U.S. Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C.
20549-1090

April 15, 2022

Re: Release No. IC–34441; File No. S7–22–21

Dear Members of the Commission:

We write in support of the proposed amendments to the Commission's rules governing money market mutual funds. We believe that the Commission's plan to increase the daily and weekly minimum liquid asset requirements to 25% and 50% respectively and to require institutional prime and institutional tax-exempt money market funds to implement swing pricing policies and procedures will enhance resilience, shift the liquidity costs of redemptions to redeeming investors (where they belong), and reduce the likelihood of damaging financial panics. We also believe that the Commission should remove the liquidity fee and redemption gate rules that it promulgated in 2014, as we saw in 2020 that the gates and fees exacerbated rather than mitigated run risk.

We expect that aspects of the new proposed framework, especially swing pricing, will be difficult to implement, and that even if the framework is fully and effectively implemented, the risk of future destabilizing runs may not be eliminated. Given the significant externalities associated with these runs, we believe that the Commission should also enhance its stress testing procedures and, if the above measures prove unsuccessful, consider imposing capital requirements. While prime money fund sponsors may protest the cost of these measures, including swing pricing, it is not the task of the Commission to ensure that operating prime money funds is a profitable business. Rather, it is the Commission's responsibility to protect investors and ensure that mutual fund sponsors internalize the costs associated with their activities. As the Commission is well aware, there is a robust market for government money funds organized pursuant to 17 C.F.R. § 270.2a-7(a)(14)—with over $4 trillion outstanding as of December 31, 2021. These money funds offer investors a safe and efficient way to use the investment company structure for cash management and related purposes. If, after implementing reforms to address as efficiently as possible the costs imposed by prime money funds on investors and other market participants, it turns out that safe prime money funds are not economical, then it would be appropriate for these funds to cease operations.

I. Prime Money Funds Externalize Costs

Prime money market funds—those that do not invest 99.5 percent or more of their total assets in cash, government securities, or fully collateralized repurchase agreements—have a dual character. Formally, they are investment companies, registered with the Commission under the

Investment Company Act and subject to regulation by the Commission under 17 C.F.R. § 270.2a-7. Functionally, they are banks, albeit ones with a narrow business model and highly liquid, short duration, high quality assets.[1] Like banks, money funds issue claims that are used as money or close substitutes for money. Their shares function this way due to their redemption practices and asset portfolios—and until 2014, the fact that they offered investors a stable net asset value.[2]

Unfortunately, to the extent that investors treat money fund shares as alternative forms of money, they expect something that funds cannot deliver, namely, par convertibility through the business cycle. As with other forms of "private money," money market fund shares are money-like during good times, but when economic and financial conditions deteriorate, they break par with government-issued cash in the absence of official sector support. Accordingly, as the possibility of non-par convertibility approaches, institutional investors in money fund shares tend to run for the exits, regardless of whether a fund's underlying assets are likely to meaningfully depreciate in value. The result is harm to the fund's non-redeeming investors, fire sales, contagion, credit market disruptions, and sharp contractions in economic activity.[3] These sorts of dynamics, when spread widely enough across the monetary system, trigger acute macroeconomic disasters. For example, these sorts of runs led to the Great Depression.[4] The Great Recession of 2008 was "great" for a similar reason,[5] with runs on a wide range of alternative forms of money, and its costs were substantial.[6]

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[1] The functional similarity between prime money funds and banking has been long recognized. See, e.g., Testimony of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, Federal Reserve Membership, Hearings Before the Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess., at 24-26 (Sept. 26, 1979); John A. Adams, *Money Market Mutual Funds: Has Glass-Steagall Been Cracked?*, 99 BANKING L.J. 4 (1982); Jonathan R. Macey & Geoffrey P. Miller, *Nondeposit Deposits and the Future of Bank Regulation*, 91 MICH. L. REV. 237, 256–60 (1992). It is arguably a consensus position today among independent experts. See, e.g., Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY 261, 269–70, 284–85 (2010); Board of Governors of the Federal Reserve System, *Money and Payments: The U.S. Dollar in the Age of Digital Transformation* 27 (2022) ("the global financial crisis in 2008 was in large part a crisis of nonbank money, and nonbank money contributed to financial strains again at the onset of the COVID-19 pandemic").

[2] One formal difference between a bank deposit and a money fund share is that the former is debt and the latter is equity. But there is no reason why an alternative form of money has to be structured as a debt instrument. The essential feature of alternative forms of money is convertibility at or very close to par, which can be achieved by debt or equity backing.

[3] For an overview, see MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION 102–42 (2016).

[4] *See, e.g.*, Ben S. Bernanke, *Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257 (1983).

[5] Ben S. Bernanke, *The Real Effects of the Financial Crisis*, Brookings Papers on Economic Activity (Sept. 13-14, 2018) (concluding that the unusual severity of the Great Recession was due primarily to the panic in money markets, which disrupted the supply of credit).

[6] Tyler Atkinson et al., *How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis*, 20 FED. RES. BANK OF DALLAS STAFF PAPERS 1, 2 (2013) (estimating the cost at $6 to $14 trillion); Andrew Haldane, *The $100 Billion Question*, Remarks at the Institute of Regulation and Risk Conference, Hong

Regulators' failure to address the gap between what investors expect from money funds and what money funds are able to deliver—and, in the past, their active efforts to facilitate this arbitrage—led to a ballooning money market fund sector in the 2000s, which culminated in runs on money funds in 2008 and a massive $4 trillion government guarantee. Subsequently, the Commission attempted to close the gap. Its 2010 rules imposed liquidity requirements, reducing the maximum weighted average maturity of fund holdings. Its 2014 rules adopted a floating net asset value and authorized liquidity fees and redemption gates, prompting many investors seeking deposit-like forms of cash to shift away from prime money funds. Accordingly, assets in prime funds fell from over $1.5 trillion to around $500 billion.[7] But as the Commission acknowledges, the 2014 rule change did not entirely solve the problem. The remaining prime money funds were once again a source of financial instability in March 2020. And official sector intervention, including $50 billion of direct support from the Federal Reserve, was once again required to prevent money funds from harming the wider economy.[8]

II. The Proposed Rules Would Internalize Costs Imposed by Money Funds

The Commission's proposal marks an important step toward ensuring that money fund sponsors and investors internalize the costs of their products. Two aspects of the noticed amendments bear emphasis.

A. Increasing Liquidity Requirements

First, the Commission's plan to increase portfolio liquidity requirements will meaningfully enhance the ability of funds to manage significant and rapid investor redemptions making such redemptions less harmful to non-redeeming investors and less likely in the first place. As we saw in March 2020, the current requirements—daily liquid assets of 10% and weekly liquid assets of 25%—are still too low. While policy makers cannot calculate the appropriate level with precision ex ante—because the level is a function of unquantifiable metrics such as market perceptions, historical experience, the prospects and expected severity of financial and economic disruption, as well as the other measures in place to force plan sponsors and redeeming investors to bear the full costs of redemption[9]—the volume of redeeming investors in March 2020 suggests that the proposed levels (daily liquid assets of 25% and weekly liquid assets of 50%) are, if anything, too low.[10] Yet further increases may be warranted if prime money funds exhibit run dynamics during periods of economic uncertainty in the future.

Kong (Mar. 30, 2010) (suggesting that the cost of the 2008 crisis may have been between $60 trillion and $200 trillion for the global economy as a whole, with 1-5 times annual GDP lost in the US alone).

[7] 86 F.R. 8942 (Feb. 10, 2021) (Chart 1).

[8] Jeanna Smialek, *Money Market Funds Melted in Pandemic Panic. Now They're Under Scrutiny*, N.Y. TIMES (Apr. 27, 2021).

[9] For a theoretical explanation for why conventional cost benefit analysis is unable to effectively aid policy making in circumstances like these and can, in fact, lead to serious policy errors, see Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. OF LEG. STUD. 351 (2014).

[10] For example, in March 2020 the largest daily outflow was around 26% and the largest weekly outflow was around 55%. But this period also featured an official sector intervention of unprecedented scale. *See*

B. Replacing Gates and Fees with Swing Pricing

The Commission's proposal to replace gates and fees with swing pricing is a second important and salutary adjustment to the regulatory framework. The Commission's adoption of a floating net asset value—aligning the regulatory treatment of money funds with the regulatory treatment of all other investment companies—was a meaningful step toward eliminating the externalities associated with prime money funds. However, due to the costs of redemption and the investors' ability under the existing rules to avoid liquidity fees by redeeming prior to a fund's decision to impose such fees, the current regulatory framework does not fully ensure that every redeeming investor receives value that actually represents the investor's pro rata economic interest in the fund's assets.[11] In other words, even with floating NAV, early redeemers are still able to shift costs to non-redeemers. Swing pricing offers enhanced floating NAV or floating NAV+.

Swing pricing is complex and will be challenging to administer. But this complexity reflects the complexity of the underlying problem associated with the prime money fund business model. Among other things, even with swing pricing, early redeemers may get a better price which will create incentives for money fund investors to get out quickly.[12] It is possible, although we think unlikely, that correcting for the externalities imposed by prime money funds on other investors and the broader economy will be so costly as to make prime money funds uneconomical to operate. Under the law, that would not be a reason to shy away from appropriate regulation. The Commission is obligated to carry out the goals of the statutory scheme as efficiently and effectively as it can and let market participants determine how to organize their investment companies and invest their portfolios in light of the appropriate regulatory framework.

It is worth noting that it could exacerbate threats posed by money funds to U.S. financial stability were the Commission to remove gates and fees without replacing them with swing pricing or some similar scheme. While, gates and fees exacerbate run dynamics ex post, they potentially reduce the likelihood that investors seeking instruments that behave like bank deposits or cash will select prime funds ex ante.

III. Further Reforms Merit the Commission's Consideration

Given the high costs to investors and other market participants of runs on prime money funds, the Commission should also enhance stress tests and, if the above measures prove unsuccessful, consider imposing capital requirements.

A. Enhancing Stress Tests

Stephen G. Cecchetti & Kermit L. Schoenholtz, SEC Money Market Fund Reform Proposals Fall Far Short, Again, Money & Banking (Jan. 28, 2022). Moreover, as of year-end 2021 daily liquid asset levels for prime institutional funds averaged 53%, more than twice the new proposed minimum. SEC Division of Investment Management, Money Market Fund Statistics (Jan. 14, 2022).

[11] Jeffrey N. Gordon & Christopher M. Gandia, *Money Market Funds Run Risk: Will Floating Net Asset Value Fix the Problem?*, 2014(2) COLUMBIA BUS. L. REV. 314 (2014).

[12] These dynamics underline the importance of increasing liquidity requirements or imposing capital requirements, which are easier to administer.

The Commission should also consider further strengthening money fund stress tests, which the Commission imposed in 2010 and strengthened in 2014.[13] The existing regime does not conform to best practices for stress testing. Among other things, neither the funds nor the Commission disclose to investors the scenarios or the results. Accordingly, the market lacks the tools to determine whether the tests are appropriately calibrated, reducing the usefulness of the exercise with no apparent benefit.

B. Exploring Capital Requirements

If the above measures prove unsuccessful, the Commission should consider imposing capital requirements. As the Council,[14] and leading independent experts, have noted, capital could help absorb losses in a crisis period.[15] While most prime money funds are invested in highly liquid and short-dated assets and therefore do not need the level of capital maintained by commercial banks,[16] some minimum capital level may be justified to the extent other reforms, such as the ones currently under consideration, fail to achieve their goals.

IV. Conclusion

In sum, we commend the Commission for pursuing these important amendments to the regulatory framework governing money market funds. Recent events demonstrate that ex post liquidity fees and gates are inadequate to prevent dangerous runs. Enhanced ex ante liquidity requirements and swing pricing are needed to reduce the externalities associated with prime funds. Enhanced stress testing should also be considered, along with, if necessary, capital requirements. Of necessity, these measures will increase costs for funds and lower returns for their investors during normal times. These costs, however, are not a reason for the Commission to dial back its amendments. To the contrary, given the comparatively larger costs of monetary instability, reforms are needed even if they reduce the viability of unstable investment company business models.

Respectfully submitted,

Simon Johnson and Erkki Liikanen
on behalf of the Systemic Risk Council

[13] *See* Rule 2a-7(j).

[14] The Systemic Risk Council, No. S7-01-21, Release No. IC-34188 (Apr. 12, 2021), at 6–7 ("funds . . . 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").

[15] *See, e.g.*, Martin N. Baily; John Y. Campbell; John H. Cochrane; Douglas W. Diamond; Darrell Duffie; Kenneth R. French; Anil K. Kashyap; Frederic S. Mishkin; David S. Scharfstein; Robert J. Shiller; Matthew J. Slaughter; René M. Stulz, Money Market Fund Reform, Number S7-03-13 (September 17, 2013); Stephen G. Cecchetti & Kermit L. Schoenholtz, SEC Money Market Fund Reform Proposals Fall Far Short, Again, Money & Banking (Jan. 28, 2022).

[16] Samuel G Hanson, David S Scharfstein & Adi Sunderam, *An Evaluation of Money Market Fund Reform Proposals*, 63 IMF ECON. REV. 984-1023 (2015) (concluding that a capital requirement of four percent or less would be appropriate for prime institutional funds and would lower returns to ordinary shareholders by just five basis points).

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