



16 August 2021

Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
SWITZERLAND

RE: Policy proposals to enhance money market fund resilience: Consultation Report

Ladies and Gentlemen:

We welcome the opportunity to comment on a recent consultation report (“Consultation Report” or “Report”) published by the Financial Stability Board (“FSB”) regarding policy proposals to enhance money market fund (“MMF”) resilience. The Consultation Report states that the main objective of the policy proposals laid out is to enhance MMF resilience, including with respect to the appropriate structure of the sector and of underlying short-term funding markets. The proposal’s aim is to inform jurisdiction-specific reforms with the goal of enhancing financial stability and minimizing the need for future central bank interventions.

In this letter, we highlight some general observations regarding MMFs and discuss the way these funds and their underlying investments performed during the market events of March 2020. We also examine the potential financial market risks of MMFs – including systemic risk – and address some of the specific policy proposals in the Consultation Report.

Our letter seeks to emphasize the following points:

- 1) **MMFs provide unique benefits as a cash management tool and are uniquely important to commercial paper (“CP”) markets.** MMFs play a positive and important role in the global financial system. Banking regulations have resulted in banks turning away deposits, thus increasing the important role that MMFs play for investors. MMFs account for a large share of the buy-side market for CP, particularly for banks reliant on U.S. Dollar (“USD”) wholesale funding.
- 2) **Contrary to conventional thinking, the data shows that MMFs were quite resilient during March 2020, and the discussions of MMF vulnerabilities should focus on the stress-amplifying effects of the unintended consequences of current regulations.** Retail MMFs and government MMFs did not exhibit any significant vulnerabilities during the market events of March 2020, and survey data shows that many institutional prime MMF investors actually increased their prime MMF holdings

during this time as well. Redemptions by institutional investors from prime MMFs were largely driven due to the “cliff effect” associated with liquidity thresholds that would trigger requirements for fund boards to consider imposing redemption gates.

- 3) **Market events of March 2020 underscore the need for a holistic look at risks associated with private short-term funding markets.** Regulatory reform should be focused on the source of systemic risk – the banking sector – not MMFs. Redemptions from institutional MMFs did not trigger the March 2020 stress experienced in short-term lending markets. While improvements to MMF liquidity regulation can mitigate the modest amplifying effects that prime MMF redemptions can have on market stress, the primary focus of regulators should be the fragile funding sources of banks, particularly non-U.S. “universal” banks.
- 4) **As regulators contemplate future reforms, simple actions that address the root causes of 2020 market issues are preferable.** Removing the SEC regulatory threshold that led to accelerated institutional prime MMF redemptions in favor of discretionary gating would go a long way towards addressing valid concerns about the stress-amplifying role that some MMFs can play. To directly address concerns about systemic risks related to short-term lending market risks, however, regulators should focus on improving banking sector regulations – not the sideshow of MMFs.

We expand on these points below.

1. MMFs provide unique benefits to investors and commercial paper issuers that cannot be replicated by other existing financial products

The FSB asks: “Does the report accurately describe potential MMF substitutes from the perspective of both investors and borrowers? To what extent do these substitutes differ for public debt and non-public debt MMFs? Are there other issues to consider?” (Question 5).¹ This section examines these questions and illustrates why MMFs provide unique benefits to investors and issuers that are not necessarily equally matched by MMF alternatives.

a) Benefits to investors

To begin with, MMFs serve as an important cash management tool for corporate treasurers as well as for individual investors. As such, MMFs provide a high degree of liquidity, diversification, and limited volatility under normal and reasonably stressed market conditions.² To preserve the principal value of cash received, MMFs in the U.S. operate under strict investment rules requiring that MMF portfolios consist of high-quality, diversified assets.³ The dollar-weighted average portfolio must not exceed 60 days,⁴ and funds must also limit holdings of illiquid securities to less

¹ FSB, POLICY PROPOSALS TO ENHANCE MONEY MARKET FUND RESILIENCE: CONSULTATION REPORT 1 (June 2021), <https://www.fsb.org/wp-content/uploads/P300621.pdf> [hereinafter FSB CONSULTATION REPORT]

² IOSCO, MONEY MARKET FUNDS DURING THE MARCH-APRIL EPISODE 4 (Nov. 2020), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD666.pdf>.

³ 17 CFR § 270.2a-7(d)(2)-(3)

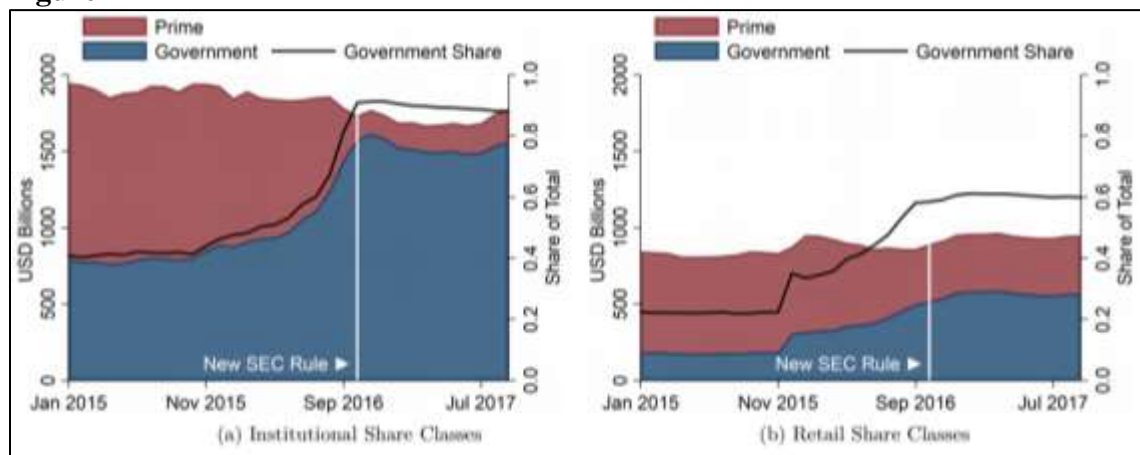
⁴ 17 CFR § 270.2a-7(d)(1).

than five percent of total assets and adhere to strict minimum daily and weekly liquidity requirements,⁵ which are discussed in greater depth below. MMFs in other jurisdictions also have significant maturity and liquidity requirements.⁶

In the U.S., government MMFs (meaning that at least 99.5% of total assets are in cash, government securities, and/or fully collateralized repurchase agreements⁷) and retail MMFs (meaning an MMF “that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons”⁸) may maintain a stable net asset value of \$1.00 per share.⁹ The NAV for non-government, non-retail MMFs – known as “institutional prime MMFs” – was required to float beginning in October 2016 as part of 2014 MMF regulatory changes adopted by the U.S. Securities and Exchange Commission (“SEC”).

The SEC’s policy shift resulted in a massive outflow from institutional prime MMFs into government MMFs, underscoring that the stable NAV of government and retail MMFs is an important and desirable feature of MMFs. A New York Fed working paper analyzing a dataset covering approximately 90% of U.S. MMF industry assets found that, in the months between the SEC’s deciding to require a floating NAV for MMF institutional share classes and the policy’s being implemented, institutional prime share classes shrank to account for just about 10% of total prime MMF assets from approximately 60% in January 2015.¹⁰ As **Figure 1** shows, this effect was significantly less pronounced for retail share classes of prime MMFs, which were allowed to keep a stable NAV and by October 2016 still accounted for approximately 40% of total retail MMF assets.¹¹

Figure 1



⁵ 17 CFR § 270.2a-7(d)(4).

⁶ See FSB CONSULTATION REPORT, *supra* note 1, at 10.

⁷ 17 CFR § 270.2a-7(d) (14).

⁸ 17 CFR § 270.2a-7(d)(21).

⁹ 17 CFR § 270.2a-7(c)(1).

¹⁰ Marco Cipriani & Gabriele La Spada, *Sophisticated and Unsophisticated Runs* (Fed. Reserve Bank of NY Staff Report No. 956, Dec. 2020), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr956.pdf

¹¹ Figure 1 is copied from Cipriani & La Spada, *supra* note 10. The figure is produced using iMoneyNet data, which Cipriani & La Spada report covers approximately 90% of overall MMF total net assets, as reported in SEC Form N-MFP filings.

As the figures above suggest, the stable NAV is a feature of retail and government MMF share classes in the U.S. that investors desire. In fact, a 2011 survey indicated that a shift to a floating NAV would cause 47% of retail MMF investors to stop using or decrease use of MMFs.¹² The stable NAV allows for important tax and accounting efficiencies and also affords retail investors the ability to write checks from MMF accounts.¹³ These benefits offset the lower yields offered by stable NAV MMFs relative to other mutual funds¹⁴ and to the point of the questions posed by the FSB, underscore why other mutual funds or floating NAV MMFs would not be an adequate substitute for the use of stable NAV funds by retail MMF investors.

Bank deposit accounts – another potential alternative to MMFs contemplated in the Consultation Report – are also generally not an adequate substitute for MMFs. Investors benefit from MMF diversification as a pooled investment vehicle, because MMF investments are diversified across different markets, instruments, and debt issuers. As the FSB notes, MMFs “offer investors more diversified credit risk exposures than uninsured bank deposits or direct investment in money market instruments.”¹⁵ Moreover, Basel III’s Liquidity Coverage Ratio has also driven institutions to turn away corporate deposits.¹⁶ Indeed, a Novantas survey of over 30 large commercial banks found that 72% had taken steps in Q3 2020 to actively discourage commercial deposit growth.¹⁷ Some large banks have in fact responded with the approach of moving client funds into MMFs.¹⁸

¹² See Letter from Scott C. Goebel, General Counsel, FMR Co. to Elizabeth M. Murphy, Sec., SEC, at 4 (Feb. 3, 2012), <https://www.sec.gov/comments/4-619/4619-116.pdf>

¹³ See Letter from Eric J. Pan, President & CEO, Inv. Co. Inst., to Vanessa Countryman, Sec., SEC, at 56-57 (Apr. 12, 2021), https://www.ici.org/system/files/private/2021-04/21_itr_mmf.pdf [hereinafter Apr. 2021 ICI Letter]; Hester Peirce & Robert Greene, *Opening the Gate to Money Market Fund Reform*, 34 PACE L. REV. 1093, 1132-1133 (2014), <https://digitalcommons.pace.edu/cgi/viewcontent.cgi?article=1868&context=plr>.

¹⁴ See *id.*

¹⁵ FSB CONSULTATION REPORT, *supra* note 1, at 15

¹⁶ See Louie Woodall, *Too much of a good thing? Banks mull over excess deposits*, RISK.NET (Mar. 10, 2021); Kimberly Long, *Liquidity rule forces corporate deposit rethink*, EUROMONEY (Aug. 13, 2015), <https://www.euromoney.com/article/b12kmk0wv5g6m7/liquidity-rule-forces-corporate-deposit-rethink>. The expiration of pandemic-related temporary removals of Treasuries and deposits from supplementary leverage ratio (“SLR”) calculations is also reportedly driving large commercial banks to turn away deposits. See Harry Terris & Rucha Khole, *US banks move to deflect unwanted deposit inflows*, S&P GLOBAL MARKET INTELLIGENCE (Feb. 22, 2021), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-banks-move-to-deflect-unwanted-deposit-inflows-62722072>. However, the March 2021 expiration of these temporary changes was necessary given economic shifts and in order to eliminate potentially harmful distortions created by the temporary transformation of the SLR into a risk-based capital requirement. See Letter from Stephen Matteo Miller, Sr. Res. Fellow, Mercatus Ctr. at George Mason Univ., to the Fed. Reserve Sys. (Apr. 14, 2020); https://www.mercatus.org/system/files/miller_-_pic_-_temporary_exclusion_of_u.s._treasury_securities_and_deposits_at_federal_reserve_banks_from_the_supplementary_leverage_ratio_-_v1.pdf.

¹⁷ Novantas, *This Month In Commercial Banking – December 2020* (Dec. 16, 2020), <https://www.novantas.com/industry-insight/novantas-viewpoint/2020-dec-this-month-in-commercial-banking/> (citing Novantas Comparative Deposit Analytics data) [hereinafter Novantas 2020 Survey]. Novantas’s Comparative Deposit Analytics entails over 30 contributing banks accounting for \$2.5 trillion in consumer and commercial deposits. See Novantas, *Comparative Deposit Analytics*, <https://www.novantas.com/products/comparative-deposit-analytics/>.

¹⁸ See Novantas 2020 Survey, *supra* note 17; Nina Trentmann & David Benoit, *Banks to Companies: No More Deposits, Please*, WALL ST. J. (June 9, 2021), <https://www.wsj.com/articles/banks-to-companies-no-more-deposits-please-11623238200>.

The FSB Consultation Report contemplates “public debt MMFs” (government MMFs) as a potential substitute for non-public debt MMFs (prime MMFs).¹⁹ Importantly, however, prime MMFs provide benefits to corporate treasurers that cannot be replicated by government MMFs, bank deposits, or direct investments in underlying instruments. For starters, direct investing does not offer the same liquidity that prime MMFs offer.²⁰ Also, prime MMFs offer corporate treasurers a cash management solution invested in a range of high quality financial and non-financial company debt, enabling diversification away from bank deposits (which are uninsured above certain levels) or government MMFs with investments concentrated in government debt.²¹ In addition, when government debt levels are not high enough to allow for government MMFs – which have tight investment restrictions – to reach issuance levels sufficient to meet the demands of MMF investors, prime MMFs fill a necessary role in meeting demand for corporate treasurers seeking to place funds in a safe, diversified cash management tool.²² Policymakers should not assume perpetually high levels of government debt.

b) Benefits to Issuers

Prime MMFs are also significant purchasers of commercial paper – unsecured, short-term debt issued by companies with maturities usually ranging from 1 to 270 days, with the typical maturity being about 30 days. As of early 2021, U.S. MMF investments in U.S. Dollar (“USD”)-denominated commercial paper represented about 20% of total USD-denominated commercial paper outstanding.²³ Notably, however, U.S. MMFs play a much less significant role in CP markets than before the SEC’s 2014 MMF regulatory changes were implemented – as the Consultation Report illustrates, U.S. MMFs in 2010 accounted for roughly 40% CP holdings.²⁴

Conversely, the FSB explains that between 2014 and 2020, European MMFs’ share of Euro-area bank-issued short-term debt holdings has grown from roughly 55% to over 70%.²⁵ This statistic reflects the extent of the reliance of European banks on local currency-denominated short-term debt to fund operations. Overall, short-term debt securities account for over 4 percent of total banking system liabilities across the EU, and over 6 percent and 8 percent in France and Sweden, respectively.²⁶ Short-term debt issued by European banks also accounts for a disproportionately high share of U.S. prime MMFs’ CP holdings, as **Figure 2** illustrates. The Consultation Report

¹⁹ FSB CONSULTATION REPORT, *supra* note 1, at 16.

²⁰ *Id.* at 17

²¹ *See id.* at 15; Laurie White & Daniel Tronstad, *Prime MMFs: Why they are so attractive to cash investors* (Wells Fargo, Investment Perspectives), <https://www.wellsfargoassetmanagement.com/assets/public/pdf/insights/investing/prime-mmfs-why-they-are-attractive-to-cash-investors.pdf>

²² Indeed, during the onset of the coronavirus pandemic, as money market funds received huge inflows from investors seeking safer assets, both prime MMFs and government MMFs experienced growth in assets, but some government MMFs were not able to accept investments during the short time before the U.S. government began issuing new debt. *See* Sam Goldfarb & Paul J. Davies, *Banks Pile Into Treasuries, Helping to Fund Government Borrowing Spree*, WALL ST. J. (Sep. 20, 2020), <https://www.wsj.com/articles/banks-pile-into-treasuries-helping-to-fund-government-borrowing-spree-11600603200>.

²³ FSB CONSULTATION REPORT, *supra* note 1, at 46.

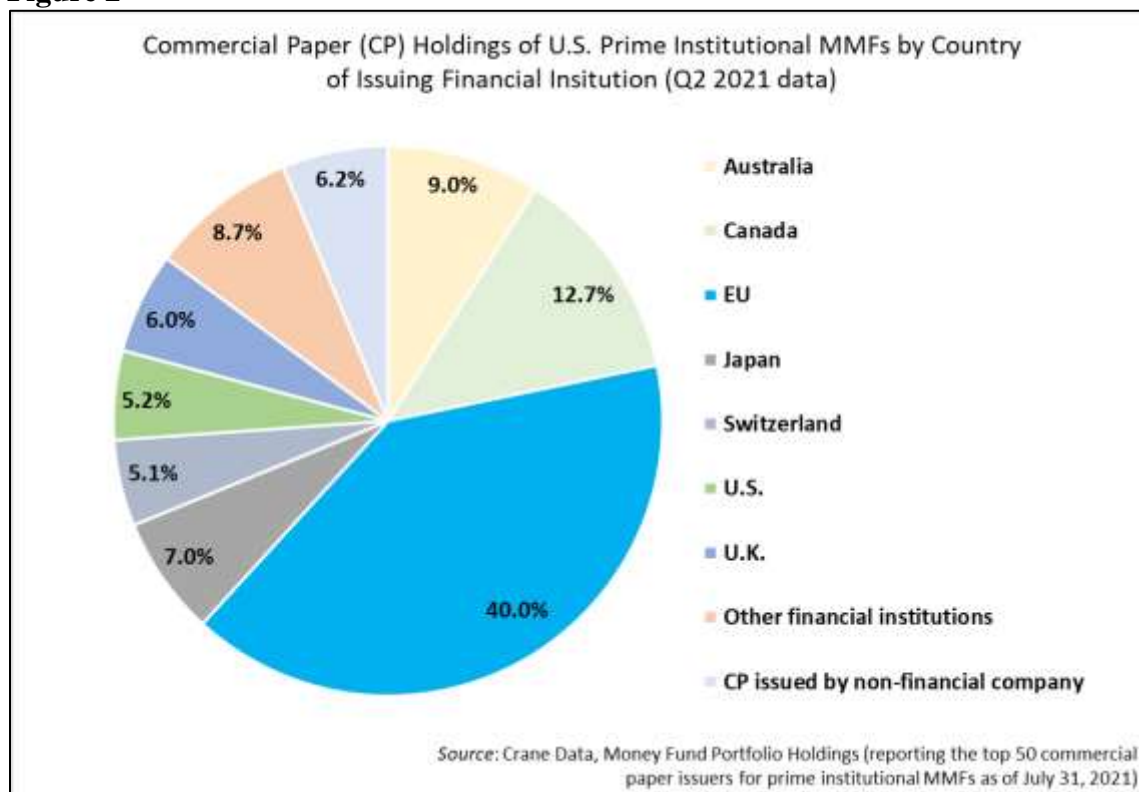
²⁴ *Id.*

²⁵ *Id.*

²⁶ European Banking Authority, *Share of funding sources*, https://tools.eba.europa.eu/interactive-tools/funding-plans/2019/fp19_visualisation_page.html

states that U.S. MMFs “provide wholesale dollar funding for banks headquartered outside the US that do not have access to insured retail dollar deposits,”²⁷ but it does not adequately examine ways to mitigate the risks of disproportionately high reliance by European banks on short-term debt financing.

Figure 2



2. The FSB’s portrayal of MMF vulnerabilities is misguided

The Consultation Report seeks feedback as to whether the Report “appropriately describe[s] the most important MMF vulnerabilities, based on experiences in 2008 and 2020” (Question 6).²⁸ For reasons explained below, it largely does not.

a) Market events of 2020 do not signal a need for further U.S. retail MMF regulatory changes

The Report appropriately notes that large-scale redemptions from certain MMFs in 2008 were triggered by credit events – namely, the bankruptcy of Lehman Brothers and the resulting loss of principal for certain large MMFs, as a result of which the NAV of one stable NAV institutional prime MMF fell below \$1.00 (known as “breaking the buck”).²⁹ It also appropriately distinguishes these events – which entailed a flight to quality – from the market events of 2020. The market

²⁷ FSB CONSULTATION REPORT, *supra* note 1, at 16.

²⁸ *Id.* at 1.

²⁹ *Id.* at 18.

turmoil of March 2020, as the Report explains, was liquidity-driven, stemming from a confluence of factors including pandemic-related uncertainties that created increased demand for cash, resulting in a flight to liquidity.³⁰

Accordingly, it is not appropriate for the FSB to use – as it does in the Report – the market events of March 2020 as a justification to revisit policy responses to the supposed susceptibility of certain MMFs to credit event-driven runs.³¹ Years of policy deliberations resulted in the SEC’s 2010 and 2014 MMF regulatory changes, which were explicitly designed to make MMFs more resilient by reducing, among other things, credit risks.³² Moreover, research shows that during 2020 there was no widespread concern that issuers of short-term debt held by prime MMFs would default as credit risk concerns did not influence MMF investor withdrawals in 2020.³³ Future FSB and U.S. actions regarding MMFs should take note of this finding and focus on potential liquidity-related MMF vulnerabilities.

Rather than focusing on these issues, the Consultation Report includes a description of MMF market dynamics and suggests that stable NAV MMFs are particularly exposed to credit risk.³⁴ As discussed above, in the U.S. context, this category includes all retail prime MMFs. While a stable NAV arguably amplifies the first-mover advantage enjoyed by investors redeeming shares after portfolio losses,³⁵ U.S. MMF regulations adequately control for this risk within retail prime MMFs. Data from both 2014 and 2020 underscore this point.

To begin with, during the month starting September 10, 2008, Federal Reserve economist Patrick McCabe estimates that U.S. institutional prime MMF total assets were depleted by 30% compared to 5% for retail prime MMFs.³⁶ Data published by the SEC underscores the negligible volume of retail prime MMF redemptions relative to institutional prime MMF redemptions in the weeks after the Lehman Brothers bankruptcy.³⁷ More recently, the SEC reports that in the last three weeks of March 2020, publicly offered institutional prime MMFs lost nearly \$99 billion (roughly 21%) of total net assets, while “internal” prime MMFs actually had net inflows of close to \$4 billion (roughly 2%) of total net assets.³⁸ Meanwhile, although prime retail MMFs maintained a stable NAV in the aftermath of the SEC’s 2014 reforms – and were thus, according to some, more

³⁰ *Id.*

³¹ *Id.* at 23-24.

³² See SEC, *SEC Adopts Money Market Fund Reform Rules* (July 23, 2014), <https://www.sec.gov/news/press-release/2014-143> (stating that the 2014 reforms “build upon the reforms adopted by the Commission in March 2010 that were designed to reduce the interest rate, credit and liquidity risks of money market fund portfolios”).

³³ COMMITTEE ON CAPITAL MARKETS REGULATION, *MONEY MARKET FUNDS AND THE 2020 COVID CRISIS* (2021) 11, <https://www.capmksreg.org/wp-content/uploads/2021/05/CCMR-Prime-MMFs-and-COVID-05.24.2021.pdf> (citing research published by Federal Reserve and Bank for International Settlement economists)

³⁴ FSB CONSULTATION REPORT, *supra* note 1, at 23 (stating that “MMFs are exposed to credit risk and even relatively small changes in credit risk may cause investors to abruptly lose confidence in the capacity of MMFs to maintain principal stability” and that “[t]his is particularly the case for stable NAV funds”).

³⁵ See Craig M. Lewis, *Money Market Funds and Regulation*, 8 ANN. REV. FIN. ECON. 25, 26-27 (2016).

³⁶ Patrick E. McCabe, *The Cross Section of Money Market Fund Risks and Financial Crises* 9 (Fed. Reserve Bd., Working Paper No. 2010-51, 2010), <http://www.federalreserve.gov/pubs/feds/2010/201051/201051pap.pdf>.

³⁷ See Lewis, *supra* note 34, at 31 (providing a graphic with daily total net asset values broken down by different types of funds adapted from a 2012 SEC report).

³⁸ Viktoria Baklanova et al., *Prime MMFs at the Onset of the Pandemic: Asset Flows, Liquidity Buffers, and NAVs* 2 (SEC, Public Information, Apr. 15, 2021), <https://www.sec.gov/files/prime-mmfs-at-onset-of-pandemic.pdf>.

susceptible to an early redeemer’s first-mover advantage during the market events of March 2020 – these funds experienced withdrawals of just 11% of total net assets during this time.³⁹

These facts explain why, in response to the FSB’s question (Question 8) as to whether potential changes to MMF regulation that it is considering should apply to all MMFs,⁴⁰ we believe strongly that, apart from minor changes to MMF liquidity regulation, no further regulatory changes should be applied to U.S. stable NAV retail or government prime MMFs. The events of March 2020 – as well as September 2008 for that matter – provide no basis for new regulatory approaches to stable NAV MMFs.⁴¹ Moreover, data from a survey of over 400 institutional investors suggests that March 2020 prime MMF outflows were orderly, with 30% of surveyed investors actually increasing prime MMF holdings from March 13-19.⁴²

b) Further FSB analysis on the impacts of 2020 market events on U.S. institutional MMFs should focus on the crisis-amplifying effects of poorly-designed regulations

The Consultation Report accurately notes that “[r]egulatory thresholds may cause investors to pre-emptively redeem to avoid the consequences of a fund crossing” liquidity thresholds established by regulators that, when breached, enable MMF boards to suspend redemptions.⁴³ This is precisely what took place in March 2020. As a result of 2014 SEC regulations, prime MMFs may impose redemption gates or liquidity fees when weekly liquid assets (“WLA”) fall below 30% of total assets.⁴⁴ This created a “cliff effect,” whereby redemptions accelerated as this threshold was reached. As now-SEC Commissioner Hester Peirce correctly warned in 2014: “a pre-determined trigger invites advance redemptions.”⁴⁵

This warning proved to be accurate, as numerous empirical studies indicate that institutional prime MMF investor withdrawals in March 2020 were motivated by a desire to pull assets out of a fund in advance of the 30% threshold being reached.⁴⁶ Moreover, the Investment Company Institute found that during March 2020, withdrawals from prime institutional MMFs accelerated once the WLA as a share of total assets approached 35%.⁴⁷ A March 2020 report from a large U.S. asset manager appropriately called the 30% WLA threshold an “amber flashing light” for investors, noting that “the fear of the imposition of a liquidity fee or redemption gate essentially

³⁹ *Id.*

⁴⁰ FSB CONSULTATION REPORT, *supra* note 1, at 2.

⁴¹ See COMMITTEE ON CAPITAL MARKETS REGULATION, *supra* note 32, at 5.

⁴² Letter from Tory Hazard, CEO, Institutional Cash Distributors, LLC, to Vanessa Countryman, Sec., SEC, at 1 (Apr. 12, 2021), https://icdportal.com/wp-content/uploads/ICD_MMf_Reform_Comments_04-12-2021.pdf.

⁴³ FSB CONSULTATION REPORT, *supra* note 1, at 2.

⁴⁴ Additionally, funds with WLAs below the 30 percent minimum threshold are prohibited from purchasing assets that are not WLAs, including CP and NCDs with maturities exceeding 7 days.

⁴⁵ Peirce & Greene, *supra* note 13, at 1162.

⁴⁶ See COMMITTEE ON CAPITAL MARKETS REGULATION, *supra* note 32, at 13 (citing Fernando Avalos & Dora Xia, *Investor size, liquidity and prime money market fund stress*, BIS Q. REV. (2021), https://www.bis.org/publ/qtrpdf/r_qt2103b.pdf; Cipriani & La Spada, *supra* note 10); Lei Li et al., *Liquidity Restrictions, Runs, and Central Bank Interventions: Evidence from Money Market Funds* (Working Paper, May. 24, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3607593.

⁴⁷ Apr. 2021 ICI Letter, *supra* note 13, at 11-13.

converted the 30% WLA threshold to a new ‘break the buck’ triggering event for investors.”⁴⁸ Data also indicates that fund sponsors purchased securities from institutional prime MMFs in order to prevent the funds from breaching the 30% WLA threshold.⁴⁹

Thus when the Report asks “[w]hat are the key vulnerabilities that MMF reforms should address” (Question 1), it seems plainly clear that in the U.S. context, the main driver of institutional prime MMF redemptions was created by the SEC in 2014. Addressing this vulnerability should be the focal point for future MMF regulatory changes in the U.S.

3. Market events of March 2020 underscore the need for regulatory reforms aimed at reducing financial stability risks resulting from private short-term debt markets

The Consultation Report asks “[w]hat policy options would be most effective in enhancing the resilience of MMFs . . . and in minimising the need for extraordinary official sector interventions in the future?” (Question 2). Actually, it is important for the FSB and regulators to realize that the two parts of this question are not really interrelated, given that 91% of MMF assets under management in the U.S. were with funds that were quite resilient during the market events of March 2020.⁵⁰ Yet the Report buckets these questions together.

The FSB is rightly concerned by the significant central bank emergency operations launched in March 2020 targeted at improving the stability of CP markets in which some MMFs heavily invest. However, it is important for the FSB and regulators to note that prime MMF redemptions did not trigger these stresses. Measures of illiquidity and stress in short-term debt markets grew precipitously days before prime MMFs experienced any sizable withdrawals.⁵¹ Significant prime MMF redemptions began on Wednesday, March 11. But by the weekend of March 15, the Federal Reserve System had followed the Bank of England, the Bank of Japan, the European Central Bank, and the People’s Bank of China in announcing a comprehensive package of support measures,⁵² and this move was in turn followed by the creation of a Commercial Paper Funding Facility to serve as a liquidity backstop to CP issuers on Tuesday, March 17.⁵³ After this announcement, institutional prime MMF outflows began to shrink.⁵⁴

⁴⁸ See Li Lei et al., *supra* note 46, at 2 (citing Barbara Novick et al., *Lessons from COVID-19: U.S. Short-Term Money Markets* (Jul. 2020), <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-lessons-from-covid-19-us-short-term-money-markets-july-2020.pdf>).

⁴⁹ See COMMITTEE ON CAPITAL MARKETS REGULATION, *supra* note 32, at 13.

⁵⁰ SEC, Div. of Inv. Mgmt. Analytics Off., *Money Market Fund Statistics*, Table 2 (Jul. 13, 2021), <https://www.sec.gov/files/mmf-statistics-2021-06.pdf> (as of June 2021, according to SEC data, institutional public prime MMFs accounted for \$434 billion – 9% of total MMF net assets, which equaled \$5.0255 trillion). Notably, beginning months after the market turmoil of March 2020, retail prime MMFs began to experience noticeable outflows. *Id.* at 7. Yet there is no reason to believe that this is directly attributable to the events of March 2020, and could be due to individual investors steadily drawing down on savings.

⁵¹ INVESTMENT COMPANY INSTITUTE, EXPERIENCES OF US MONEY MARKET FUNDS DURING THE COVID-19 CRISIS 14-15 (Nov. 2020), https://www.ici.org/system/files/attachments/pdf/20_rpt_covid3.pdf.

⁵² See Christopher G. Collins & Joseph Gagnon, *A timeline of central bank responses to the COVID-19 pandemic* (Peterson Institute for International Economics, Realtime Economic Issues Watch, Mar. 30, 2020), <https://www.piie.com/blogs/realtime-economic-issues-watch/timeline-central-bank-responses-covid-19-pandemic>.

⁵³ See Federal Reserve Board, Federal Reserve Board announces establishment of a Commercial Paper Funding Facility (CPFF) to support the flow of credit to households and businesses (Press Release, Mar. 17, 2020), <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200317a.htm>.

⁵⁴ INVESTMENT COMPANY INSTITUTE, *supra* note 51, at 15.

Given the FSB's inquiry regarding how best to reduce the need for official interventions in the future, it is important to consider that the market turmoil that necessitated extraordinary central bank actions primarily stem from the banking sector's high reliance on short-term debt markets to fund operations, not from U.S. MMFs' purchase of bank-issued CP. European banks are particularly reliant on short-term funding, as **Figure 2** illustrated.

Regulators are right to be worried about the reliance of certain highly leveraged global European banks' heavy reliance on short-term funding.⁵⁵ Overhauling U.S. MMF regulation to protect banks from the systemic risks posed by certain bank financing choices, however, clearly puts the cart before the horse. Such an approach is an indirect, inefficient, and inappropriate way to address valid concerns about the systemic risks posed by banks with risky funding structures.⁵⁶ Perhaps the FSB should encourage European banking regulators to look anew at their regulatory schemes to bolster the financing practices and capital positions of their supervised entities.⁵⁷

4. As regulators contemplate future reforms, simpler is better

The Consultation Report asks: "Are the representative policy options appropriate and sufficient to address MMF vulnerabilities?" (Question 9). Because the Consultation Report's assessment of the vulnerabilities in MMFs lacks sufficient detail and fails to acknowledge that U.S. retail and government MMFs exhibited no significant vulnerabilities either during 2008 or 2020 market events, many of its suggested policy options are inappropriate. The FSB also asks: "Does the report appropriately categorise the main mechanisms to enhance MMF resilience? Are there other possible mechanisms to consider? Should these mechanisms apply to all types of MMFs?" (Question 7). The FSB should be surgical and consider only policy options applicable to institutional MMFs that have demonstrated during the market events of 2020 and 2008 issues

⁵⁵ See Hal S Scott, *Dependence of the Financial System on Short-Term Funding* in CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS (2016), <https://covid-19.mitpress.mit.edu/pub/5mma9bnu/release/1> (noting that short-term wholesale funding has "been found to be the best predictor of a bank's contribution to systemic risk").

⁵⁶ Letter from Hester Peirce, Sr. Research Fellow & Robert Greene, Research Assoc., Mercatus Ctr. at George Mason Univ., Money Market Fund Reform; Amendments to Form PF (Sep. 17, 2013), <https://www.mercatus.org/publications/financial-markets/money-market-fund-reform-amendments-form-pf> (stating that: "Attempting to regulate MMFs in order to protect the financial institutions that depend on them for funding is a very indirect way to address concerns about financial firms' penchant for short-term financing").

⁵⁷ The European Central Bank ("ECB") found that by mid-2018, U.S. dollar funding accounted for nearly 16% of funding received by Euro area globally systemically important banks ("G-SIBs), and as much as 29% at certain institutions. Because most Euro area banks do not have a U.S. branch network to collect USD deposits, the ECB finds that over 90% of this USD funding comes is attributable to wholesale funding. ECB, FINANCIAL STABILITY REVIEW, NOVEMBER 2018 -- EURO AREA FINANCIAL INSTITUTIONS 83-4 (2018), <https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr201811.en.pdf>. Also, due to regulatory differences, EU G-SIBs are generally less-well-capitalized than large U.S. G-SIBs. See Sean Campbell, Large Bank Capital and International Competitiveness: U.S. vs. Europe (Banknotes Blog, Fin. Serv. Forum, Sep. 30, 2019), <https://fsforum.com/news/large-bank-capital-and-international-competitiveness>. Indeed, at the end of 2017, the self-reported Basel III leverage ratio of European and Canadian G-SIBs was 4.91%, while across U.S. G-SIBs, the Basel III leverage ratio was 6.74%. Thomas Hoenig, Global Capital Index: Capitalization Ratios for Global Systemically Important Banks (G-SIBs) (Fed. Deposit Insur. Corp., data as of December 31, 2017), <https://www.fdic.gov/about/learn/board/hoenig/capitalizationratio4q17.pdf>.

worth policymakers' attention.⁵⁸ In order to guide the FSB's deliberations regarding how best to address these issues, this section also examines how the Consultation Report inappropriately categorizes several mechanisms it proposes as options to enhance MMF resilience.

a) Several policy options considered by the FSB are operationally unworkable, undermine the attractiveness of MMFs, and would accelerate financial turmoil

Many of the FSB's proposals are operationally unworkable and counterproductive – and thus not appropriate.⁵⁹ The FSB's "minimum balance at risk" ("MBR") policy option, whereby a percentage of an investor's MMF investments would be held back for a period of time to absorb losses during a crisis, was previously considered by U.S. regulators but not adopted. Survey data suggests that the MBR would undermine the usefulness of MMFs and the U.S. Financial Stability Oversight Council found in 2012 that the "operational and technology costs" of the MBR "could be substantial" for MMF shareholders.⁶⁰ Calibrating the MBR delay period would be a precarious task for regulators because a period viewed as too short by market participants would make MMFs *more* vulnerable to runs.⁶¹ Moreover, analyses show that even very high MBR hold back percentages (*e.g.*, 3%) would be insufficient to stop runs,⁶² and discussions with MMF investors actually suggest that "an MBR would increase a shareholder's likelihood of redeeming during a financial crisis."⁶³

The FSB is therefore wrong to assert that the MBR "would . . . reduce the vulnerability of MMFs to runs driven by credit concerns."⁶⁴ Moreover, because the market events of 2020 were driven by liquidity – not credit – concerns, the MBR should be off the table as a reasonable policy option.

It is likewise inappropriate for the FSB to consider a capital buffer. Like the MBR, a capital buffer would do nothing to address the underlying factors that led to accelerated March 2020 institutional prime MMF redemptions – namely, the "cliff effect" imbedded in a 2014 SEC regulation. Indeed, the FSB is right to acknowledge that: a "capital buffer would not mitigate incentives to redeem or inhibit large redemptions that stem from an aggregate increase in the demand for liquidity."⁶⁵

Also, in its 2014 rulemaking process, the SEC thoroughly considered the implications of a capital buffer requirement on mitigating credit concerns, but ultimately rejected the idea largely because

⁵⁸ As a result, the FSB's contemplation of the removal of the stable NAV does not make sense in the U.S. context, because institutional prime MMFs already have a floating NAV.

⁵⁹ This section focuses on the MBR and capital buffers. There are reasons to believe that "swing pricing," another policy option considered by the FSB, would be costly and operationally difficult to implement in the U.S. *See* PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS OVERVIEW OF RECENT EVENTS AND POTENTIAL REFORM OPTIONS FOR MONEY MARKET FUNDS (2020), <https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf>.

⁶⁰ *See* Peirce & Greene, *supra* note 13, at 1149.

⁶¹ Indeed, this drawback is acknowledged by supporters of the MBR. Patrick E. McCabe et al., *The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Funds* 41 (Federal Reserve Bank of New York Staff Report No. 564, July 2012), http://www.newyorkfed.org/research/staff_reports/sr564.pdf.

⁶² *See* Peirce & Greene, *supra* note 13, at 1150.

⁶³ Letter from Paul Schott Stevens, President & CEO, Inv. Co. Inst., to Amias Gerety, Deputy Assistant Sec'y, Fin. Stability Oversight Council 50 (Jan. 24, 2013), available at http://www.ici.org/pdf/13_fsoc_mmf_rec.pdf.

⁶⁴ FSB CONSULTATION REPORT, *supra* note 1, at 31.

⁶⁵ FSB CONSULTATION REPORT, *supra* note 1, at 32.

of the adverse impact it would have on MMFs' viability.⁶⁶ Indeed, the expected compensation required to compensate buffer investors for associated risks will result in a MMF only being able to offer shareholders returns equivalent to government securities.⁶⁷ This in turn could significantly reduce the buy-side market for CP, especially for CP issued by large European banks that rely heavily on wholesale funding.⁶⁸ Therefore, the FSB is wrong to state that: "A capital buffer is likely to improve the stability and resilience of [short-term funding markets] by reducing the vulnerability of MMFs to runs mainly due to credit concerns in stress situations."⁶⁹

From an operational perspective, building a meaningfully sized buffer presents a myriad of challenges and would likely take a very long time.⁷⁰ For similar reasons the FSB's variant option of a "liquidity exchange bank" is inappropriate and politically infeasible, and as the FSB suggests, such an idea faces operational, governance, and legal hurdles that are likely insurmountable.⁷¹

Perhaps most importantly, any purported benefits of a capital buffer also presuppose that it will be appropriately set across the MMF industry. Yet, difficulties in determining the appropriate level for a capital buffer have been well established, both in the context of MMFs and for banks.⁷² While the FSB is right to acknowledge that appropriately calibrating a capital buffer "could present challenges" it fails to take note of the tremendous potential costs to the financial system and economy created by inappropriately calibrated capital buffers.⁷³ The opportunity cost of capital associated with a capital buffer large enough to cover losses like those experienced following the

⁶⁶ SEC, *Money Market Fund Reform; Amendments to Form PF*, 79 Fed. Reg. 47736, 47921-4 (Aug. 14, 2014), <https://www.govinfo.gov/content/pkg/FR-2014-08-14/pdf/2014-17747.pdf>. The SEC concluded that "we continue to believe that a NAV buffer should not be adopted because we feel that a NAV buffer would reduce yields on money market funds and would therefore render such funds to be unattractive to many investors to a greater extent than the reforms we are adopting." *Id.* at 47924.

⁶⁷ See Lewis, *supra* note 34, at 46.

⁶⁸ See SEC, *supra* note 62, at 47924. See also *supra* note 56 and accompanying text (explaining the reliance of large European banks are highly reliant on wholesale funding).

⁶⁹ FSB CONSULTATION REPORT, *supra* note 1, at 32.

⁷⁰ See Peirce & Greene, *supra* note 13, at 1147. The low interest rate environment would make building a meaningfully large buffer particularly challenging. See PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 58, at 31. A smaller buffer designed to absorb day-to-day variations in the market-based value of MMF portfolio holdings likewise presents operational challenges, and would be inappropriate to implement in the U.S. given that our country's stable NAV MMFs did not exhibit any significant issues in 2020, while institutional prime MMFs already have a floating NAV that was introduced to make sophisticated investors aware of such day-to-day variations.

⁷¹ FSB CONSULTATION REPORT, *supra* note 1, at 53. Like a similar idea contemplated in the early 2010s – an industry-wide capital buffer – a liquidity exchange bank would effectively rely upon the possibility of perpetual central bank bailout to be effective at slowing or stopping redemptions. See Peirce & Greene, *supra* note 13, at 1143.

⁷² See SEC, *supra* note 65, at 47921 n.2068 (illustrating that proponents of MMF buffers have significant disagreements regarding the appropriate size of a capital buffer). See also Atul K. Shah, *Why Capital Adequacy Regulation for Banks?*, 4 J. OF FIN. REG. & COMPLIANCE 278, 282 (1996) (explaining how the 8% minimum capital requirement originally set in Basel I was chosen).

⁷³ In 2014, the SEC found that "[t]he most significant indirect cost of a NAV buffer is the opportunity cost associated with maintaining a NAV buffer" because "[t]hose contributing to the buffer essentially deploy valuable scarce resources to maintain a NAV buffer rather than being able to use the funds elsewhere." The SEC continued: "The cost of diverting funds for this purpose represents a significant incremental cost of doing business for those providing the buffer funding." SEC, *supra* note 62, at 47923.

Lehman Brothers bankruptcy would be enormous.⁷⁴ In fact, inappropriately set capital buffers could even accelerate financial crises.⁷⁵

b) Regulators should address liquidity strains in underlying markets directly and through targeted enhancements to prime institutional MMF regulation

The Consultation Report asks: “How can the use of MMFs by investors for cash management purposes be reconciled with liquidity strains in underlying markets during times of stress?” (Question 3). Although redemptions from some MMFs modestly contributed to March 2020 market stresses in underlying CP markets, there is no need to sacrifice the many unique benefits of MMFs described above for the purposes of implementing MMF regulatory changes that will indirectly and inadequately address the unintended consequences of an easily correctable aspect of 2014 SEC regulations.

To prevent MMF regulation from amplifying the short-term funding market liquidity strains during times of stress, policymakers should remove the tie between MMF liquidity regulations and thresholds for fees and gates. As explained above, market events indicate that the SEC’s use of a 30% WLA threshold to allow for gating accelerated MMF redemptions. Instead, a MMF board should be free – subject to its determinations that gating or implementing a fee is in the fund’s best interest and is necessary for the equitable treatment of fund shareholders – to impose liquidity fee or a gate at its discretion. Such flexibility would avoid the risks created by FSB policy options that involve triggering-event thresholds, such as the MBR and capital buffers.

The Consultation Report asks: “What policy options would be most effective in enhancing the resilience of MMFs, both within individual jurisdictions and globally, and in minimising the need for extraordinary official sector interventions in the future?” (Question 2). Given the facts set forth above, in the U.S. context, the clear answer is the FSB’s contemplated policy option to remove ties between regulatory thresholds and the imposition of fees and gates. Discretionary gating in particular would be a natural extension of existing U.S. MMF board responsibilities and aligns with the fiduciary obligations of the fund’s directors to fund investors.⁷⁶ It is by far the most effective of the FSB’s currently contemplated policy options at improving the resiliency of MMFs, removing any incentive for runs, protecting shareholders, and preventing financial contagion.⁷⁷

In addition to removing the 30% WLA threshold for gating and liquidity fees, two of the FSB’s other contemplated policy options – tightening of limits on prime MMF assets and additional liquidity requirements – could, if tailored appropriately, improve the resiliency of U.S. MMFs and reduce the likelihood that MMF redemptions contribute to meaningful liquidity strains in the underlying markets in which they invest. These efforts, however, should not be focused on the types of MMFs that proved most immune to the market stresses of 2020 – government and retail

⁷⁴ In 2013, the Investment Company Institute estimated that a risk-based 3% capital buffer would cost prime MMFs approximately \$37.3 billion and take over six years to build. Letter from Paul Schott Stevens, President & CEO, Inv. Co. Inst., to Amias Gerety, Deputy Assistant Sec’y, Fin. Stability Oversight Council, *supra* note 53, at 77.

⁷⁵ See *id.* at 44 & 44 n.17 (suggesting that large-scale redemptions from a MMF sparked by a capital buffer nearing depletion could spark industry-wide contagion).

⁷⁶ See Peirce & Greene, *supra* note 13, at 1157 & 1167.

⁷⁷ See *id.*, at 1157-9.

MMFs – and be limited in scope so as to not dramatically undermine the utility of these important financial products.

The Report asks whether it “accurately describe[s] the problems in the structure and functioning of [short-term funding markets]” (Question 16).⁷⁸ In the Report, the FSB observes that “MMF reforms by themselves will not likely solve the structural fragilities in [short-term funding markets].”⁷⁹ The FSB should be clear, however, that this is because, in order to effectively target risks posed by certain banking groups’ high reliance on short-term debt and financial system risks created by this dynamic, regulators must utilize direct policy tools. Further regulatory changes to MMFs will only indirectly – and thus inadequately – address these issues. Additionally, it is inaccurate for the FSB to suggest that MMFs suffer from sector-wide vulnerabilities given that, as explained above, retail and government MMFs did not exhibit any significant vulnerabilities during recent market events, and therefore believe it is highly inappropriate for FSB to consider MMF stress tests, as it does in the Report.

In short, any MMF reform will address symptoms, not causes, of financial stability risks brought about by existing short-term funding market structures. The Consultation Report asks: “What other measures should be considered to enhance the overall resilience of [short-term funding markets]?” (Question 17).⁸⁰ The FSB should examine meaningful changes to bank regulation that could improve the resilience of short-term funding markets and reduce systemic risk. To begin with, the FSB should examine reforms to bank capital regulation that adequately control for the risks created by large banking groups’ high reliance on short-term debt as a funding source. Regulators should also revisit the LCR, which is likely forcing institutional investors to place funds in MMFs even though institutional MMFs may not be the most appropriate cash management tool.

Conclusion

The Consultation Report hinges on the predicate that significant structural MMF vulnerabilities exist, and that the March 2020 market turmoil highlighted these vulnerabilities. Against this backdrop, the FSB sets forth several policy proposals. The problem, however, is that the Report presents an inaccurate understanding of the March 2020 market events. Because it incorrectly frames problems facing MMFs, the Consultation Report proposes several potentially destabilizing policy options such as MBR and capital buffers for MMFs. Moreover, despite conceding that the market turmoil of March 2020 was a liquidity-driven phenomenon, the FSB contemplates a number of policy options that it acknowledges are aimed at controlling credit risk issues, which the SEC’s 2010-2014 regulatory changes already effectively addressed.

In order to get further MMF regulatory changes right, it is important to focus on what went wrong in March 2020 – namely, the unintended consequences of one aspect of SEC regulation created a “cliff effect” that accelerated redemptions from certain prime institutional MMFs, exacerbating already-growing liquidity stresses in short-term funding markets. Removing the gating/fee threshold that was the source of these problems is a simple solution that would go a long way towards preserving the use of MMFs by investors for cash management purposes while mitigating

⁷⁸ FSB CONSULTATION REPORT, *supra* note 1, at 3.

⁷⁹ *Id.* at 40.

⁸⁰ *Id.* at 3.

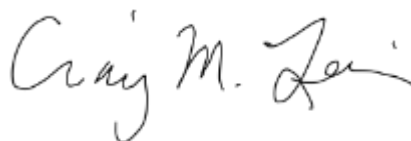
Letter from Paul S. Atkins & Craig M. Lewis to the FSB
16 August 2021

liquidity strains in underlying short-term funding markets brought about by voluminous institutional prime MMF redemptions during times of market turmoil. MMF boards in the U.S. are well-suited to implement discretionary gating, which can preserve equity and stop runs.

Respectfully submitted,



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