime funds in particular.²⁷

Not satisfied with the 2010 amendments to MMFs, FSOC issued a DFA Section 120 letter to the SEC requiring that it consider various, even more harmful reforms.²⁸ In its proposing release adopting the 2014 amendments, the SEC paid particular attention to the alternatives of floating NAV or the use of redemption fees and/or gates, which was the preferred choice of many industry participants. As documented in its proposing release, the SEC believed that a floating NAV would address “first mover advantage”, but this by itself would not prevent runs if there was a general flight to quality. In contrast, fees and/or gates alone would give fund boards the tools necessary to protect investors. Surprisingly, the SEC even considered the combined use of FNAV and fees/gates for a subset of funds that were thought to be particularly susceptible to runs – prime institutional and tax exempt (municipal) funds.

[opportunity/reform-reading-jpmorgans-jamie-dimon-complains-dodd-frank-is-hurting-economy/](#) (last visited May 27, 2021).

²⁶ As an example, suppose the cost of equity capital is 10%. If a bank acquired \$100 million in CP in a low rate crisis period, it could be yielding 25-50 bp (for a dollar return of \$250,00 to \$500,000). The Tier 1 Capital required would be \$6 million at a dollar cost of \$600,000. Thus the bank has no incentive to take such low yielding assets onto its balance sheet. The LCR and SLR also interact to discourage banks from taking deposits in low rate environments. To maintain an LCR >1, the bank must hold high quality liquid assets (“HQLA”) for the amount of deposits that could run off within 30 days. Thus, the full deposit cannot be invested in higher yielding securities. The SLR then comes into effect because the associated increase in the cost of additional required equity capital can exceed the return on the assets purchased with the deposit.

²⁷ The extent of run risk in prime MMFs is a topic of extensive debate and Federated Hermes believes that this has often been dramatically overstated. Prior to 2008, only one MMF had failed and this was a result of holding an ineligible security, with no cost to taxpayers. Since the first MMF was established, over 3,600 federally insured depositories had failed costing taxpayers over \$180 billion. See Federal Deposit Insurance Corporation (“FDIC”), Bank Failures & Assistance Data, <https://banks.data.fdic.gov/explore/failures> (last visited May 27, 2021).

²⁸FSOC, *Proposed Recommendations Regarding Money Market Mutual Fund Reform* (Nov. 2012) available at

<https://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%202013,%202012.pdf>

Under a combined approach, the floating NAV should reduce investors' incentive to redeem early to avoid a market-based loss embedded in the fund's portfolio because the fund would be transacting at the fair value of its portfolio at all times. Doing so should reduce the likelihood that investors engage in preemptive redemptions that could trigger the imposition of fees and gates. Requiring a fund to operate with a floating NAV with potential imposition of fees and gates in times of fund or market stress should thus reduce the risk that funds would face heavy redemptions.²⁹

Neither the industry, nor the Fed, favored the combined approach. It was broadly felt that either FNAV or fees/gates would be the realistic options, with the combination being overkill. Writing for the regional Federal Reserve Bank presidents, Eric Rosengren, President of the Boston Fed wrote:

Stand-by liquidity fees and temporary redemption gates do not meaningfully address the risks to financial stability posed by MMFs. This option does not eliminate run risk as investors could have an incentive to redeem before their fund breaches the WLA threshold.³⁰

In what appeared to be an abundance of caution, and perhaps a calculated strategy to be tough on institutional investors to allow lighter rules for retail prime funds, the SEC did adopt the draconian combined approach for prime institutional and tax-exempt funds,³¹ although with a variation on the original proposal in the final rule. If WLA declined to 10%, the board must impose a fee or gate of 1%, unless this was not in the best interest of shareholders; and if the WLA fell below 30%, the board must *consider* applying a fee or gate.³² It should also be noted that some of the largest asset managers also reversed their opposition to floating NAV for institutional prime MMFs which was viewed by some as an effort to avoid SIFI designation.³³

The market reaction to this final rule had the effect on prime and municipal MMFs that was predicted by the industry. Prime MMF assets fell from \$1.8 trillion at year-end 2014 to \$600 billion by year-end 2016 (the compliance date) with \$300 billion in prime funds and \$300 billion in retail funds; tax exempt assets fell from \$300 billion to \$100 billion; and government MMFs grew from \$1 trillion to \$2.2 trillion.³⁴ Enormous damage was inflicted on all stakeholders as re-intermediation ensued. Issuers of HQST paper faced higher costs and

²⁹ SEC, Money Market Fund Reform available at <https://www.sec.gov/rules/proposed/2013/33-9408.pdf> at 235.

³⁰ Federal Reserve, Comment (Sept. 12, 2013) available at <https://www.sec.gov/comments/s7-03-13/s70313-111.pdf>

³¹ Tax exempt funds were included without obvious thought or justification.

³² If WLA hit 10% the board could alternatively determine that a fee of less than 1% or up to 2% could be applied, if determined to be in the best interest of shareholders. Government funds were allowed to maintain a stable NAV, but were allowed to impose fees or gates at their discretion; and retail prime funds, whose shareholders are not viewed as prone to runs, were allowed to maintain a stable NAV; but the same fee and gate requirements for prime institutional and tax-exempt funds would also apply.

³³ See Cochran, Freeman, Clark, Money Market Fund Reform: SEC Rulemaking in the FSOC Era, 2015 COLUM. BUS. L. REV. 861 (2015) at 917-954.

³⁴ <https://www.financialresearch.gov/money-market-funds/us-mmfs-investments-by-fund-category/>

investors faced lower returns as they moved out of prime institutional MMFs, now an inferior product. In one ill-fated reform that singled out corporate and municipal issuers, decades of success in fulfilling the SEC's mandate of capital formation, efficiency and competition was wiped out. A large volume of assets moved into government funds, thus crowding out private investment.

III. The March 2020 Financial Crisis And Money Market Funds

1. Origins Of The Crisis

Federated Hermes and other commenters have propounded clear, data driven evidence concerning the origins of the market turmoil in March 2020.³⁵ It should be apparent to any neutral observer that the root cause was not the activities of financial firms. Rather, the root cause was a global economic shock to the system and orchestrated by government action to stem the pandemic which sharply reduced investor confidence, price discovery and liquidity across all markets. Predictably, as governments around the world shut down their economies to prevent spread of the virus, a contagion then ensued as the prospect of the worst pandemic in 100 years shut-down economies across the globe. In these conditions, there was a dramatic increase in the VIX, a market indicator of fear, to a record high of 83%. Credit spreads for investment grade and high yield bonds had already increased by approximately 150% from mid-February to March 18th.

Amid the growing crisis there was a general flight to safety. Large time deposits at banks, those without FDIC insurance, dropped sharply while smaller insured deposits surged. In the first weeks of March 2020, many corporations (often with high quality, but due to the crisis, temporarily illiquid direct commercial paper holdings), tapped bank credit lines. This placed liquidity strains on the banking system. The various new banking regulations limited the ability of dealers to take securities into inventory. As a result, dealers had less flexibility in intermediating fixed-income trades, including commercial paper (CP), in any reasonable size irrespective of their credit quality.³⁶ Thus, the pandemic conditions further eroded the market-making ability of bank broker/dealers, beyond the limitations created by the post-2008 crisis banking reforms.

In response to these developments, the Fed announced a series of relief measures on March 15, 2020, the most significant of which pertained to an interim change to discount window,³⁷ seeking to reverse its history of decline and stigma:

Discount Window ... The Federal Reserve encourages depository institutions to turn to the discount window to help meet demands for credit from households and businesses at this time. In support of this goal, the Board today announced that it

³⁵ See, e.g., First Federated Hermes Comment Letter, *supra* at 4.

³⁶ Investment Company Institute, *Experiences of US Money Market Funds During the COVID-19 Crisis* (Nov. 2020) available at <https://www.sec.gov/comments/credit-market-interconnectedness/c1110-8026117-225527.pdf>.

³⁷ This change was not described as permanent, but “in effect until the Board announces otherwise”, thus suggesting that it was temporary in nature. Federal Reserve, *The Discount Window and Discount Rate* available at <https://www.federalreserve.gov/monetarypolicy/discountrate.htm> (last visited May 21, 2021).

will lower the primary credit rate by 150 basis points to 0.25 percent, effective March 16, 2020. ... Providing liquidity in this way is one of the original purposes of the Federal Reserve System and other central banks around the world.

To further enhance the role of the discount window as a tool for banks in addressing potential funding pressures, the Board also today announced that depository institutions may borrow from the discount window for periods as long as 90 days, prepayable and renewable by the borrower on a daily basis. The Federal Reserve continues to accept the same broad range of collateral for discount window loans.³⁸

On April 1st, 2020, the Fed announced a temporary (1 year) amendment to the SLR that allowed banks to exclude U.S. Treasury securities and reserves held at the Fed from the denominator of the SLR calculation. This provided room for banks to increase Treasury holdings, thus improving market liquidity in that sector and, to an extent, other markets.

After the Fed's March 15 actions, there was a significant increase in discount window borrowing to a peak of approximately \$51 billion in late March.³⁹ On March 18th, the Fed announced the Money Market Liquidity Facility (MMLF) with an effective date of March 25th. Along with the measures announced on the April 1st, this program began calming the CP market, even before it was used, and encouraged bank intermediation as shown in the increase in direct dealer CP holdings. It is clear however that the flight to safety, evidenced by the growth of government MMFs by \$836 billion in March alone, vastly exceeded the outflows from prime and tax exempt MMFs.

2. Support For The Short-Term Funding Market And Prime Commercial Paper

Between March 25th and April 10th, 2020 prime and tax-exempt funds sold approximately \$51 billion in CP, and high-quality short-term paper to banks participating in the MMLF;⁴⁰ and the program did not grow thereafter. However, in a rush to judgment regarding the need to further regulate prime MMFs, many commenters and even some regulators fail to distinguish between systemic liquidity events and systemic credit events, which is essential for understanding today's reform debate. It is abundantly clear that the real problem in March was not prime MMFs but systemic illiquidity and the seizing up of markets that are essential to financial stability. And there is no evidence to conclude that prime MMF outflows contributed materially to the crisis, as if there were a reason for more aggressive regulation. For instance, the ICI has found that:

³⁸ Federal Reserve, *Federal Reserve Actions to Support the Flow of Credit to Households and Businesses* (Mar. 15, 2020) available at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315b.htm>.

³⁹ Rajdeep Sengupta and Fei Xue, *The Global Pandemic and Run on Shadow Banks* (May 11, 2020) available at <https://www.kansascityfed.org/research/economic-bulletin/global-pandemic-run-shadow-banks-2020/> (last visited May 27, 2021).

⁴⁰ Federal Reserve, Money Market Mutual Fund Liquidity Facility FAQs (May 27, 2020) available at <https://www.federalreserve.gov/monetarypolicy/files/mmlf-faqs.pdf>.

Evidence is lacking that outflows from institutional Prime money market funds in March caused or amplified stresses in short-term markets. Pressure beginning in the US Treasury bond market caused repercussions that spilled over to the short-term and long-term credit markets. Outflows from Prime money market funds began after dislocations became apparent in the Treasury bond and commercial paper markets.⁴¹

Furthermore, the Money Market Liquidity Facility (MMLF), was initiated under the authority of the Fed's lending powers as provided in the FRA Section 13(3). The conditions of such lending were amended by DFA Section 1101 to include only broad-based programs and not individual entities and require that the lending is backed by sound collateral with interest on loans determined by the nature of the collateral. Thus, the MMLF did not take credit risk and it made money for taxpayers, much the way that banks make money on loans or fees when lending backed by good collateral. Notably, in its required report to Congress on the MMLF, the Fed concluded "the Board does not expect at this time that advances under the MMLF will result in any losses to the Federal Reserve or the taxpayer."⁴² So the notion that taxpayers are on the hook when the Fed intervenes to stem a funding market liquidity crisis is a false narrative. In fact, the Fed profited from the MMLF by over \$300 million in interest and fees.⁴³

The Fed made very clear that the purpose behind the MMLF and the CPFF was to provide financing to the real economy. Regarding the CPFF, the Fed's website states: "[t]he Federal Reserve Board established a Commercial Paper Funding Facility (CPFF) on March 17, 2020, to support the flow of credit to households and businesses. Commercial paper markets directly finance a wide range of economic activity, supplying credit and funding for auto loans and mortgages as well as liquidity to meet the operational needs of a range of companies. By ensuring the smooth functioning of this market, particularly in times of strain, the Federal Reserve provided credit that supported families, businesses, and jobs across the economy." Regarding the MMLF, the Fed's website states: "[t]he Federal Reserve established the Money Market Mutual Fund Liquidity Facility, or MMLF, on March 18, 2020, to broaden its program of support for the flow of credit to households and businesses. The Federal Reserve Bank of Boston made loans available to eligible financial institutions secured by high-quality assets purchased by the financial institution from money market mutual funds. Money market funds are common investment tools for families, businesses, and a range of companies. The MMLF assisted money market funds in meeting demands for redemptions by households and other investors, enhancing overall market functioning and credit provision to the broader economy."⁴⁴

Moreover, March 2020 showed that the dynamic of contagion leading to a liquidity crisis was not limited to the commercial paper, or more generally, HQST paper, owned by prime MMFs.

⁴¹ Investment Company Institute, *supra* at 2.

⁴² Federal Reserve, *Report to Congress Pursuant to Section 13(3) of the Federal Reserve Act: Money Market Mutual Fund Liquidity Facility*, available at <https://www.federalreserve.gov/publications/files/money-market-mutual-fund-liquidity-facility-3-25-20.pdf>

⁴³ Federated Hermes First Comment Letter at 17.

⁴⁴ Federal Reserve, Coronavirus Disease 2019 (COVID-19), Funding, Credit, Liquidity, and Loan Facilities, <https://www.federalreserve.gov/funding-credit-liquidity-and-loan-facilities.htm>.

Prime MMF AUM began to be impacted on March 11th, by which time the VIX and corporate bond spreads had more than doubled.⁴⁵ The crisis had been taking place across the entire fixed income and equity markets – even in US Treasury securities – **and the exodus from risky asset classes had already been underway for weeks.** At the short end, redemptions were significant across all private market products – prime MMFs, short corporate funds, ultrashort funds, etc. However, the Fed’s programs did not address the secondary CP market generally, but only securities owned by MMFs, only representing 21% of the market.⁴⁶ In reflecting on this period, note that the conditions met the definition of a “Liquidity Event”, as defined in DFA Section 1105.

Direct owners of CP, (that is, not through a mutual fund) that hold them for liquidity or cash management purposes, represent approximately 70% of the market and had essentially no liquidity at all for a period of time.⁴⁷ The systemic consequences for those entities have not been fully assessed. Some CP issuers were able to access the Commercial Paper Funding Facility (CPFF) if they met its criteria. That many CP issuers were forced, among other things, to tap more expensive bank lines is suggested by the increase in use of the discount window that added to systemic liquidity pressures within the banking system. Why is it that redemptions in prime MMFs are a risk to the financial system while extreme illiquidity in secondary money markets generally is not? ⁴⁸ The Fed could have directed a liquidity facility to the CP/HQST market generally, which would have provided liquidity to all direct holders, including MMFs. The Fed did this in the secondary corporate bond market with the Secondary Market Corporate Credit Facility (SMCCF). Why did the MMLF single out prime and tax-exempt funds? Laser focus on MMLFs substantially depart from the original FRA objective to support the commercial paper market generally.

3. Overall Liquidity Conditions Of Prime Mmfs During March 2020

Observing the fervor to subject prime MMFs to further regulation, one might have guessed that redemptions must have been driven by fear that funds would “break the buck” or that liquidity conditions within the funds themselves were dangerously low. In fact, the opposite is true. After the 2014 reforms were enacted, it became apparent that the combination of a floating NAV AND fees and/or gates was having the impact that the market anticipated and feared. Remaining shareholders expressed concern that WLA could fall to 30% and that the fund board would even consider the imposition of a fee or gate. As a practical matter, the 30% WLA test became a trigger that could instigate redemptions, and what was supposed to be a liquidity buffer became a hard floor. Consequently, fund advisers made sure that WLA levels, which are publicly disclosed, remained comfortably above the 30% level. The average was well above 40% for institutional funds in the years before 2020 and generally rose during 2020 as the

⁴⁵ Investment Company Institute, *supra* at [at 15](#).

⁴⁶ S.P. Kothari *et al.*, *U.S. Credit Markets: Interconnectedness and the Effects of the COVID-19 Economic Shock* (Oct. 2020) available at https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf, at 5.

⁴⁷ *Id.*

⁴⁸ Perhaps in such urgent conditions, the Fed was unable to timely address secondary market CP illiquidity generally and simply relied on the previously developed framework for MMFs administered in 2008 through the Boston Fed with the view that this would calm the CP market generally.

pandemic unfolded. Similarly, during March 2020, the lowest 10 percentile of prime fund NAVs was \$.9985, not nearly breaking the buck.

This data illustrates that unlike 2008, the redemptions in March 2020 were not predominantly out of concern regarding the funds themselves. They resulted from the concern that, by dint of a well-intentioned SEC regulation, the shareholders would be subject to the possibility a liquidity fee or redemption gate imposed by fund directors. Interestingly, anecdotal observations suggest the redemption gates, fear of being locked out of redeeming, was the greater impetus to redeem than a potential 1% or 2% liquidity fee. The SEC itself has found that:

Staff outreach to market participants indicate that prime fund outflows accelerated as WLAs fell close to 30 percent. The Federal Reserve's announcements of liquidity facilities, including the Money Market Mutual Fund Liquidity Facility (MMLF), helped to restore market liquidity and improve market sentiment within days.

Thus, massive levels of liquidity were trapped in prime funds when they were needed the most. In retrospect, the 2014 reforms to prime and tax exempt MMFs was a self-imposed wound to shareholders, issuers, the economy and the integrity of the SEC's statutory mandate of capital formation and efficiency – all at the hand of a DFA-inspired reform process that sought to impose a systemic risk mandate on the SEC – leading to the 2014 MMF adopting release.⁴⁹ The current regulatory uproar in the PWG report suggests that regulators may be simply revising their old playbook to curtail non-bank financial intermediation, many of which have been provided by the Fed itself.

IV. Reforms To Address Structural Issues Supporting Market Liquidity

It is imperative for the Fed to take decisive and timely preventive measures to address market liquidity as a financial stability mandate. The need to act grows even in the US Treasury market, where dislocations and emerging illiquidity can propagate to other markets. In October 2020, Randal Quarles, Fed vice chair for supervision and chair of the FSB commented:

It may be that there is a simple macro fact that the Treasury market being ... much larger than it was a decade ago and now really much larger than it was even a few years ago, that the sheer volume there may have outpaced the ability of the private market infrastructure to support stress of any sort there ...⁵⁰

Federated Hermes recommends structural reforms that address the root causes of the failure of critical funding markets in March 2020. We recommend: (1) considerations relating to (a) the identification of Liquidity Events; (b) Federal Reserve actions taken in March and April 2020; (c) the creation of a standing bank repo facility as discussed in the FOMC minutes released on May 19, 2021; as well as (d) reforms to regulations that restrict market-making; (2)

⁴⁹ In particular, FSOC urged the SEC to adopt a systemic risk mandate in consideration of MMF reforms.

⁵⁰ Benjamin Purvis and Catarina Saraiva, *The Treasury market May Be So Big That the Fed Can't Step Away*, (Oct. 14, 2020 5:03 PM), available at <https://www.bloomberg.com/news/articles/2020-10-14/the-treasury-market-may-be-so-big-that-the-fed-can-t-step-away?sref=enGs3N51>.

amendments to rule 2a-7; (3) reforms to the short term market structure itself; and (4) considerations for balancing the SEC’s statutory mandate with financial stability objectives.

1. Considerations For The Federal Reserve To Improve Stressed Market Liquidity

A. The DFA-Defined Term “Liquidity Event”

Section 1105 of the Dodd Frank Act defines the term “Liquidity Event”:

DFA Section 1105 (g)(3): LIQUIDITY EVENT. – the term “liquidity event” means – (A) an exceptional and broad reduction in the general ability of financial market participants— (i) to sell financial assets without an unusual and significant discount; or (ii) to borrow using financial assets as collateral without an unusual and significant increase in margin; or (B) an unusual and significant reduction in the ability of financial market participants to obtain unsecured credit.⁵¹

Section 1105 identifies the circumstances and requirements under which the Fed may guarantee the obligations of solvent member banks, including that a Liquidity Event has occurred. However, it is quite clear that this definition can apply to financial crises generally; and that the March 2020 financial crisis was a “Liquidity Event” by this definition. It is understandable that the Fed would not want to employ this term if the actions to be taken did not fall under Section 1105 and it believed that confusion could therefore ensue; however, the timely use of this term, or an equivalent term, would be highly useful for alerting the banking system to engage in the activities such as the Fed prompted with its March 15th, 2020 measures; or modified or additional measures to be determined by the Fed, including those recommended in this Section IV.

B. Making The March 15, 2020 Amendments And Guidance For Use Of The Discount Window Permanent

Financial stability now stands alongside maximum employment and stable prices as a primary policy objective. However, through its historical actions the Fed reflects a belief that it can use its Section 10B and other discretionary powers to support market liquidity only in “unusual and exigent circumstances.” In fact, maintaining market liquidity is a prerequisite to financial stability, and thus a core mandate of the Fed, even if past events suggest that it does specifically recognize it as such. Indeed, broad illiquidity in markets is itself the trigger by which systemic risk imposes damaging consequences; and it may be possible for the Fed to do more to intervene at an earlier point in the cascade.

Moreover, except for significant threats to financial stability, by its actions, the Fed appears to take U.S. capital market liquidity for granted and does not acknowledge either a responsibility to promote it, or its own post-2008 reforms that have reduced it. What does this mean as a practical matter? The Fed arguably has more latitude, when appropriate, intervene to ensure funding market liquidity. Contrary to Owen’s dictum of *preventing* panics, the historical records suggest that the Fed waits until emergency conditions exit before reacting using its now diluted FRA 13(3) powers. Indeed, the LCR requirement that banks have HQLA to cover 30

⁵¹ Pub. L. 111-203, 124 Stat. 1376 (2010).

days of stressed market outflows is calibrated to the BIS assumption that it will take central banks, including the Fed, up to 30 days to react to crisis conditions.⁵²

We believe that the Fed has taken a significant step in this regard with the measure pertaining to the discount window announced on March 15th, 2020, which we repeat below:

Discount Window ... The Federal Reserve encourages depository institutions to turn to the discount window to help meet demands for credit from households and businesses at this time. In support of this goal, the Board today announced that it will lower the primary credit rate by 150 basis points to 0.25 percent, effective March 16, 2020. ... Providing liquidity in this way is one of the original purposes of the Federal Reserve System and other central banks around the world.

To further enhance the role of the discount window as a tool for banks in addressing potential funding pressures, the Board also today announced that depository institutions may borrow from the discount window for periods as long as 90 days, prepayable and renewable by the borrower on a daily basis. The Federal Reserve continues to accept the same broad range of collateral for discount window loans.⁵³

In its release announcing this measure, the Fed indicated that it would remain in effect until the Board determined otherwise. We suggest that the Fed give consideration to making this measure permanent to institutionalize a more rapid response to emerging systemic illiquidity; and take additional measures to reduce the stigma associated with discount window borrowing.

In this context, the aforementioned the timely designation of a Liquidity Event would be an *additional* tool and signal to spur banks to greater activity under this and related provisions. Moreover, we recommend that these measures be directed to money market liquidity generally and have broad based eligibility,⁵⁴ with the goal of materially reducing the need for any ad hoc emergency facilities.

We also note that provision 10B(b)4 states: “No Obligation To Make Advances. A Federal Reserve bank shall have no obligation to make, increase, renew, or extend any advance or discount under this Act to any depository institution.” This provision reminds banks that they should be wary of relying on the discount window. We recommend that the Fed take steps by regulation, or if necessary, legislation to remove or blunt the adverse effect of this provision, particularly in stressed market conditions.

C. A Standing Bank Repo Facility

In the FOMC minutes released on May 19, 2021, some participants suggested a standing repo facility whereby banks could obtain short term loans to fund US Treasury holdings. This

⁵² Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* (Jan. 2013) available at <https://www.bis.org/publ/bcbs238.pdf>.

⁵³ The Discount Window and Discount Rate, *supra*.

⁵⁴ As is contemplated in Section 1101 of the Dodd Frank Act for emergency lending programs and codified in Section 13(3) of the Federal Reserve Act, 12 U.S.C. 343(3).

would quickly improve liquidity in the Treasury market during stress periods and could provide a lower borrowing cost to banks than the discount window.

“Nearly all participants commented that a standing repo facility, by acting as a backstop, could help address pressures in the markets for U.S. Treasury securities and Treasury repo that could spill over to other funding markets and impair the implementation and transmission of monetary policy,”

“Many participants noted that a standing facility could provide a timely and automatic response to incipient market pressures; they remarked that such pressures can be difficult to anticipate and, as a result, might not be as promptly addressed with discretionary operations,”

The April Federal Open Market Committee minutes showed that many officials were positive about a standing repo facility because it would be there all the time, ready to deal with stress and liquidity needs, and would save the central bank from making judgment calls about needing to use other market-calming interventions.⁵⁵

We strongly endorse the proposed repo facility and suggest that it be expanded to other low risk asset classes, such as HQST paper generally. However, in order for such facility to be truly effective in crisis conditions, the recommended amendments to the SLR referenced in Section D below (or similar amendments), would also be necessary.

D. Regulations Affecting Market-Making

We recommend that, working with Congress as necessary, federal agencies should undo the damage from the regulatory response to the financial crisis of 2008. Specifically, the market-making activities of banks and their affiliates have been sharply curtailed as an unintended consequence of the Volcker rule and the other regulations that cause banks to seek rather than provide liquidity in a crisis. As a very simple step, regulation should not discourage bank ownership of commercial paper having minimal credit risk. We suggest that the Fed give consideration to studying how the complex array of new bank regulations reduced market-making in March 2020; and evaluate means of reducing these constraints during a liquidity crisis, or designated Liquidity Event.

- ***The Volcker Rule.*** Section 619 of the DFA provides that banks with a federal backstop cannot engage in proprietary trading or having an ownership interest in hedge funds or private equity vehicles. The complex and demanding compliance requirements are set forth in such detail so as to discourage market-making generally and particularly the risk of a violation in stressed market conditions. The starting point for understanding why this might be the case is the requirement that dealers may only hold inventories, on a desk-by-desk basis, based on anticipated customer trading needs. Buying up large blocks of securities that are underpriced in a crisis as a result of fire sales is not an option under the

⁵⁵ Michael S. Derby, *Fed Officials Voice Support for New Tool to Smooth Market Stress, Minutes Show* (May 19, 2021 4:55 PM) available at <https://www.wsj.com/articles/fed-officials-voice-support-for-new-tool-to-smooth-market-stress-minutes-show-11621457740> (last visited May 27, 2021).

Volcker Rule if the levels acquired cannot be shown as need to meet anticipated customer needs or the preapproved trading limits of the institution or where needed to meet the institution's own internal cash management needs. The Fed itself acknowledges the adverse impacts from this rule:

Overall, our results show that the Volcker Rule has had a real effect on dealer behavior, with significant effects only on those dealers affected by the Volcker Rule and not all bond dealers.”⁵⁶

At a minimum, the overly precise rules that are designed to remove every scintilla of potential proprietary trading should be replaced by principles-based regulation that uses overall market-based risk measures (value-at-risk, VaR) by asset class, while requiring that each individual trading desk not exceed a determined VaR multiple of allocated capital.

- ***Allow All High-Quality Paper With Minimal Credit Risk And Maturities Of 90 Days Or Less To Be Included HQLA, Including During Stressed Conditions.*** To enhance liquidity in the funding markets, banks should be allowed and encouraged to include HQST paper acquired through market-making as HQLA. Such paper is typically (already) included in HQLA eligible securities, but banks may be averse to the acquisition of potentially less liquid HQST during a crisis for inclusion in HQLA. We also suggest that, in order to facilitate market-making, banks be encouraged to access the discount window under the revised procedures enacted in January 2003,⁵⁷ and as was directed by the Fed on March 15th, 2020, with particular emphasis on HQST. This action is particularly recommended for HQST paper maturing in 7 days or less that may be temporarily illiquid due to market conditions.
- ***Consider Allowing Any Discount Window Or Standing Repo-Eligible Paper To Be Included In HQLA During Stressed Market Conditions Such As A Liquidity Event.*** During stressed market or crisis conditions, such action would greatly enhance the ability of banks to take onto their balance sheets temporarily illiquid assets. To be fully effective, the corresponding required amendments to the SLR would also be appropriate.
- ***Address The Adverse Impact Of The SLR Particularly In Low-Rate Environments*** On April 1, 2020, over two weeks after the March 15th action with respect to the discount window, and six weeks into the crisis, the Fed temporarily relaxed (for 1 year) the SLR by allowing bank holdings of U.S. Treasury securities and reserves held at the Fed to be excluded from the total assets, or the denominator of the SLR. Banks strongly suggested that this amendment be made permanent, but the Fed repealed it on March 31, 2021. This event underscores the fact that the SLA allows no risk weighting in the calculation of total assets, but that in a crisis, the Fed can determine that Treasuries and reserves held at the Fed can be given a zero weight, presumably because of their zero or de minimis risk.

⁵⁶ Jack Bao *et al.*, *The Volcker Rule and Market-Making in Times of Stress* (2016) available at <https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf>, at 30.

⁵⁷ <https://www.newyorkfed.org/aboutthefed/fedpoint/fed18.html>,
<https://www.occ.treas.gov/news-issuances/bulletins/2003/bulletin-2003-36a.pdf>

We recommend that the Fed be more proactive in waiving the inclusion of any assets that can serve as discount window collateral and that this determination be responsive to real time indications of stress or crisis, such as spread widening, primary dealer commentary, discount window or standing repo facility usage – which could trigger timely Liquidity Event designation.

- **Conforming Amendments.** Implement any conforming changes to other capital or liquidity requirements to give effect to these amendments, particularly if a Liquidity Event has been designated, so that market-making actions taken by banks are balance sheet neutral.

2. Reforms To Rule 2a-7

Federated Hermes has already provided its 2a-7 reform recommendations in the First Federated Hermes Comment Letter, and we will not repeat that entire commentary here. However, in short:

- 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 an 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, without reference to any specific level of liquidity.⁵⁸

...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. As a fund’s board is charged with safeguarding the interest of its shareholders, it is appropriate for the board to make this determination, without prior notice to or approval from the SEC.⁵⁹

We respect the SEC’s mandate of investor protection and understand that linking WLA thresholds to board action was presumably intended to assure that fund boards are proactive in meeting their responsibilities. However, there can be instances in which rules, that initially seem to be protective, can have unintended and damaging consequences.

- **Fund Policies and Procedures.** We believe that fund boards should have power and obligation to authorize the application of liquidity fees or redemption gates when it believes it would be in the best interests of shareholders and the funds.

⁵⁸ Federated Hermes First Comment Letter at 18.

⁵⁹ Federated Hermes First Comment Letter at 20.

3. Reforms To The Secondary Market Structure For Commercial Paper

The commercial paper market is unnecessarily fragmented. Today non-financial corporate CP is traded on several electronic platforms (e.g., TradeWeb and Boom) where investors can view bids and offers of multiple broker-dealers. This contrasts with prior years where only the bank sponsor for the CP of an individual corporate issuer would make an active market. However, broadening participation and capital allocation would be beneficial.

Critically, however, a large volume of the CP market is bank paper, where only the issuing bank makes a market. Understandably, banks don't want to support the activities of their competitors and allocate capital for that purpose. However, this comes at the expense of liquidity in the market, and ultimately, financial stability. The Fed and SEC should intervene to broaden bank CP market-making just as the market for non-financial CP has evolved over time.

Additionally, a further valuable expansion of electronic venues would be to enable investors, issuers and broker/dealers to all view and post bids and offers – an all to all platform. Broker/dealers may resist this change if they believe that they will be disintermediated. However, the funding markets are too critical to be remain in the 20th century. We recommend that the SEC and Fed intervene to promote a broad electronic venue with these characteristics, working with investors, issuers, broker/dealers and venue providers to arrive at a model that provides greater transparency and liquidity, particularly in periods of market stress.

4. Considerations For Balancing The SEC's Statutory Mandate With Liquidity And Financial Stability Concerns

A. The SEC's Mandate And Its Conflict With FSOC's Mandate Of Financial Stability

In a plain English summary of its statutory mandate, the SEC states:

For more than 85 years since our founding at the height of the Great Depression, we have stayed true to our mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.⁶⁰

After the 2008 financial crisis and the passage of DFA, the SEC was faced with the challenge of adopting new MMF reforms amid a dramatically changed regulatory landscape. In particular, FSOC's DFA Section 120 action pushed the SEC to adopt additional MMF reforms through the lens of financial stability, which is not within the SEC's statutory mandate. During the MMF reform debate, the chair of the SEC, Mary Jo White, participated as a member of FSOC. In July of 2020, Janet Yellen, Chair of the Fed during the MMF reform debate, provided an account of FSOC's efforts to persuade the SEC to adopt a financial stability mandate that could apparently supersede other elements of the SEC's mandate.⁶¹

⁶⁰ What We Do, *supra*.

⁶¹ Dodd Frank Update, *Former Fed chair Yellen wants new Dodd-Frank* (July 17, 2020) available at <https://www.doddfrankupdate.com/DFU/ArticlesDFU/Former-Fed-chair-Yellen-wants-new-DoddFrank-79789.aspx> (last visited May 27, 2021).

One can anticipate that with Secretary Yellen now chairing FSOC, the question of a financial stability mandate for the SEC may be revisited. One of the problems in regulating on the basis of systemic risk is that, despite the efforts of the Office of Financial Research to identify and quantify financial stability risks, it is difficult to define beyond generalizations, and impossible to measure in the sense of actual probabilities and costs. There is a tendency of those who embrace this mandate to hold the view that, although the probability of a systemic event taking place may be low (such as the 2020 pandemic), the cost is so great that regulation is warranted, even if it could be crippling to market functions that are mandates of other agencies, in this case the SEC. In these matters, when there is no common ground, debates often devolve to platitudes.

Federated Hermes recommends that the SEC not be ensnared in a redirection or usurpation of its defined mission toward goals that cannot be reconciled with its statutory mandate. Such usurpation could easily lead to legal challenges as actions not supported by the facts or applicable law. Any such revisions should result from legislation that defines the role of financial stability in relation to existing statutory mandates for the applicable federal agencies, with particular attention to the SEC's mandate of investor protection, orderly markets, efficiency and capital formation that promotes economic activity.

B. Liquidity Is The Intersection Of The SEC's Mandate And Financial Stability

The path to financial instability begins with a shock to the system that induces deep uncertainty in valuations and a failure of price discovery. There may be a particular market that is first affected, but depending on the interconnectedness, that is often itself unknown to market participants, contagion may cascade to other parts of the market. With uncertainty of the price floor, there are either no bids or bid/ask spreads widen dramatically. Liquidity dries up.

The SEC's mandate of orderly markets inherently concerns liquidity: disorderly markets arise when there is a lack of price discovery, prices move wildly, broker-dealers disengage and liquidity declines. A clear point of crisis intervention, that regulation and market infrastructure can both address, is liquidity. It is the medium through which price discovery takes place, capital is rationally allocated, decisions more thoughtfully made, and contractions are mitigated.

Within the SEC, the Division of Trading and Markets particularly has this responsibility. While the Division references oversight of the securities exchanges and securities firms, market infrastructure for fixed income over the counter markets and electronic venues is rapidly developing and regulation is still evolving.

The SEC's regulation of fixed income markets, including alternative trading systems (ATS, or electronic venues), has promoted market efficiency and lowered trading costs in normal periods, but this has not necessarily translated to improved liquidity in turbulent periods. In fact, in December 2015, Congress directed the SEC's Division of Economic and Risk Analysis to report on the impacts of the Dodd Frank Act, the Volker Rule and other financial regulations on market liquidity in U.S. Treasury and corporate debt markets.

While there is little consensus in existing work concerning the direction, causal attribution, and mechanisms behind observed changes, evidence suggests that in recent years dealers have been less likely to engage in risky principal transactions. In addition, dealers generally decrease liquidity provision in times of severe market stress, such as during the financial crisis.

Evidence from the crisis [of 2008] suggests that during times of severe market stress, dealers may not lean into the wind, but instead make larger cuts in inventory of bonds that are aggressively sold by their customers. Such evidence supports a finding that dealers decrease liquidity provision in times of severe market stress.⁶²

A major challenge for SEC's regulatory initiatives for promoting liquidity is that the prescriptions for orderly markets and efficiency in normal periods are quite different from those crisis periods. These are the periods when combined effects of capital requirements, the Volker Rule, bank liquidity ratios and stress test requirements take their toll. In these environments, banks' broker-dealers are working to assure their own liquidity before providing it to the market, even as trading revenue can improve due to the widened bid/ask spreads on what is traded. It is fair to say that the SEC has primarily focused on the former. Here the SEC has already implemented rule 22e-4 to improve the liquidity in open-end stock and bond funds; and has implemented the 2014 reforms to rule 2a-7. The new rules have enhanced management awareness of liquidity characteristics of various instruments and made for better oversight of liquidity levels by fund advisers, boards and the SEC.

Nonetheless, the SEC can focus greater attention on regulations that can enhance bond and money market liquidity in crisis periods. That is, the markets themselves, not just funds. This avenue can be pursued both in the regulation of broker/dealers and markets.

The SEC can also proactively engage with stakeholders to improve the market for HQST paper, which remains in a primitive state compared with other markets. More generally, the Division of Trading and Markets should undertake a thorough review of the short-term markets to identify additional means of improving liquidity during stressed market periods.

V. Conclusion

The March 2020 liquidity crisis stemmed from the worst pandemic in 100 years and a concurrent global economic shutdown that was deeper, more sudden and more synchronized than the Great Depression. Disruption to the money markets only came after deep contractions in equity and bond markets and even pronounced illiquidity in segments of the U.S. Treasury market. In considering further reforms to MMFs, it must also be noted that the credit quality and liquidity levels of prime and tax exempt MMFs met or exceeded regulatory requirements during the duration of the crisis. Outflows from these funds were exacerbated by a defect in the 2014 MMF reforms that linked the 30% WLA test to board action on fees or gates. The Fed predicted

⁶² SEC, *Access to Capital and Market Liquidity* (Aug. 2017) available at <https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-2017.pdf>, at 9.

this would trigger redemptions – and it did. There are no additional reforms needed for these funds, other than to correct that defect.

Both the Fed and the SEC should address a root cause of financial contagion in the March 2020 crisis – a widespread and sharp drop in liquidity across markets, particularly in the funding markets that are vital to the functioning of the capital markets. We recommend that both agencies examine regulations that may stifle rather than promote liquidity and market-making in crisis periods. In recognition of the Fed’s unique role, while its actions in 2020 quickly stemmed the market turmoil when enacted in mid-March, significant damage had already, and unnecessarily, been done. We recommend that the Fed consider steps be more proactive in *preventing* panics – in line with a central feature of its original statutory mission. A helpful step would be to make the very effective measures on use of the discount window announced on March 15, 2020 permanent; and to similarly relax regulations that curtail market-making in stressed market conditions. We suggest that the Fed also consider making timely use of the Liquidity Event, or similar designation, defined within DFA, as a means of alerting banks to make use of the ensemble of facilities available to them to support liquidity and market-making. We believe that these actions would significantly stem a cycle that neither industry nor the Fed want – the creation of ad hoc Section 13(3) special facilities.

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Federated Hermes appreciates the opportunity to present our views on these topics and hopes that you find them useful and constructive. We welcome any questions you may have and are happy to meet to discuss any matters in further detail.

Very truly yours,

A handwritten signature in blue ink, appearing to read "Michael R. Gots".

Chief Risk Officer
Federated Hermes, Inc.