

June 2, 2023

The Honorable Gary Gensler, Chair  
United States Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549

**Re: Supplemental Comment Letter of Federated Hermes, Inc. Responding to Chair Gensler Speech on May 25, 2023 to the Investment Company Institute on the U.S. Securities and Exchange Commission’s Proposed Amendment to Rule 2a-7 Requiring the Use of Swing Pricing in Institutional Prime and Tax-Exempt Money Market Funds (SEC File No. S7-22-21)**

Dear Chair Gensler:

In your remarks to the Investment Company Institute on May 25, 2023,<sup>1</sup> you invited additional comments on MMF reform. I happened to be there in person and want to thank you for this opportunity to provide further commentary. Below, I have provided responses to certain points you made in your speech. I’ve also provided further thoughts on the proverbial elephant in the room that you neglected to mention: the current banking crisis.

**Maturity Transformation of Weeks, Not Years, Makes All the Difference in Interest Rate Risk and Funding Risk.** In your remarks, you said that MMFs, like banks, engage in maturity transformation. Not like banks they don’t. MMFs came through the past year without a scratch in spite of sudden, large interest rate increases well in excess of what the markets had anticipated or the Federal Reserve had warned banks to prepare for in February 2022. The nation experienced three of the largest bank failures in history this Spring, and the FDIC had to cover all depositors to prevent further contagion. Not because of credit risk, but because upward movements in interest rates caused the market value of bank portfolio assets to plummet. The current value of fixed-rate instruments varies inversely to interest rates. The price impact is significantly larger for longer duration instruments. In addition, short-term debt instruments convert to cash at maturity and, therefore, do not need to be sold to raise cash. The duration of bank portfolios is measured in years and the portfolios are not marked to market. This is true even for banks’ so-called “high quality liquid assets” (“HQLAs”) whose regulatory purpose is to provide cash as needed to pay near-term withdrawals and funding outflows. In contrast, MMF portfolio duration is measured in days and weeks and for institutional prime and tax-exempt MMFs, portfolio securities with remaining maturities greater than 60 days are carried at current market value. One of these things is not like the other.

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<sup>1</sup> Chair Gary Gensler, *Bear in the Woods*, Remarks before Investment Company Institute (May 25, 2023), <https://www.sec.gov/news/speech/gensler-remarks-investment-company-institute-05252023>.

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**The Federal Reserve Was Created by Congress in 1913 to Provide Liquidity in the Short-Term Funding Markets to Prevent Financial Crises.** In your remarks, you suggest that the Federal Reserve was forced to “bail out” MMFs in 2008 and 2020 and that this is not the statutory purpose of the Federal Reserve. In your words as regards investment funds: “Congress never authorized for direct open support from the Fire Department.”<sup>2</sup> Instead, you indicate the Federal Reserve is only intended by Congress to be a lender to banks. First, there was no bail-out. The Federal Reserve provided liquidity to the commercial paper markets, including MMFs, in 2008 and 2020 exactly as intended by Congress. Second, Congress did not preclude the Federal Reserve from non-bank lending. After the Financial Panic of 1907, in which the commercial paper markets froze, Congress studied various solutions to provide liquidity in those markets as needed to prevent future panics. The Federal Reserve System was created not simply as a clearing house for bank payments or a lender to banks or a global interest rate manager. The central role that Congress tasked the Federal Reserve with is making liquidity available in the commercial paper and short-term credit markets when needed to prevent a financial crisis.<sup>3</sup> It is quite evident in the full formal name of the legislation we think of as the Federal Reserve Act of 1913 which created the Federal Reserve System: “An Act To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.” Contrary to your suggestion, the Federal Reserve did not act outside of its power in 2008 and 2020. The Federal Reserve acted exactly as intended by Congress. The “Fire Department,” as you called the Federal Reserve, did its job, and it turned a massive profit for the U.S. Treasury on these emergency credit market funding facilities, as they almost always do in these situations.<sup>4</sup>

**The 1940 Act Was Not Intended to Authorize a Departure from Market Pricing of Fund Portfolios And Shares.** In your remarks, you note that key statutory objectives of the Investment Company Act of 1940 (the “1940 Act”) included protecting shareholders from dilution and illiquidity, drawing from the experiences with investment trusts in the 1920s and 1930s. We note that there is no evidence that MMF shareholders have suffered material dilution from the cost of investor redemptions during March of 2020 or at any other time. Nor is it clear that Congress intended the 1940 Act to address this particular type of potential dilution by swing pricing or otherwise. You then make a great leap of faith right over the “protecting shareholders” part of that thought to a conclusion that somehow the 1940 Act’s overriding purpose is to lock investors in

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<sup>2</sup> Q&A at end of remarks of Chair Gensler at ICI, May 25, 2023, video at minute 33:10.

<sup>3</sup> See, e.g., O.M.W. Sprague, The Federal Reserve Act of 1913, 28 Quarterly Journal of Economics, 213 (Feb. 1914); Henry Parker Willis, The Federal Reserve Act of 1913, 4 American Economic Review 1 (Mar. 1914).

<sup>4</sup> With the notable exception of the emergency funding provided to certain auto industry participants in 2008. See Federal Reserve Office of Inspector General, The Federal Reserve’s Section 13(3) Lending Facilities to Support Overall Market Liquidity (Nov. 2010) (documenting multi-billion dollar profitability of Federal Reserve’s 2008 emergency lending programs), [https://oig.federalreserve.gov/reports/FRS\\_Lending\\_Facilities\\_Report\\_final-11-23-10\\_web.pdf](https://oig.federalreserve.gov/reports/FRS_Lending_Facilities_Report_final-11-23-10_web.pdf); U.S. Treasury, TARP Program (“As of October 31, 2016, cumulative collections under TARP, together with Treasury’s additional proceeds from the sale of non-TARP shares of AIG, exceed total disbursements by more than \$7.9 billion”, <https://home.treasury.gov/data/troubled-assets-relief-program>; TARP Program/Auto Industry, <https://home.treasury.gov/data/troubled-assets-relief-program/automotive-programs> (“the auto industry rescue resulted in a cost of \$9.3 billion to the government”).

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place to deter redemptions and thereby prevent recognition of market losses by use of “swing pricing.” But there is no basis in the 1940 Act for pricing shares below market prices to deter redemptions, and there is no logical nexus in the absence of material dilution for doing so in the name of investor protection. Indeed, swing pricing would create an opportunity for dilution of existing MMF shareholders by persons who buy shares at the reduced swing price during an outflow period. Simply put, in a “Dash for Cash” scenario, investors want out and wouldn’t be deterred by a fee or a swung price. And why shouldn’t they be able to get out? The real question is, will the prospect of such a fee actually exacerbate redemptions? Imposing mandatory redemption fees or swing pricing will not make mutual funds generally—or MMFs in particular—better, safer, or more attractive from an investor perspective. That will make them less so.

Similarly, imposing a requirement for intermediaries to transact at a 4-digit NAV on U.S. government and retail MMFs will not serve any purpose other than reducing their efficiency and utility to investors as a cash management tool.<sup>5</sup> The real objective here seems to be to finish the job the Financial Stability Oversight Council (FSOC) started in 2014 to destroy what is left of MMFs as a useful tool to cash managers and force investors to park their short-term cash balances at below-market rates in bank deposits. At the same time, this approach forces state and local governments and businesses as short-term cash borrowers to borrow only from banks and similarly subsidize their high-risk inefficient balance sheets. Harming investors, deterring capital formation, and making markets less efficient and less competitive is precisely the opposite of the SEC’s statutory mandate in the 1940 Act.

**The Unmentioned Banking Crisis.** We note that you made no comment on the current banking crisis and its relation to your MMF proposals. Since 2010, some banks have operated their balance sheets by financing with essentially zero-rate deposits their investments in long-term portfolio assets. As long as short-term interest rates remained low and funding remained stable, a good profit could be had. This worked until it didn’t. The fundamental cause of the current crisis is that many banks were unprepared for a five hundred basis point upward shock to interest rates that the Federal Reserve conducted in 2022-2023.<sup>6</sup> The Federal Reserve utterly failed to coordinate between its policy objectives in combatting inflation and its supervisory responsibilities over the banking system in making sure the system could withstand the magnitude of rate shocks the

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<sup>5</sup> Without provision for use of a so-called Reverse Distribution Mechanism (RDM), bank and broker-dealer sweep systems will not be able to process MMF transactions because their systems cannot process a 4-digit NAV. We understand that the costs of such changes to legacy systems currently in use would be prohibitive.

<sup>6</sup> In contrast, stress testing at MMFs takes extreme market movements into consideration and involves a portfolio that turns over many times per year at current market interest rates. For example, in one scenario, our MMFs in 2022 were stress tested assuming a sudden redemption of 40% of shares and a simultaneous 125 basis point rate increase for short-term rates. Given the very short duration of the MMF portfolio and its frequent maturity and turnover to new portfolio assets earning current market rates multiple times per year, this amount of assumed near-term rate increase repeated multiple times during the year more than covered the actual 500 basis point rate increases to date in 2022-2023. MMFs were, consequently, far more prepared for the interest rate hikes actually imposed by the Fed than were banks whose portfolios take years to mature and be replaced at current market interest rates.

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Federal Reserve imposed.<sup>7</sup> The lesson of 1980 had been forgotten. This failure to coordinate manifested itself in at least two key regards: (1) the proscriptive stress test scenarios published by the Federal Reserve and FDIC in February 2022 for the tests to be conducted by large banks assumed interest rate increases that were four hundred basis points below what the Federal Reserve actually did,<sup>8</sup> and (2) the Federal Reserve's liquidity rules (net stable funding ratio and liquidity coverage ratio) fail to require that HQLAs be marked to market and treat large payroll and similar business deposits well above deposit insurance limits that are "operational deposits" as not being subject to sudden outflow.<sup>9</sup> When rates rose suddenly, this hot money flew out of the most-exposed banks and the HQLAs held by the banks contained significant unrecognized losses from rising interest rates because they were not marked to market.<sup>10</sup> When HQLAs were needed to meet these cash outflows, their sales triggered recognition of massive losses that wiped out bank capital.<sup>11</sup>

Had more large corporate deposits above FDIC insurance limits been swept off bank balance sheets into MMFs over the past few years, this hot money would not have caused the damage that it did to the banking system and the FDIC. MMFs are designed to handle large fast outflows, and massive interest rate shocks. Banks are not designed to handle these types of rate shocks or funding losses. Rather than recognizing this truth, or the damage caused by the 2014 amendments to the utility of MMFs that contributed to their replacement in cash sweep programs by businesses holding very large short-term cash balances as bank deposits, in your remarks, you appear to be toeing the FSOC party line that all the wreckage in the banking sector means we have to do something about MMFs.

The solution is not to cause further harm to MMFs and force cash investors to place more money in bank deposits. Instead the solution is to allow MMFs to do the job for which they were designed, to provide a safer (for everyone, including investors, taxpayers and the banks) and more efficient alternative for holding short-term cash balances. The only change required at this point to MMF regulation is to allow MMFs to use liquid assets for their intended purpose of meeting investor redemptions by de-linking gates and fees from daily and weekly liquid asset ratios.

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<sup>7</sup> See Bill Dudley, *What the Fed Missed in its Bank Crisis Confessional*, Bloomberg Opinion (May 10, 2023); Warren Hsung and J.P. Rothenberg, *Comparative stress testing in the U.S. and Switzerland*, ABA Banking Journal (May 22, 2023).

<sup>8</sup> Federal Reserve, Dodd-Frank Act Stress Test Publications, 2022 Stress Test Scenarios, <https://www.federalreserve.gov/publications/2022-Stress-Test-Scenarios.htm#:~:text=This%20year's%20scenario%20features%20a,the%20first%20quarter%20of%202023>.

<sup>9</sup> 12 CFR 249.

<sup>10</sup> Erica Jiang, Tomasz Piskorski, Gregor Matvos, Amit Seru, *Monetary Tightening and U.S. Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?*, Stanford SIEPR Working Paper No. 23-13 (rev. Apr. 5, 2023); Itamar Drechsler, Alexi Savov, and Philipp Schnabl, *Why Do Banks Invest in MBS?*, NYU Stern School of Business Working Paper (Mar. 13, 2023).

<sup>11</sup> In your remarks, you also stated that MMFs didn't have sufficient capital. This is also incorrect. They are 100% capitalized.

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Respectfully,

/s/ Peter J. Germain

Peter J. Germain

Executive Vice President

Chief Legal Officer

Federated Hermes, Inc.