April 12, 2021

The Honorable Allison Herren Lee
Acting Chair
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: *Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report, File Number S7-01-21*

Dear Acting Chair Lee:

Thank you for the opportunity to comment on the President's Working Group on Financial Markets' report on the risks of money market funds (MMFs) and proposals for reforming the MMF industry.

It is well known that MMFs were conceived as a product in the early 1970s as a workaround for deposit interest rate caps at national banks under Regulation Q. MMFs are SEC-registered investment companies, which, instead of taking deposits and paying interest like a bank, issue shares and pay dividends. As you know, SEC rule 2a-7 requires some MMFs to maintain a stable net asset value (NAV) of $1 per share.

As a result, MMF shares are functionally similar to bank deposits. MMF shares have no fixed maturity, can be exchanged for cash at par on demand, and are claims on a portfolio, either corporate securities or government securities, depending upon the nature of the fund. Unlike bank deposits, MMF shares are not guaranteed by the FDIC; instead, the fixed $1 NAV is guaranteed by a private company, the MMF's sponsor. On the asset side, because they are investment funds, MMFs do not make loans like banks; instead, they purchase securities, including safe assets like U.S. Treasuries, but also other short-term, runnable liabilities like commercial paper and securities subject to repurchase agreements.[1] In an important sense, MMFs are funded like a commercial bank with the asset portfolio of an investment bank, creating the potential for asset-liability mismatches, opacity and other risks that can cause MMFs to face panics and runs similar to those that banks experienced in the past and which led to safety nets such as deposit insurance and central bank liquidity supports.

The fragility of this business model was on display during the global financial crisis of 2008, when Reserve Primary Fund, the nation's oldest MMF, disclosed that it had significant holdings of commercial paper issued by Lehman Brothers, one of Wall Street's largest investment banks. With Lehman on the brink of bankruptcy, there was a high probability that the commercial paper would not be repaid in full, and so Reserve Primary's investors started a run by redeeming their shares in exchange for cash. As a result, Reserve Primary "broke the buck," meaning that its value

[1] Large banks in particular have received a significant portion of their funding from MMFs – by one estimate, large banks sourced 35% of their short-term, wholesale funding from MMFs. *See* Samuel G. Hanson, David S. Scharfstein & Adi Sunderam, *An Evaluation of Money Market Fund Reform Proposals*, IMF Econ. Rev., Int'l Monetary Fund, vol. 63(4), 984-1023 (Nov. 2015).

per share fell below the $1 NAV.[2] There were similar concerns about MMFs that had invested in products like asset-backed commercial paper. Concerned that other MMFs might also break the buck, investors began to withdraw their holdings in other MMFs, resulting in fire sales of the assets of these finds in order to meet redemption requests. One consequence of the run on MMFs was that they could no longer invest in commercial paper or repo transactions, which led to a freezing of short-term credit markets and eliminated a crucial source of cheap short-term funding for banks. In addition, the fire sales also caused the value of a variety of banks' assets to decline.

When attempts by fund sponsors to provide additional liquidity to certain money markets failed to contain the fallout, the Federal Reserve guaranteed *all* assets held in MMFs, which involved using up to $50 billion of the Treasury's Exchange Stabilization Fund (ESF) to guarantee over $3 trillion in MMF industry assets. This decision significantly expanded the Federal safety net to guarantee the value of MMF shares that were not meant to benefit from government guarantees.[3] By supporting a legacy arbitrage scheme originally designed to circumvent banking regulations, the US government established a dangerous precedent, creating unnecessary risk and moral hazard and increasing the fragility of the system.

In an effort to prevent a repeat of this episode, including preventing future public support for the MMF industry, a series of legislative and regulatory reforms were enacted. In the Emergency Economic Stabilization Act (EESA), Congress prohibited the Treasury Department from using public funds held in its ESF to backstop or otherwise enable programs supporting MMFs in the future.[4] In June 2013, the SEC proposed reforms to the MMF structure, either requiring institutional MMFs to adopt a floating NAV or impose a liquidity fee on, or halt, redemptions if a MMF's weekly liquid assets fell below certain thresholds.[5] The SEC ultimately finalized this rule in July 2014,[6] notwithstanding the warnings from some commenters that the liquidity fee and gating proposals would not significantly reduce the risk of runs on MMFs.[7]

The MMF industry's poor performance during the onset of the COVID-19 pandemic strongly suggests that these reforms were not effective. Beginning in mid-March 2020, investors again began to run from certain prime MMFs for fear that they would not be able to redeem their shares at the promised $1 NAV. The Federal Reserve once again used section 13(3) of the Federal

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[2] Under the "penny rounding method," Rule 2a-7 allows MMFs to record holdings at: 1) their *expected value* at maturity, meaning that they assume that they will repay in full; and 2) rounding to the nearest $0.01 per share at least once a day – meaning that the fund cannot drop below $0.995 per share.

[3] Also relevant to MMFs' access to the "safety net," the Fed has created a reverse repo lending facility (RRP) that "effectively grants shadow banks – dealers and money funds – a checking account at the Federal Reserve[,]" and has been heavily used by MMFs. Zoltan Pozsar, *Shadow Banking: The Money View* 10, Ofc. of Fin. Research Working Paper No. 14-04 (July 2014); *see also* Josh Frost, Lorie Logan, Antoine Martin, Patrick McCabe, Fabio Natalucci & Julie Remache, *Overnight RRP Operations as a Monetary Policy Tool: Some Design Considerations* 10, Fed. Reserve Bank of N.Y. Staff Rep. No. 712 (Feb. 2015)(MMFs constituted 85% of the RRP facility's early usage).

[4] *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110–343, tit. I, §132(b), 122 Stat. 3765 (2008).

[5] *See* Securities & Exchange Comm'n, Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 36834 (June 19, 2013).

[6] *See* Securities & Exchange Comm'n, Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47736 (Aug. 14, 2014).

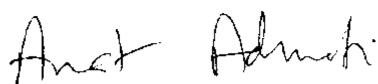
[7] *See* Letter from Eric S. Rosengren to Elizabeth M. Murphy, Sept. 12, 2013, https://www.bostonfed.org/news-and-events/press-releases/2013/the-12-federal-reserve-bank-presidents-encourage-money-market-mutual-fund-reform-submit-joint-letter-commenting-on-the-secrsquos-proposal.aspx.

Reserve Act to create the money market mutual fund liquidity facility (MMMLF) to support MMF assets, and the associated share prices. The Coronavirus Aid, Relief, and Economic Security Act (CARES) Act also reversed EESA's limitations on the ESF, allowing the Treasury Department to invest $10 billion in credit protection in the special purpose vehicle established by the Fed to administer the MMMLF.[8] The U.S. government was once again the de facto deposit insurer to the MMF industry, and the MMMLF ultimately peaked at $51 billion in monthly outstanding loans.

The relevant lessons from these recurring episodes for your current undertaking should be abundantly clear. First, MMFs are permitted to act as investment funds during good times, while being treated as insured banks during times of market distress. This arrangement is rife with issues of regulatory arbitrage, and these repeated bailouts raise significant moral hazard concerns. Second, the reforms instituted after the 2008 crisis were ineffective, at best. At worst, gates and liquidity fees can exacerbate runs by creating financial benefits for first movers. The answer to addressing the legal and economic fictions that have been created and exploited by the MMF industry is not more complexity, risking further unintended consequences. Instead, the next stage of MMF reform should offer MMFs a choice: they should either elect to float their NAV and be treated like any other mutual fund, or they can choose to promise a fixed NAV and be subject to basic banking regulations, especially capital requirements.[9] .

To summarize, if an entity wants to act like a bank, then it should be treated like one and subject to proper regulations; if it wants to be treated like a mutual fund, then it should act like one. We urge the Commission to do the right thing and put the public interest ahead of special interest politics. Thank you for considering our views on this important matter of financial stability.

Sincerely,



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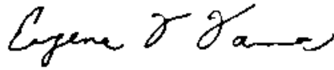
[8] *See* Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116–136, tit. IV, § 4015, 134 Stat. 281 (2020); *see also* Board of Governors of the Fed. Reserve System Report to Congress Pursuant to Section 13(3) of the Federal Reserve Act: Money Market Mutual Fund Liquidity Facility 1-2, Mar. 25, 2020, https://www.federalreserve.gov/publications/files/money-market-mutual-fund-liquidity-facility-3-25-20.pdf.

[9] On the significant social benefits that can be obtained by higher equity requirements (at little if any costs to society) see various materials linked at this website: https://www.gsb.stanford.edu/faculty-research/excessive-leverage. The SEC failed to control properly the excessive leverage and risk of investment banks under its regulatory mandate prior to the 2008-2009 financial crisis, and these investment banks either became insolvent (like Lehman Brothers and Bear Stearns) or converted to Bank Holding Companies and relied on central bank support (like Morgan Stanley and Goldman Sachs). *See*, *e.g.*, ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 177 & 334 n.43 (Princeton U. Press 2013).



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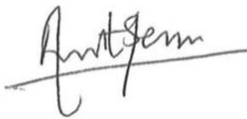

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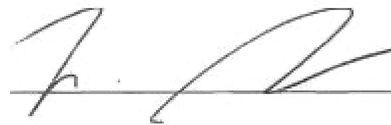

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Cc: The Honorable Hester Peirce
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