April 12, 2021

Via Electronic Mail (rule-comments@sec.gov)

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report, File No. S7-01-21

Dear Ms. Countryman:

The Americans for Financial Reform (AFR) Education Fund appreciates the opportunity to submit this comment in response to the Commission's Request for Comments on the recommendations of the President's Working Group on Financial Markets, "Overview of Recent Events and Potential Reform Options for Money Market Funds" (the "Request"). Members of the AFR Education Fund coalition include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

The context for the Commission's Request is the events of March 2020 in which credit markets came under severe stress and were eventually bailed out through large-scale public backstop programs created by the Federal Reserve. The Commission previously provided a good analysis of the March 2020 events in its October 2020 report entitled "US Credit Markets: Interconnectedness and the Effect of the Covid-19 Shock".[2] That report lays out stresses across a wide range of credit markets, including short-term funding markets, long-term corporate bond markets, and mortgage markets, all of which ended up receiving government support.

The March 2020 event most relevant to money market fund reform was the breakdown in $10 trillion in short-term funding markets, in which money market funds play a large role. As the Commission's October 2020 report describes, there were other causes of the stress in short-term funding markets beyond money market funds, including the unwinding of leveraged trades by hedge funds, particularly in the U.S. Treasury and MBS markets, stresses in repo financing and other securities lending markets, and pro-cyclical increases in margin demands at derivatives CCPs. We believe all of these require attention from the Commission and more broadly the FSOC and other financial regulators.

[1] A list of coalition members is available at: https://ourfinancialsecurity.org/about/coalition-members/
[2] Securities and Exchange Commission, "U.S. Credit Markets: Interconnectedness and the Effect of the Covid-19 Shock", October, 2020, available at https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf

However, the need for more effective money market fund regulation, as highlighted in the recommendations of the President's Working Group, is particularly glaring. This is the second major systemic event related to runs on money market funds in the past 12 years, and the second time in 12 years that the Federal government has felt it necessary to provide a large-scale bailout to the money market fund sector to stop a run. As the President's Working Group report states:

> "Prime and tax-exempt MMFs have been supported by official sector intervention twice over the past twelve years…. Because prime and tax-exempt MMFs again have shown structural vulnerabilities that can create or transmit stress in short-term funding markets, it is incumbent upon financial regulators to examine the events of March 2020 closely, and in particular the role, operation, and regulatory framework for these MMFs, with a view toward potential improvements. In addition, absent regulatory reform or other action that alters market expectations, these prior official sector interventions may have the consequence of solidifying the perception among investors, fund sponsors, and other market participants that similar support will be provided in future periods of stress."

We strongly agree with this assessment that additional regulatory reform is needed to fix the structural vulnerabilities of money market funds and end the perception that this sector is receiving an unpriced government guarantee from the taxpayer.

The structural issues in money market funds are related to the perception that they are effectively act as fully liquid bank deposits which can be redeemed on demand for their full quoted value rather than investment products which may suffer losses, especially as assets are sold for redemption. As discussed further below, many mutual fund structures to some degree have vulnerabilities related to the combination of short-term liquidity guarantees for investors combined with investment in less liquid assets which must be sold to finance redemptions. However, money market funds are particularly vulnerable due to the expectation that they are fully liquid holdings that are effectively money good in a manner similar to bank deposits, despite the fact that they are not regulated as such.

In 2010 and 2014 regulatory reforms were made that created tighter controls on assets that could be held by money market funds, permitted money market funds to impose gates and fees on redemptions under certain circumstances, and required prime institutional money market funds to float their net asset value (NAV).[3] Yet despite these changes, in March 2020 prime institutional money market funds experienced an outflow of 30 percent of their assets in just two weeks, and it is likely that subsector would have collapsed without government support. This underlines the structural weakness of the money market fund arrangement, especially where sophisticated institutional investors are involved who respond quickly to market signals.

Given the experience of March 2020, it seems clear that the 2010 and 2014 reforms did not adequately address core financial stability issues with money market funds. These core structural issues include the incentive for rapid withdrawal which is created by the fact that those who withdraw early can avoid costs

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[3] "SEC Approves Money Market Fund Reforms to Better Protect Investors", Press Release, January 27, 2010, available at https://www.sec.gov/news/press/2010/2010-14.htm, "SEC Adopts Money Market Reform Rules", Press Release, July 23, 2014, available at https://www.sec.gov/news/press-release/2014-143

that their run imposes on investors who do not withdraw until the fund has lost many of its assets. In some cases, such as the option to impose gates or fees on redemptions, some of the 2014 reforms may even have contributed to the instability of the market by creating incentives to withdraw assets before limits on redemptions were put in place.

In our view, it is time for regulators to address the instability of the money market fund financing model more directly and go beyond the changes made in 2010 and 2014. There are a range of options in the President's Working Group report laying out how this could be done:

- Several proposed mechanisms make incremental changes to the 2010 and 2014 reforms, for example by expanding NAV requirements to retail prime and other types of funds, changing conditions for gates and fees to make them less likely to contribute to runs, or changes in permissible asset investments or liquidity management rules.

- Several proposed mechanisms seek to backstop losses through requirements such as a requirement for a loss-absorbing capital buffer for money market funds, a private Liquidity Exchange Bank that would apparently seek to provide a private version of the kind of Federal government insurance provided to bank deposits, or a requirement for sponsor support.

- Other proposed mechanisms such as a "minimum balance at risk" requirement or swing pricing would directly address investor incentives to run by ensuring that all investors who redeem funds are at risk for any losses created by a run on money market funds. This would internalize the externalities created by investors who redeem their shares early and reduce or eliminate their incentive for early redemptions.

Some of these mechanisms could usefully be combined. However, we believe that any set of reforms should include steps such as minimum balance at risk or swing pricing which directly address investor incentives for rapid redemptions (a "run") from money market funds. We believe that without including such strong measures other reforms are likely to be inadequate to prevent a run on money market funds, especially prime funds.

The 2008 and 2020 experiences provide evidence that reforms which do not fundamentally re-align incentives for early redemption from money market funds will not adequately address run risk. For example, an incremental change to the 2014 reforms such as expanding the scope of the floating NAV requirement seems unlikely to stem a future run given that the institutional prime funds which were already required to float their NAV were at the heart of the March 2020 run. Since the 2014 gates and fees options were not present at all in the 2008 run on money market funds, it also seems unlikely that reforming these options would be adequate to prevent future runs.

Similar issues exist with loss absorbency requirements. Given the very large withdrawals observed in March 2020 (e.g. 30 percent of institutional prime assets redeemed in two weeks) and in September 2008 (24 percent of prime fund assets withdrawn), a capital buffer requirement alone seems unlikely to provide sufficient loss absorbency to address a run. It also seems unlikely that a private insurance scheme could adequately backstop the sector.

In contrast, reforms such as minimum balance at risk requirements seem to be the most direct way to address incentives to run, since they align incentives so that investors who may wish to redeem shares early experience the full cost of their actions. The details of such arrangements can be administratively complex, and regulators should seek to design arrangements that are as simple and transparent as possible and are calibrated to provide reasonable incentives to avoid a run without excessive penalties to early redeeming investors. Combining a reform such as a minimum balance at risk with other mechanisms such as a moderate capital buffer requirement could multiply the effectiveness of both reforms and give more flexibility in the technical details of each. We would refer to the Commission to the excellent discussion of this approach by economists at the Federal Reserve Bank of New York, which contains a good discussion of the ways in which a small capital charge would usefully complement a minimum balance at risk requirement.[4] In the case of swing pricing, expanding the floating NAV requirement could make a swing pricing requirement easier to implement and more consistent and transparent.

Although not in the scope of the current Request, such incentive-changing reforms also hold promise beyond the narrowly defined money market mutual fund space. Requirements like minimum balance at risk or swing pricing could also be used to address the potential instability of other short-term cash management vehicles which perform liquidity transformation but are not technically money market funds, as well as longer-term bond mutual funds or exchange traded (ETF) funds that also promise rapid redemption of illiquid bonds. While the Commission report on the March 2020 disruptions expresses the opinion that redemptions from long-term bond funds were not a major source of financial instability, it also notes that bond ETFs saw a sharp divergence between asset values and market prices, and that there were $255 billion in net outflows from conventional corporate bond funds over the month of March.[5] One may disagree with the characterization in the report that this outflow is “small” compared to the $1 trillion in total bond market trading during March. We also do not know if these initial signs of instability could have grown into a more serious disruption if the Federal Reserve had not taken the unprecedented step of signaling it would backstop the corporate bond market more generally. Other researchers have drawn conclusions that differ from those of the Commission and found selling pressure on bond funds did contribute significantly to the March 2020 financial instability.[6]

In a recent speech, Federal Reserve Governor Brainard highlighted the potential advantages of incentive-changing reforms such as minimum balance at risk or swing pricing requirements across a range of different types of vehicles[7]:

> “To be sure, domestic money market funds are not the only vulnerable cash-management investment vehicles active in U.S. short-term funding markets. For example, offshore prime

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[4] McCabe, Patrick et. al, “The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds”, Brookings Institution, July, 2016, available at https://www.brookings.edu/wp-content/uploads/2016/07/2013a_mccabe.pdf

[5] See page 38 of October 2020 Commission report

[6] Ma, Yiming and Xiao, Kairong and Zeng, Yao, Mutual Fund Liquidity Transformation and Reverse Flight to Liquidity (July 29, 2020). Jacobs Levy Equity Management Center for Quantitative Financial Research Paper, 2020, Available at SSRN: https://ssrn.com/abstract=3640861 or http://dx.doi.org/10.2139/ssrn.3640861

[7] Brainard, Lael, “Some Preliminary Financial Stability Lessons from the Covid-19 Shock”, March 1, 2021, available at https://www.federalreserve.gov/newsevents/speech/files/brainard20210301a.pdf

> money funds, ultrashort bond funds, and other short-term investment funds also experienced stress and heavy redemptions last March….The COVID shock also highlighted the structural vulnerabilities associated with the funding risk of other investment vehicles that offer daily liquidity while investing in less-liquid assets, such as corporate bonds, bank loans, and municipal debt. Open-end funds held about one-sixth of all outstanding U.S. corporate bonds prior to the crisis. Bond mutual funds, including those specializing in corporate and municipal bonds, had an unprecedented $250 billion in outflows last March, far larger than their outflows at any time during the 2007–09 financial crisis. The associated forced sales of fund assets contributed to a sharp deterioration in fixed-income market liquidity that necessitated additional emergency interventions by the Federal Reserve."

We would urge the Commission to work through the Financial Stability Oversight Council with other regulators such as Governor Brainard to determine the full range of regulatory reforms that could be useful in ensuring that SEC-regulated funds do not contribute excessively to financial instability.

In sum, we believe that recent experience shows that the Commission should follow up on the recommendations of the President's Working Group by instituting new reforms to money market funds that go well beyond the 2010 and 2014 changes. Any such package of reforms should include steps that directly address the fundamental incentives for run risk in this sector by incorporating minimum balance at risk or swing pricing requirements. The Commission should also consider whether such reforms should be extended to other types of funds where they might be beneficial for financial stability. We would be happy to discuss the details of such changes with Commission staff.

Thank you very much for your time and attention. If you have questions, please contact Marcus Stanley, the Policy Director of the AFR Education Fund, at marcus@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform Education Fund