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February 1, 2022

Via e-mail to rule-comments@sec.gov

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

Re: Money Market Fund Reforms: Proposed rule
Release No: IC-34441; File No: S7-22-21

Dear Ms. Countryman,

Thank you for the opportunity to comment on the SEC's proposed Money Market Fund Reforms. Below is a revised version of comments that previously appeared on our blog at:

https://www.moneyandbanking.com/commentary/2022/1/28/sec-money-market-fund-reform-proposals-fall-far-short-again

In announcing publication of the SEC's most recent proposed amendments to the rules governing money market funds, Chair Gary Gensler said:[1]

"[H]ere we are again. The events of March 2020 suggest that more can be done to improve the resiliency of money market funds […]. This is about systemic risk. Those of us at the SEC have an obligation to the public to once again come back and see if we can shore up this system a bit more."

We couldn't agree more. As the principal regulator of U.S. money market funds (MMFs), the SEC has a duty to end the market distortions and moral hazard that repeated public rescues create. There have been two MMF bailouts, so far. The first came at the height of the Great Financial Crisis of 2008, while the second followed in the March 2020 COVID crisis. While the Treasury provided guarantees only once, the Federal Reserve offered emergency liquidity assistance both times.

These repeated government interventions encourage MMF managers to behave in ways that make future financial crises more likely. In effect, the authorities are subsidizing liquidity even when there is no direct cost to taxpayers. Moreover, there is no credible way for the Fed to promise *not* to intervene should a systemic disruption again loom in short-term funding markets. Indeed, Paul Tucker suggests requiring "the issuers of assets treated as safe, regardless

[1] See Gensler, Gary, "Statement on Money Market Fund Reform," December 15, 2021 at https://www.sec.gov/news/statement/gensler-mmf-20211215.

of their legal form, to have access to the central bank's discount window."[2] The only realistic means to end the subsidies created by the implicit promise of future bailouts is to force MMFs to be far more resilient than they are today.

Not surprisingly, everyone knows that MMF regulation needs reform. In December 2020, the President's Working Group on Financial Markets (PWG) proposed a set of possible MMF reforms.[3] The SEC then sought public comments on this list of proposals.[4] Last June, the Hutchins Center-Chicago Booth Task Force on Financial Stability's proposed reforms included several aimed at MMFs.[5] And, a few months ago, the Financial Stability Board released its own proposals for strengthening the global MMF industry.[6]

Against this background, the SEC's December 2021 reform proposals are seriously disappointing. As SEC Chair Gensler suggests, they probably "shore up this system a bit more." We would go much farther. The proposals are woefully inadequate on several fronts:

- Ignoring the functional equivalence between banks and MMFs, and without providing a quantitative assessment of costs and benefits, the SEC rejects a role for capital requirements.
- In calibrating the need for additional MMF liquidity, the SEC implicitly assumes the continued presence of a Fed liquidity backstop.
- The SEC misses the opportunity to require that MMF stress tests (which have been compulsory for over a decade) meet fundamental principles of *transparency, severity and flexibility*.
- Even the SEC's most promising proposal—to require swing pricing for selected MMFs—is operationally difficult to implement, so (like most useful reforms), it already faces strong resistance from the industry.[7]

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[2] See Sir Paul Tucker, "Macroprudential policy as part of a broader financial stability regime: does it exist, what should it be?" Macroprudential Matters, September 13, 2021 at https://macroprudentialmatters.com/macroprudential-policy-as-part-of-a-broader-financial-stability-regime-does-it-exist-what-should-it-be.

[3] See President's Working Group on Financial Markets, "Overview of Recent Events and Potential Reform Options for Money Market Funds," December 2020 at https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf; as well as our discussion at Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Fix Money Funds Now," www.moneyandbanking.com, January 4, 2021.

[4] See https://www.sec.gov/comments/s7-01-21/s70121.htm.

[5] See Hubbard, Glenn, Donald Kohn, Laurie Goodman, Kathryn Judge, Anil Kashyap, Ralph Koijen, Blythe Masters, Sandie O'Connor, and Kara Stein, "Task Force on Financial Stability," Hutchins Center on Financial & Monetary Policy at Brookings, June 2021 at https://brook.gs/32PDp3L; as well as our discussion at Cecchetti, Stephen G. and Kermit L. Schoenholtz, "The Urgent Agenda for Financial Reform," www.moneyandbanking.com, October 4, 2021.

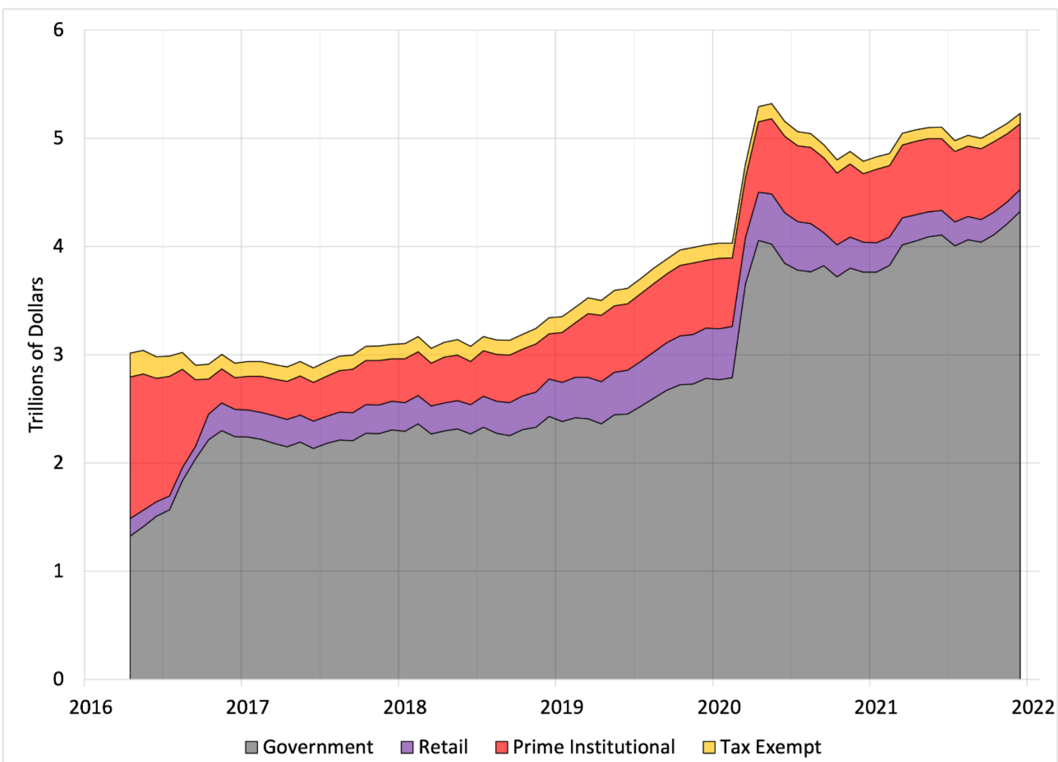
[6] See Financial Stability Board, "Policy Proposals to Enhance Money Market Fund Resilience, Final Report," October 11, 2021 at https://www.fsb.org/2021/10/policy-proposals-to-enhance-money-market-fund-resilience-final-report.

[7] See, for example, page 5 of the ICI comment (April 12, 2021) on the PWG proposals at https://www.sec.gov/comments/s7-01-21/s70121-8662926-235321.pdf.

In the remainder of this letter, we start with basic facts about the scale and mix of MMFs today. We then describe the SEC's proposals, before focusing on their key shortcomings. We hope that the public comments that the SEC receives will motivate it, at the very least, to conduct a serious *quantitative* assessment of introducing capital requirements for the most vulnerable MMFs, to re-assess the scale of additional liquid assets needed for MMF resilience *in the absence of a Fed backstop*, and to propose ways to enhance the effectiveness and utility of MMF stress tests.

Before proceeding, however, we need to make one thing clear: we do *not* propose to substitute banks for MMFs. In our views, MMFs already function as banks—for the most part, as very safe banks. But if banks are to avoid runs and fire sales, all of them need a mix of risk-adjusted capital and liquidity requirements, along with a lender of last resort (LOLR). The safer the bank, the smaller those capital requirements need to be and the less important the LOLR. But regardless of its structure; regardless of the extent of credit, liquidity and maturity transformation on its balance sheet; every bank needs to issue some capital. To be clear, even a narrow bank that holds only reserve deposits at a central bank requires capital to guard against operational risk. So, the number should never be zero.

Chart 1: U.S. MMF assets by fund category (Trillions of dollars), April 2016-December 2021



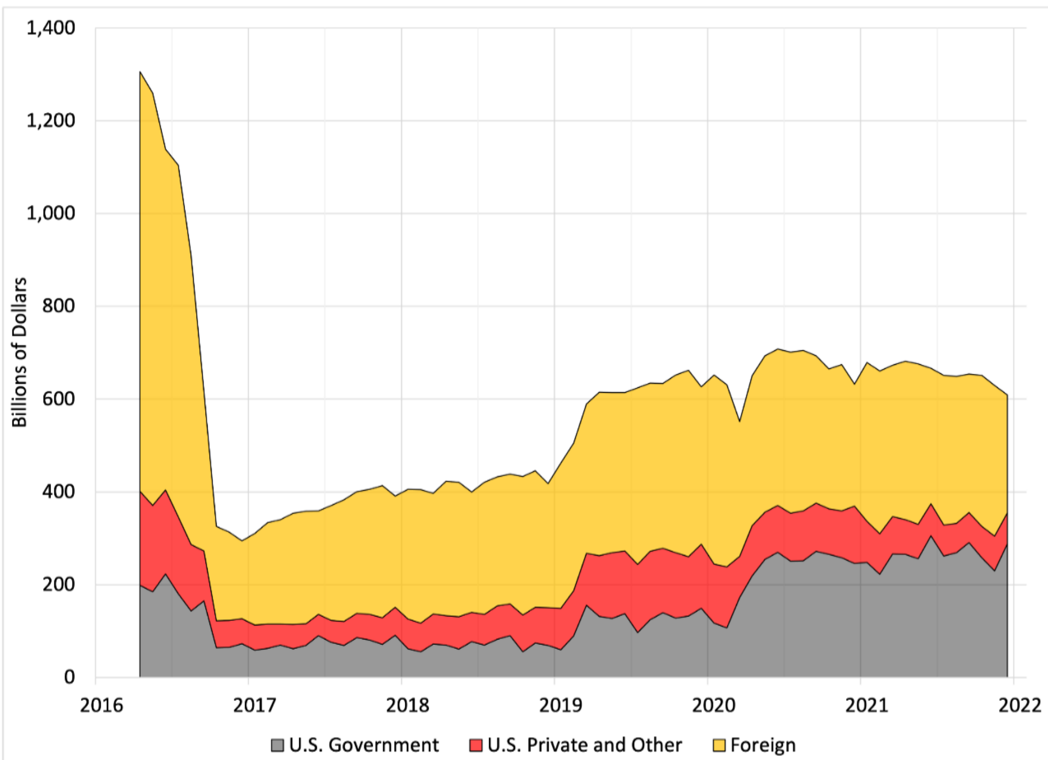
Source: Office of Financial Research U.S. Money Market Fund Monitor.

MMFs by the numbers. Turning to some preliminary facts, we distinguish two types of U.S. MMFs: those with a fixed net-asset-value (NAV) and those with a floating NAV. Following the

SEC money fund reforms of 2014, government-only and retail funds continue to fix their NAV at $1, but prime institutional and tax-exempt funds must set their NAVs in line with the changing market value of their assets. As we highlight in Chart 1, at the end of 2021, government-only (gray) and retail (purple) funds held a combined $4.5 trillion of assets, or nearly 87% of the $5.2 trillion total. Prime institutional (red) and tax-exempt (yellow) funds accounted for the remaining $0.7 trillion.

Chart 1 highlights two large shifts toward government funds. The first occurred in late 2016, as implementation of the SEC's 2014 reform requiring prime institutional funds to adopt floating-NAVs loomed. Given the modest sacrifice of return, shareholders revealed their strong preference for the cash-like features of a stable-value (fixed NAV) fund. The second shift came in March 2020 when the COVID crisis prompted a run out of riskier assets into cash equivalents.

Chart 2: U.S. prime institutional MMF assets (Billions of Dollars), April 2016-December 2021

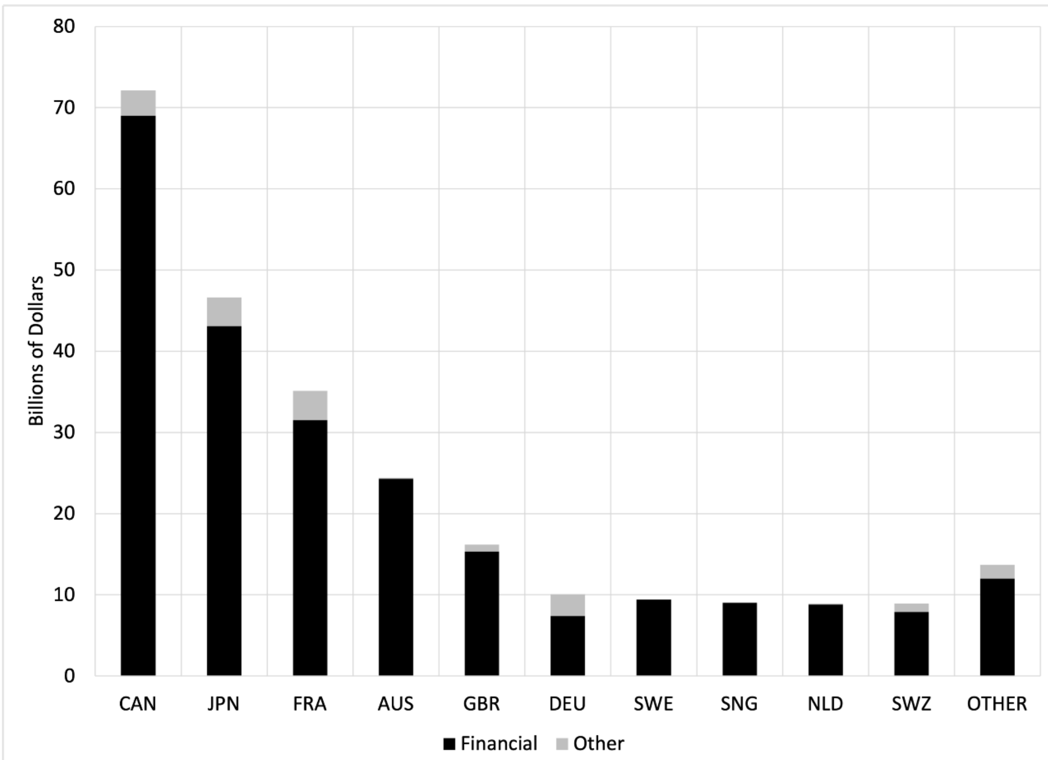


Source: Office of Financial Research U.S. Money Market Fund Monitor.

Importantly, Chart 1 *understates* the shift to safety in the composition of MMFs. To see this, in Chart 2 we plot important details of prime institutional funds' holdings. At the end of 2021, government instruments (in gray) accounted for $288 billion—a whopping 81%—of prime institutional funds' $355 billion in U.S. assets (gray *plus* red). As a result, these MMFs currently invest just $61 billion in U.S. private short-term funding instruments (in red). That is, MMF holdings account for only about 3% of outstanding commercial paper (CP) and large certificates of deposit (CD) issued by U.S. entities. At the same time, however, prime institutional funds provide substantial short-term finance to *foreign* (mostly financial) borrowers (in yellow).

Of the $254 billion foreign assets at the end of 2021, most are accounted for by the liabilities of foreign banks. Indeed, as Chart 3 shows, the liabilities of Canadian, Japanese, French, and Australian financial intermediaries alone account for two-thirds of this total ($168 billion). Their role in providing short-term finance to foreign banks is the primary reason that U.S. prime institutional MMFs remain a source of systemic risk.

Chart 3: U.S. prime institutional MMFs: Foreign assets by country (Billions of U.S. dollars), End-2021



Source: Office of Financial Research U.S. Money Market Fund Monitor.

The SEC proposals. Turning to their 325-page December 2021 report, the SEC provides a largely qualitative discussion of the PWG's MMF reform proposals from a year earlier, endorsing several and rejecting others.[8] For the most part, the reform proposals focus on the floating-NAV funds, especially the prime institutional funds that experienced the largest outflows in the March 2020 episode.

The SEC recommends the following three reforms:

[8] See President's Working Group on Financial Markets, "Overview of Recent Events and Potential Reform Options for Money Market Funds," December 2020.

- *Liquidity Fees and Gates.* Removal of optional liquidity fees and redemption gates for non-government funds (reversing the 2014 reform).
- *Swing Pricing.* Requiring swing pricing for floating-NAV prime institutional and tax-exempt funds.
- *Portfolio liquidity requirements.* Raising the daily liquidity asset (DLA) requirement from 10% to 25% of assets and the weekly liquidity asset (WLA) requirement from 30% to 50% of assets.

The SEC argues that each of these would mitigate first-mover advantage, thereby reducing the likelihood of MMF runs. We agree that fees and gates should be removed, but are concerned about the operational challenges of implementing swing pricing, and doubt that the new liquidity requirements are properly calibrated.

Fees and Gates. The SEC reform of 2014 allowed funds the option to impose such liquidity restrictions once a fund's weekly liquid assets (WLA) fell below 30% of total assets. Following the 2020 crisis, researchers have found compelling evidence that these liquidity rules exacerbated the runs on prime funds as their WLA declined.[9] Accordingly, we welcome this proposal.

We note, however, that this vulnerability should have come as no surprise to the SEC. Critics ranging from the Federal Reserve Bank Presidents to the Squam Lake Group had cautioned in their 2013 comments regarding the preliminary SEC proposals that became the 2014 reforms.[10] In 2014, former SEC Commissioner Kara Stein also warned explicitly of an increased likelihood of runs "as the chance that a gate will be imposed increases."[11] In effect, the SEC's 2021 proposal to remove these optional liquidity restrictions belatedly endorses this earlier criticism without acknowledging it.

Swing pricing. Research on U.K. bond funds concludes that swing pricing reduces first-mover advantage and the risk of runs.[12] Very briefly, swing pricing adjusts the price (NAV) at which aggregate transactions settle to place the burden of transactions costs on those redeeming their shares rather than on remaining shareholders.

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[9] See Li, Lei, Yi Li, Marco Macchiavelli and Xing (Alex) Zhou, "Liquidity Restrictions, Runs, and Central Bank Interventions: Evidence from Money Market Funds," The Review of Financial Studies, November 2021 at https://doi.org/10.1093/rfs/hhab065.

[10] See the comment letters https://www.sec.gov/comments/s7-03-13/s70313-111.pdf and http://www.squamlakegroup.org/Squam%20MMF%20SEC%20Comment%20Letter%20Sept%2017%202013%20.pdf.

[11] See Stein, Kara M., "Statement of Commissioner Kara M. Stein," July 23, 2014 at https://www.sec.gov/news/public-statement/2014-07-23-open-meeting-statement-kms; as well as our discussion at Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Regulating Money Market Mutual Funds: An Update," www.moneyandbanking.com, July 28, 2014.

[12] See Jin, Dunhong, Marcin Kacperczyk, Bige Kahraman, and Felix Suntheim, "Swing Pricing and Fragility in Open-end Mutual Funds," The Review of Financial Studies, Volume 35, Issue 1, January, 2022, pages 1-50 at https://academic.oup.com/rfs/article/35/1/1/6162183.

As the SEC claims, swing pricing ought to reduce first-mover advantage in funds holding illiquid assets, including MMFs that purchase commercial paper, bank CDs, or municipal debt.[13] However, we note that U.S. bond funds generally have *not* implemented swing pricing despite having that option since 2018. In part, this reluctance reflects a coordination problem—no fund wishes to go first if it will lose shareholders to other funds that reject swing pricing. But it also reflects operational challenges in the U.S. context.[14] And, these U.S. impediments to swing pricing appear greater in the case of those MMFs that, in addition to needing time to estimate the swing factor, also set their NAV more than once a day.[15] So, while the introduction of swing pricing would be helpful, we are cautious about relying on it as the principal (and virtually sole) means to improve resilience of MMFs.

Portfolio liquidity requirements. The SEC proposes raising MMF portfolio daily liquidity asset (DLA) requirements from 10% to 25% of assets and weekly liquidity asset (WLA) requirements from 30% to 50% of assets. While we agree that this is a step in the right direction, our conclusion is that the increase is seriously inadequate for at least two reasons. First, the new requirements fall well short of recent norms in the prime institutional fund industry, which reported average DLA (WLA) shares of 53% (63%) at the end of 2021.[16] (As a benchmark, we note that—at the end of 2021—average DLA and WLA of government MMFs was 79% and 90% of assets, respectively.)

More importantly, the SEC calibrates the new requirements using data from March 2020, when the largest weekly outflow from a prime institutional fund was around 55% of total assets and the largest daily outflow was about 26%, similar to the new minimum WLA and DLA proposals. We are struck by the implication that a requirement designed to reduce run risk would be based on net redemption patterns during the exact period when Fed intervened to backstop the entire financial system. Indeed, net redemptions from prime institutional funds peaked *the day before* the Fed announced its Money Market Liquidity Fund.[17]

If the goal is to set prime institutional MMF liquidity requirements sufficiently high to avoid the need for special central bank support, the episode of March 2020 is an outrageously inappropriate benchmark. Yet, the SEC's liquidity requirement modeling relies specifically on the "distribution of redemptions from 42 institutional prime funds observed during the week of March 16 to 20, 2020." Remarkably, even applying this weak test, the SEC estimates that about

[13] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Open-ended Funds vs. ETFs: Lessons from the COVID Stress Test," www.moneyandbanking.com, January 18, 2021.
[14] See Kashyap, Anil, Donald Kohn, and David Wessel, "What is swing pricing?" Hutchins Center on Financial & Monetary Policy at Brookings, August 3, 2021 at https://brook.gs/3LcE4xA.
[15] See, for example, page 20 of the ICI comment at https://www.sec.gov/comments/s7-01-21/s70121-8662926-235321.pdf.
[16] See Tables 7 and 8 in the SEC's Money Market Fund Statistics for the period ending December 2021: https://www.sec.gov/files/mmf-statistics-2021-12.pdf.
[17] See Chart 3 of the December 2020 report of the President's Working Group at https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf.

8% of prime institutional funds would have run out of DLA on at least one day that week.[18] For comparison, imagine the systemic consequences if 8% of commercial banks were forced to sell illiquid assets in a stressed week to meet deposit withdrawals.

Shouldn't MMF liquidity requirements be set to ensure that all prime institutional MMFs can withstand a high-stress period without reliance on public support?

What's missing from the SEC proposals? Finally, we highlight two elements we believe to be missing from the proposed reforms: the imposition of risk-adjusted capital requirements and the enhancement of stress tests.

Capital requirements. Analysts have long proposed risk-adjusted capital requirements as a device to make risky MMFs safer. For example, the Squam Lake Group in 2013 identified a capital buffer as its preferred approach for regulating prime MMFs.[19] More recently, the Systemic Risk Council argued that "funds and other vehicles with access to Federal Reserve liquidity insurance need to be required to issue capital instruments of some kind that will absorb losses ahead of those investor claims that rely upon being liquid and safe."[20] Operationalizing the capital buffer by adding a loss-bearing, subordinated class of liabilities would not require changing the structure of current MMF shares, but would make them less risky by converting them into *senior* liabilities. (We do not discuss the "minimum balance at risk"—MBR—alternative to capital requirements primarily because it would weaken the cash-management feature of MMFs while posing operational challenges.[21])

Economists have previously estimated the costs of imposing risk-adjusted capital requirements on MMFs. Importantly, it makes no sense to claim (as some capital requirement opponents do) that MMFs are safe while simultaneously arguing that capital requirements would make them unviable. Precisely because MMFs generally perform less liquidity, credit and maturity transformation than banks, the necessary risk-adjusted capital buffers to achieve bank-level resilience ought to be relatively small. Using a bank safety standard, Hanson, Scharfstein and Sunderam (HSS) conclude that a capital requirement of 3 to 4 percent of unsecured, non-

[18] The 8% estimate is our interpolation of Figure 14 (page 212) of the SEC analysis at https://www.sec.gov/rules/proposed/2021/ic-34441.pdf.

[19] See the comment letter at http://www.squamlakegroup.org/Squam%20MMF%20SEC%20Comment%20Letter%20Sept%2017%202013%20.pdf.

[20] See Systemic Risk Council, "Systemic Risk Council responds to Securities and Exchange Commission consultation on reform of money funds and other open-ended funds," April 12, 2021, at https://www.systemicriskcouncil.org/2021/04/systemic-risk-council-responds-to-securities-and-exchange-commission-consultation-on-reform-of-money-funds-and-other-open-ended-funds .

[21] For a discussion of minimum balance at risk, see McCabe, Patrick E., Macro Cipriani, Michael Holscher, and Antoine Martin, "The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds," Brookings Papers on Economic Activity, Spring 2013, at https://brook.gs/3sapNIN.

government assets would be reasonable for prime institutional MMFs.[22] HSS then go on to estimate that this would depress the return to ordinary MMF shareholders by only *5 basis points*. Similarly, former SEC chief economist Lewis reckons the necessary capital buffer for a well-diversified MMF at only 0.6% of total assets, implying an even lower cost to ordinary MMF shareholders.[23]

Against this background, the 2021 SEC report provides a relatively brief *qualitative* discussion of the pros and cons of capital requirements, with the latter including operational challenges, uncertainty about the opportunity cost of the required capital, the reduced willingness of MMFs to hold riskier short-term private debt, and the potential for heightened redemption if the buffer becomes impaired. The report then concludes that "capital buffers may not have the same benefit for investment products such as money market funds, where the investors bear the risk of loss, as they do for banks" (page 258).

In our view, this conclusion is directly contrary to the facts. Precisely because of prime institutional funds' systemic importance for short-term financial markets (especially for the dollar funding of foreign banks), the Federal Reserve has felt compelled to backstop MMFs twice since 2008, and would almost surely do so again tomorrow if there were another funding crisis.

Against this background, three of the SEC's arguments against capital requirements appear to us to be features, not flaws. First, if capital requirements prompt MMF managers to reduce their holdings of risky short-term private debt, it is because the requirements compelled them to internalize the spillovers that their actions have on other parts of the financial system. Second, it ought not be too difficult to estimate the cost of capital involved. In fact, HSS did it by exploiting the similarity between the risk of MMF losses and the default risk on bonds issued by financial firms. Third, if an MMF should experience losses, the incentive for shareholders to run must be lower in the presence of a capital buffer than it would be without one.

Finally, the SEC offers no evidence that the operational challenges of establishing a capital buffer would be greater than the challenges of introducing swing pricing.

Enhancing stress tests. Beginning in 2010, the SEC required MMFs to implement stress tests. The Commission enhanced the testing requirement in 2014,[24] so that today MMFs must periodically assess the impact on their asset liquidity of scenarios that assume increases in short-term

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[22] See Hanson, Samuel G., David S. Scharfstein, and Adi Sunderam, "An Evaluation of Money Market Fund Reform Proposals," IMF Economic Review, vol 63, no 4, pg. 984-1023, November 2015 at https://ideas.repec.org/a/pal/imfecr/v63y2015i4p984-1023.html.
[23] See Lewis, Craig M., "Money Market Funds and Regulation," Annual Review of Financial Economics, October 2016, vol 8, pg. 25-51 at https://www.annualreviews.org/doi/abs/10.1146/annurev-financial-121415-032823.
[24] See Securities and Exchange Commission, "Money Market Fund Reform; Amendments to Form PF," October 14, 2014 at https://www.sec.gov/rules/final/2014/33-9616.pdf.

interest rates, credit events, and wider credit spreads, along with various levels of redemptions.[25]

Even today, however, the SEC stress testing regime does not conform with basic principles of effective stress testing: namely, *transparency, severity and flexibility*.[26] First, to impose effective market discipline, the scenarios must be sufficiently consistent in form and substance to facilitate comparison of the results and the individual results must be published. However, the current regime provides no such transparency for MMFs. Not only are the results unpublished, but we do not even know whether the stress test scenarios are comparable across funds.

Lacking such transparency, there also is no way to judge whether the stress tests are adequately severe to detect MMF vulnerabilities. And there is no way to know whether the hypothetical scenarios are evolving sufficiently to ensure their continued relevance (as financial conditions change) and to prevent stress test gaming.

Given the SEC's support for the use of stress testing in risk management, we are at a loss to explain these fundamental flaws in the MMF stress testing regime. We can only hope that the Commission will revisit this issue and make high-quality stress testing a key part of enhancing MMF resilience going forward.

Conclusion. To conclude, we are profoundly disappointed. The Commission is once again missing an opportunity to implement desperately needed reforms in the regulation of MMFs. While the proposal to eliminate voluntary liquidity fees and gates is laudable, and the introduction of a workable swing pricing regime would be helpful, these actions alone likely would not put an end to government bailouts of MMFs. It is well past the time for MMFs to face risk-adjusted capital requirements, realistically calibrated liquidity requirements, and credible stress tests.

Thank you for your consideration. Please let us know if you have any questions or require any additional information. We would be happy to meet with you if it would be helpful as you assess the comments on the SEC proposal.

Sincerely,

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[25] See Berkowitz, Jeremy, "Money Market Mutual Funds: Stress Testing & New Regulatory Requirements," Harvard Law School Forum on Corporate Governance, July 14, 2015 at https://corpgov.law.harvard.edu/2015/07/14/money-market-mutual-funds-stress-testing-new-regulatory-requirements.

[26] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Ensuring Stress Tests Remain Effective," www.moneyandbanking.com, January 22, 2018.