

**Response to the Financial Stability Board’s Consultation Report:
Policy Proposals to Enhance Money Market Fund Resilience**

August 16, 2021

CFA Institute¹ is writing in response to the above-mentioned FSB Consultation Report.² CFA Institute speaks on behalf of its members and advocates for investor protection and market integrity before standard setters, regulatory authorities, and legislative bodies worldwide. We focus on issues affecting the profession of financial analysis and investment management, education and competencies for investment professionals, and on issues of fairness, transparency, and accountability of global financial markets.

We welcome the Consultation’s focus on the vulnerabilities of money market funds (MMFs) and policy options to reduce the potential risks they pose for short-term funding markets (STFMs). Our response focuses on those issues. We also applaud the Consultation for providing a helpful framework to assess policy priorities, but we do not comment on that part of the Report.

Executive Summary

The Consultation is noteworthy in its delineation of the key features and vulnerabilities of MMFs. Indeed, the combination of two defining features of MMFs—their vulnerability to runs, and the impact of those runs on STFMs—have both direct and indirect consequences for the real economy. These two features justify the special attention that policymakers and regulators are devoting to MMF reforms.

Questions posed in the Report highlight the central challenge for authorities in regulating MMFs: reducing the systemic financial risks they pose in times of stress, while seeking to avoid reforms that would render the MMF business model unviable.

We favor a combination of three sets of MMF reforms: (1) internalizing costs by establishing a minimum balance at risk (MBR); (2) delinking requirements to impose fees and gates from liquidity measures such as weekly average liquidity (WAL); and (3) requiring a floating NAV for all funds. In addition, we recommend that policymakers and regulators give serious consideration to swing pricing, a policy option that would present challenges but nonetheless shows promise in deterring runs.

Finally, authorities should consider capital buffers or alternative measures to ensure that MMF sponsors internalize costs that are now externalized onto taxpayers and the real economy. Capital buffers probably represent the most controversial option discussed in the Consultation Report. For that reason, authorities

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² Financial Stability Board, Policy Proposals to Enhance Money Market Fund Resilience: Consultation Report (June 30, 2021) (“FSB Consultation Report”), available at <https://www.fsb.org/wp-content/uploads/P300621.pdf>.

should also consider variants or alternatives to accomplish the same objective. We outline some of those alternatives in the “Capital Buffers or Alternatives” section below.

Government funds have shown far greater liquidity and resilience than other types of funds. Therefore, authorities should consider exempting government funds from all of the measures listed above, save one. The one policy exception would be to proscribe the use of a stable NAV for all funds, including government MMFs. For the reasons discussed below, we support a uniform requirement for all funds, without exception, to adopt a floating NAV.

We agree that policymakers and regulators should consider reforms to reduce the maturity mismatches that make MMFs vulnerable, such as further limiting eligible assets and requiring even higher portions of their assets to have shorter maturities or higher liquidity than is currently required, consistent with the continued financial viability of the product. In that regard, authorities should carefully examine the right balance of measures to strengthen market resiliency while ensuring the overall mix and viability of MMF funds.

Introduction

How can the use of MMFs by investors for cash management purposes be reconciled with liquidity strains in underlying markets during times of stress?

We begin with this question in the Consultation Report because it identifies the core challenge presented by the current structure of MMFs: they offer a bank-like product akin to bank deposits, but without the safeguards of banks. MMFs have no capital, no insurance, no access to central bank liquidity and no legal requirements for support from the MMF sponsors or parent companies.

MMFs offer attractive features to investors, including the perception of safety and liquidity, the convenience of a cash management account, and competitive returns. These benefits, however, derive in part from favorable regulatory treatment (no regulatory capital requirements) and implicit government support in times of crisis (which lowers MMFs’ costs of funding). As a result, some of the risks and economic costs of MMFs are shifted, or externalized, onto short-term funding markets, the real economy, and, in times of distress, to taxpayers in the form of central bank interventions.

The challenge for authorities is to reconcile two seemingly conflicting goals: (1) to reduce the systemic financial risks posed by MMFs in times of stress, and (2) to avoid reforms that would render the MMF business model unviable.

Attempts to accomplish both goals have eluded policymakers for years. In the span of a single generation—in 2008 and again in 2020—global central banks have seen the need to intervene twice to support MMFs. Once again, authorities around the world are contemplating potential money market fund reforms, most of which have been discussed for years.³ The persistence of the policy debates testifies to the challenges suggested by the Report’s Question 3: how to reconcile the goals of shoring up systemic protections while preserving the viability and benefits of MMFs.

³ See, e.g., Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform (“FSOC 2012 Proposed Recommendations”) (November 2012); Samuel G. Hanson, David S. Scharfstein and Adi Sunderam, IMF Economic Review Vol. 63, No. 4, “An Evaluation of Money Market Fund Reform Proposals,” (“Hanson et al 2015”) (2015) at 995, available at <https://www.jstor.org/stable/24738130>; and Patrick E. McCabe, Marco Cipriani, Michael Holscher, and Antoine Martin, “The Minimum Balance at Risk: A Proposal to Mitigate the Systemic Risks Posed by Money Market Funds,” Brookings Papers on Economic Activity (Spring 2013).

It may be that there is no perfect answer to this dilemma. On balance, authorities should err on the side of further reforms that will provide additional tools to reduce MMF structural vulnerabilities and make future bailouts less likely. In the following section, we discuss tools that we see as most promising.

What are the key vulnerabilities that MMF reforms should address? What characteristics and functions of the MMFs in your jurisdiction should be the focal point for reforms?

Does the report appropriately describe the most important MMF vulnerabilities, based on experiences in 2008 and 2020? Are there other vulnerabilities to note in your jurisdiction?

The Consultation carefully delineates the key features and vulnerabilities of MMFs and the destabilizing impact they can have on STFM, which include commercial paper (CP), negotiable certificates of deposit (CDs) and repo markets. We would emphasize what is unique about MMFs and the significance of systemic financial risks.

MMFs are not unique in their potential market, credit and maturity transformation risks. Nor are they the only type of pooled investment vehicles to lack loss-absorbing capital. MMFs stand out, however, in the combination of their vulnerability to runs, their interconnections with short-term funding markets, and the impact that runs on MMFs have on the financial system and the real economy.⁴

These risks can be attributed to the following:

1. The ability of certain types of MMFs to maintain a stable value per share⁵
2. The absence of loss-absorption capacity
3. A first-mover advantage to redeem that makes it rational for investors to redeem at the first sign of potential trouble
4. The attraction of a base of highly risk-averse investors that are prone to withdraw assets when even small losses appear possible⁶
5. The likelihood that a run on a single MMF can spread quickly to others because of correlated holdings
6. The high risk of contagion because of the sizable and highly interconnected ties between MMFs and the rest of financial system.⁷

These attributes, which were identified in by the U.S. Financial Stability Oversight Council (FSOC) a 2012,⁸ persist today despite the regulatory reforms that have been adopted since then.

The Consultation's description of MMF vulnerabilities is consistent with the FSOC's 2012 report.⁹ The Report rightly draws attention to the risks of contagion within the MMF industry and the broader

⁴ See Hanson *et al Id.* at 1006 (observing that troubled MMFs, compared with other types of mutual funds, may present greater risks of runs, fire sales, contagion to other MMFs, and disruption of primary capital market activity).

⁵ Under reforms that the U.S. SEC adopted in 2014 and became effective two years later, prime and tax-exempt MMFs sold to institutional investors are required to use a floating NAV, while retail prime funds, retail tax-exempt funds, and government funds are permitted to use a stable NAV. See SEC, Press Release: SEC Adopts Money Market Fund Reform Rules (July 23, 2014).

⁶ The runs in 2008 and 2020 attest to the fragility of this trust. For data on the scale of those runs, see *infra* at 4.

⁷ See FSOC 2012 Proposed Recommendations *supra* note 3 at 4, 18 and 23-24.

⁸ *Id.*

⁹ Specifically, the Consultation depicts MMFs as subject to two broad types of vulnerabilities that can be mutually reinforcing: susceptibility to sudden and disruptive redemptions, and challenges in selling assets, particularly under stressed conditions. Those features can contribute to a first-mover advantage for redeeming investors and make individual MMFs, or the entire MMF sector, vulnerable to runs. In explaining the second vulnerability (challenges in

financial markets. Further, the Report speaks of the “susceptibility of non-public debt MMFs to sudden and disruptive redemptions in episodes of stress has been evident in a number of jurisdictions and triggered by different shocks, most notably in the US and Europe in September 2008 and March 2020.”¹⁰

We would emphasize the binary or cliff-like nature of customer trust in MMFs, a trust encouraged by the use of MMFs as a cash management instrument and, where applicable, by the stable NAV. This trust in the safety of MMFS has a binary, all-or-nothing quality to it: perceptions can swing suddenly from safe to unsafe at the mere suggestion that something may be amiss.¹¹ Bengt Holmstrom, the Nobel laureate for economics, is among those who have spoken of the information-insensitive nature of assets such as these in normal times.¹² But when a shock suddenly makes them information-sensitive, the abrupt change can have a cliff-like quality that precipitates a run.¹³

In an article in the IMF Economic Review, a trio of Harvard Business School co-authors aptly described this sudden loss of trust:

According to this view, risk-averse investors treat assets that are classified as "safe" in a qualitatively different way than they treat assets that are classified as "slightly risky." As a result, panic-driven runs can occur when investors reclassify an asset from "safe" to "slightly risky." This mechanism naturally generates runs on MMFs, which are designed to be regarded as "safe" by investors in normal times. However, in times of financial stress, investors can quickly change their opinions if an MMF suffers losses, or has portfolio holdings that expose it to significant risk of loss.¹⁴

We have seen the results of this loss of trust twice in a generation. In September 2008, a single MMF—the Reserve Primary Fund—broke the buck after Lehman Brothers Holdings, Inc. went bankrupt. The Reserve Primary Fund held only 1.2% of its assets in Lehman, and yet the \$62 billion prime fund saw about \$40 billion in redemptions in just two days. The loss of trust spread immediately to the other MMFs, prompting investors to withdraw \$315 billion, or 15%, from prime MMFs in a single week. As credit markets seized up, commercial paper markets shut down for even the highest-quality issuers.¹⁵

selling assets), the Consultation notes that some MMFs hold financial instruments that have limited liquidity, even under normal market conditions. See FSB Consultation Report *supra* note 2 at 4.

¹⁰ *Id.* at 4 (also noting that common MMF features “may cause investors to react to news about one fund by redeeming shares from other funds,” and that the use of MMFs for cash management and other functions, such as meeting margin calls, may exacerbate the stresses).

¹¹ See Hanson *et al* 2015 *supra* note 3 at 993 (“According to this view, risk-averse investors treat assets that are classified as "safe" in a qualitatively different way than they treat assets that are classified as "slightly risky." As a result, panic-driven runs can occur when investors reclassify an asset from "safe" to "slightly risky." This mechanism naturally generates runs on MMFs, which are designed to be regarded as "safe" by investors in normal times. However, in times of financial stress, investors can quickly change their opinions if an MMF suffers losses, or has portfolio holdings that expose it to significant risk of loss.”).

¹² See Bengt Holmstrom, Understanding the Role of Debt in the Financial System, BIS Working Papers No 479, Bank for International Settlements, at 25 (“[T] there is a danger in the logic of money markets: if their liquidity relies on no or few questions being asked, how will one deal with the systemic risks that build up because of too little information and the weak incentives to be concerned about panics. I think the answer will have to rest on over-collateralisation, stress tests and other forms of monitoring banks and bank-like institutions.”).

¹³ *Id.*

¹⁴ See Hanson *et al* 2015 *supra* note 3 at 993.

¹⁵ FSOC 2012 Proposed Recommendations *supra* note 3 at 4 and 24-25.

In March 2020, the shock was different, but the results were similar. Over a two-week period, MMFs experienced the following net redemptions:

- About \$100 billion, or 30% of fund assets, from U.S. institutional prime MMFs offered to the public¹⁶
- \$40 billion, or 9% of fund assets, from U.S. retail prime MMFs¹⁷
- \$11 billion, or 8% of fund assets, from U.S. municipal MMFs¹⁸
- \$95 billion, or 25% of fund assets, from dollar-denominated MMFs in Europe.¹⁹

(Other funds also experienced outflows. U.S. ultrashort bond mutual funds, for example, saw outflows of \$33 billion, or 16%, the month of March 2020.²⁰)

The outflows from prime MMFs abated only after central banks announced programs to support STFM (along with additional measures to support the flow of credit to households and businesses).²¹ In the U.S., for example, the Federal Reserve announced on March 18 that it had authorized a Money Market Mutual Fund Liquidity Facility (MMLF).²² The facility began operating on March 23, and usage of it peaked in early April at just over \$50 billion, or 5% of net assets in prime and tax-exempt MMFs at the time.²³

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?

We favor a combination of three sets of MMF reforms: (1) internalizing costs by establishing both a minimum balance at risk (MBR) and; (2) delinking requirements to impose fees and gates from liquidity measures such as weekly average liquidity (WAL); and (3) replacing a standing NAV with a floating NAV for all MMFs.

In addition, authorities should give serious consideration to swing pricing, which presents challenges but nonetheless shows promise in deterring runs. Finally, authorities should consider mechanisms to internalize at least some of the potential costs of MMFs onto fund sponsors. As the Consultation Report notes, policy options could include a capital buffer or provisions for sponsor support. A third alternative would be to explore a private insurance fund set up and maintained by MMF sponsors.

We recognize that no one reform will be adequate on its own, and even a combination of them could be insufficient to stop a run under circumstances of panic or extreme duress. Furthermore, these potential actions were all discussed in previous iterations of the MMF reform debate, but have not been adopted (with the partial exception of a floating NAV.) Perhaps there is no perfect answer to the policy dilemmas that regulators and policymakers confront. We believe this combination of potential reforms, however, would serve to make MMFs more resilient and thus reduce the likelihood that future bailouts will be needed.

¹⁶ Report of the President's Working Group on Financial Markets (December 2020) ("PWG Report 2020") at 14, available at <https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf>.

¹⁷ *Id.* at 15.

¹⁸ *Id.* at 15.

¹⁹ *Id.* at 16.

²⁰ *Id.* at 16.

²¹ *Id.* at 17.

²² *Id.* at 17-18.

²³ *Id.* at 17.

Swing Pricing

The report highlights swing pricing as a potential option to reduce the likelihood of destabilizing redemptions. When a shareholder redeems shares from a mutual fund, the redemption can cause the fund to trade assets and thereby incur transaction and other costs. These costs are generally passed on to the remaining shareholders.

Swing pricing seeks to remove this externality and instead pass the costs on to the redeeming shareholder.²⁴ In full swing pricing, the fund adjusts the NAV every trading day—moving the NAV up when net flows are positive and down when they are negative.²⁵ In partial swing pricing, which the Report focuses on,²⁶ the fund adjusts the NAV only when the net fund flows exceed a predetermined threshold.²⁷

The Report explains the promise of this option in deterring runs:

Swing pricing could materially reduce redemption risk and reduce or remove first-mover advantages arising from mutualised liquidity, if it is implemented in a manner that is likely to pass on to redeeming investors the costs they impose on the fund.²⁸

It is not clear, however, that swing pricing would achieve these objectives in practice. On the contrary, swing pricing could have the opposite effect. Investors might view swing pricing as a kind of redemption fee, and the swing price threshold could have the same effect on investor behavior as a liquidity threshold tied to a redemption fee. The experience of March 2020 offers evidence that, when the WAL threshold was linked to the imposition of fees and gates, it had the perverse effect of encouraging redemptions.²⁹ Investors rushed to redeem shares before funds levied fees or closed the gate. It seems reasonable to suspect that a swing pricing threshold would have a similar effect.

Nonetheless, there appears to be some empirical evidence that swing pricing does indeed reduce run risks. A study of U.K. corporate bond funds found that “the same investor is significantly less likely to redeem her shares in a stress period when a fund uses swing pricing than when the fund uses traditional pricing.”³⁰ This empirical evidence, while promising, applies to corporate bonds, not MMFs. Further research would be needed to establish that MMF investors would respond in similar fashion.

Findings on swing pricing were inconclusive in a U.K. survey of liquidity management among U.K. open-end funds.³¹ The Bank of England and Financial Conduct Authority (FCA) conducted the survey

²⁴ For a description of swing pricing, see Dunhong Jin, Marcin Kacperczyk, Bige Kahraman, and Felix Suntheim, IMF Working Paper, *Swing Pricing and Fragility in Open-end Mutual Funds*, (“IMF Working Paper 2019”) (November 2019) at 4 (swing pricing aims “to adjust funds’ net asset values so as to pass on the costs stemming from transactions to the shareholders associated with that activity.”). In an ideal world, in which swing pricing overcame various challenges and succeeded in preventing investors from fund dilution caused by redemptions, it would be used by all mutual funds, not just MMFs, and at all times, not just distressed conditions.

²⁵ *Id.* at 4.

²⁶ See FSB Consultation Report *supra* note 2 at 28 (describing swing pricing as a mechanism that allows fund managers to reduce the fund’s NAV when outflows exceed a “swing threshold.”).

²⁷ See IMF Working Paper 2019 *supra* note 24 at 4-5.

²⁸ See FSB Consultation Report *supra* note 2 at 29.

²⁹ See *infra* discussion on Reducing Threshold Effects.

³⁰ See IMF Working Paper 2019 *supra* note 24 at 6.

³¹ Liquidity management in UK open-ended funds: Report based on a joint Bank of England and Financial Conduct Authority Survey (26 March 2021), (UK Liquidity Management”), at 20, available at <https://www.bankofengland.co.uk/report/2021/liquidity-management-in-uk-open-ended-funds>.

over a time period that included the extreme market conditions of March 2020. The Bank and the FCA reported:

There is a body of literature that demonstrates that alternative pricing rules, such as a swing price or dual price, can reduce the sensitivity of outflows to bad performance...But, on this matter, the survey proved inconclusive: while preliminary analysis indicated signs that swing pricing may have helped to reduce outflows, it was difficult to separate the use of swing pricing as a separate factor in reducing outflows.”³²

Given some empirical support for swing prices, we believe that this option merits further serious exploration by regulators. We would caution, however, that this option would need to overcome several obstacles to be successful.

First, swing pricing appears to expand tracking error, and that in turn can (1) dissuade investors from investing in a fund with swing pricing and (2) dissuade funds from adopting swing pricing mechanisms.³³ These drawbacks may explain why MMF managers in the U.S. have not implemented swing pricing, even though they have had the option to do so since November 2019.

Funds might also find it challenging to calibrate the appropriate threshold to trigger partial swing pricing and the right swing multiple to capture all the costs of redeeming shareholders. The U.K. survey of open-end funds, for instance, found that they calculated swing pricing based mainly on bid-ask spreads, which can be difficult to ascertain in highly volatile markets and do not capture the market impact of price changes caused by the trades.³⁴

As the Report notes, fund managers might balk at voluntarily using the mechanism because of the stigma of doing so. As an alternative, authorities could mandate the use of swing pricing and specify minimum parameters that would trigger its use. But that would simply shift the onus onto authorities to calibrate appropriate parameters. Even then, as the Report acknowledges, “There is also a risk that investors anticipate changes in parameters by authorities and redeem pre-emptively, which could have broader effects than actions undertaken by individual funds.”³⁵

In sum, while swing pricing would present challenges, that should not deter authorities from seriously exploring this as a policy option to deter runs.

Minimum Balance at Risk (MBR)

In this option, investors could get most, but not all, of their money back immediately upon redemption. A small fraction of each investor’s shares (“MBR shares”) could be redeemed only after a certain period of time had elapsed. If an MMF suffered a material loss in that interval, the MBR shares would be first in line to absorb the loss. By serving as a speed bump on a portion of redemptions, MBRs would directly address the misperception of MMF investments as perfectly liquid. Moreover, subordination of the MBR shares would counteract the first-mover advantages of redemption and thereby serve as a disincentive to a

³² *Id.* at 20.

³³ See IMF Working Paper 2019 *supra* note 24 at 22 (“Although the results indicate that swing pricing may be a useful financial stability tool, our analysis also documents an important cost associated with such rules: funds with alternative pricing rules have difficulty attracting new investor capital outside the crisis periods, largely because their portfolios exhibit greater tracking errors.”).

³⁴ See UK Liquidity Management *supra* note 31 at 16-17.

³⁵ See FSB Consultation Report *supra* note 2 at 30.

run.³⁶ Nonetheless, an MBR would not prevent all runs, because the rational incentive to run could still outweigh the first-loss disincentive provided by the MBR.³⁷

As the Report notes, this policy option could make MMFs less bank-like and therefore less attractive to investors. But investors must accept the reality that, in times of stress, MMF investments are simply not as safe as bank deposits. By making this clearer to investors, regulations can help prevent future central bank bailouts of MMFs. Nor would we view it as necessarily negative if the adoption of an MBR policy caused investor demand to shift to other cash management vehicles, such as bank deposits or government debt MMFs. We agree with the Consultation that such shifts would enhance financial stability.³⁸

Capital Buffers or Alternatives

A capital buffer would provide another policy option to reduce the likelihood of destabilizing redemptions. Capital buffers could be held outside the MMF in an escrow account financed by fund managers or by outside investors (e.g. the sponsor), who would demand compensation for the risks they would incur. Just as with an MBR, a capital buffer would absorb losses in certain rare, pre-defined events, such as a material loss to the fund occurring over a short period of time.

Based on our conversations with investment professionals and financial experts, capital buffers probably represent the most controversial option discussed in the Consultation Report. The idea of capital buffers has circulated as a potential reform for years in the U.S. So, too, have strong objections to this policy option. Critics maintain that capital buffers represent a macroprudential banking-style measure that is unsuited to MMFs, which are investment products. Some financial market participants and observers also worry that capital buffers could weaken or even destroy the viability of MMFs.

On balance, we believe that authorities should consider exploring capital buffers. Given the controversy that this option would likely engender, however, authorities should also consider variants or alternatives to accomplish the same objective. For example, if authorities were to adopt capital buffers, they should also commit to reviewing the consequences of that regulation after a certain number of years, such as five years. Alternatively, authorities might consider a pilot test program to determine the efficacy of capital buffers.

Authorities could also consider other measures in lieu of capital buffers to accomplish the same goals. The Consultation Report presents sponsor support as one such alternative. Another might be for the MMF industry to establish its own liquidity reserve pool, which could purchase assets and provide liquidity to individual funds that experience stress and require some level of liquidity support. Critics of capital buffers might find any of these alternatives more palatable.

In its 2012 report, FSOC suggested that an MMF be permitted to use any funding method to build its capital buffer, and it presented three ways in particular: from sponsor support, with assets going into an escrow account; capital market issuance of subordinated, non-redeemable equity shares; or through retained earnings.³⁹ FSOC also suggested that the size of the required buffer be scaled to the riskiness of

³⁶ See PWG Report 2020 *supra* note 16 at 25.

³⁷ Suppose, for example, that 3% of an investor's investment were subject to the MBR. It would still be rational to redeem shares and accept a potential loss of that 3%, if an investor believed that the NAV would fall even more than 3% in the delayed interval. See Hanson *et al* 2015 *supra* note 3 at 986.

³⁸ This policy option could also have some negative consequences, such as making funding sources less diverse and more costly for borrowers. See FSB Consultation Report *supra* note 2 at 31.

³⁹ See FSOC Proposed Recommendations *supra* footnote 3 at 39-40.

the MMF's assets.⁴⁰ Other experts have in the past estimated that subordinate MMF shares would have default risk comparable to an A-rated or BBB-rated long-term bond issued by a financial firm.⁴¹

We agree with the Consultation's assessment that a capital buffer could improve the resilience of MMFs and STFMs,⁴² but would be unable to stop a major run. For instance, a capital buffer could not have withstood the dash for cash in March 2020.⁴³ Nonetheless, a capital buffer could provide sufficient loss-absorbing capacity to deter runs in certain deteriorating circumstances, such as market fluctuations or a limited credit event. As long as the capital buffer were perceived as adequate to meet those limited circumstances, it should have a deterrent effect.⁴⁴

The Report also notes that "concerns that a buffer is too small to absorb potential losses could trigger pre-emptive redemption." For that reason, if authorities adopt a capital buffer regulation, they should also consider countercyclical provisions to relax the buffer requirement temporarily in times of stress.⁴⁵

Combination of MBR and Capital Buffer or Alternatives

Neither a capital buffer nor an MBR alone could stop a run in times of great stress. Therefore, authorities should consider adopting both policy reforms to make MMFs more resilient.

The Consultation Report argues that policy options could be incompatible if they pulled MMFs in different directions by making them more cash-like or more investment-like.⁴⁶ We disagree. In our view, a combination would be incompatible only if one option strengthened resilience while another option weakened it. But that is not the case here. Both a subordinated capital buffer (or alternative measure, such as sponsor support) and an MBR provide loss-absorbing capital to the MMF. The capital buffer (or alternative) provides *ex ante* capital from sponsors, investors in subordinated shares, or the fund's retained earnings. The MBR would provide *ex post* capital from redeeming investors. Both measures would have some deterrent effect on runs, and both would internalize costs that are now externalized on short-term funding markets, taxpayers, and the real economy.

We agree that a capital buffer (or the alternative of sponsor support or industry insurance) would support principal stability and thus make an MMF more cash-like, whereas an MBR would place the investor's cash at risk and therefore make the MMF more investment like. But we do not see that distinction as determinative. Instead, the key question is whether a combination would strengthen MMF resilience by reducing the first-mover advantages that encourage runs and absorbing losses in the event of heightened withdrawals. Therefore, authorities should consider the combination of policy options—an MBR together with a capital buffer or alternative measure—because both would work toward the two key

⁴⁰ *Id.* at 39.

⁴¹ See Hanson *et al* 2015 *supra* note 3 at 1002.

⁴² See FSB Consultation Report *supra* note 2 at 32 ("A capital buffer is likely to improve the stability and resilience of STFMs by reducing the vulnerability of MMFs to runs mainly due to credit concerns in stress situations.").

⁴³ *Id.*

⁴⁴ See Hanson *et al* 2015 *supra* note 3 at 999 ("By reducing the *ex ante* probability that investors suffer a major loss in the first place and weakening run incentives following modest MMF losses, capital may decrease the probability of system-wide runs.").

⁴⁵ See Kurt N. Schacht and Stephen Deane, CFA Institute Comment Letter to the SEC Re: File No. S7-01-21, Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report (April 14, 2021) ("CFA Institute Comment Letter 2021") and Hanson *et al* 2015 *Id.* at 1002.

⁴⁶ See FSB Consultation Report *supra* note 2 at 43, ("Options that are incompatible may, for example, pull MMFs in different directions between making them more cash-like or investment-like (e.g. introducing features to support principal stability such as a capital buffer, versus removing the stable NAV; or adopting limits on eligible assets to make MMFs more liquid, versus moving away from daily dealing).").

objectives (albeit imperfectly, because even the combination would be insufficient to stop a run in all circumstances).

Reducing Threshold Effects

Regulatory thresholds are meant to strengthen the resilience of MMFs, but may have the opposite effect. The U.S. experience with liquidity thresholds, for instance, suggests that the requirement has produced perverse incentives for both fund managers and investors.

One of the MMF reforms adopted by the U.S. SEC in 2014 linked a liquidity threshold to the imposition of gates and fees. Specifically, the rule gave boards of all prime and tax-exempt MMFs the option, but not the requirement, to impose liquidity fees, redemption gates,⁴⁷ or both, if the weekly liquid assets (“WLA”) fall below 30%. And if the WLA falls below 10%, the fund is required to impose a 1% fee on all redemptions unless the fund’s board determines that such a fee is not in the best interest of the fund or that a lower or higher fee is more appropriate.⁴⁸

At the time the Commission adopted this rule, critics (including one commissioner) argued that gates or fees would only encourage runs.⁴⁹ A gate, for instance, will stop runs *ex post*, but will encourage runs *ex ante*. That is just what appears to have happened in March 2020. Once their WLA fell below 35% and approached the 30% threshold, prime MMFs saw accelerated redemptions from both institutional and retail investors.⁵⁰ The President’s Working Group on Financial Markets observed:

Definitive thresholds for permissible imposition of liquidity fees and redemption gates may have the unintended effect of triggering preemptive investor redemptions as funds approach the relevant thresholds. Some preliminary research suggests that redemptions accelerated in March 2020 from funds with declining WLAs.⁵¹

In other words, the 30% threshold served as a magnet for a run. Moreover, MMF managers appeared to avoid selling their most liquid assets to keep from falling below the 30% threshold. Thus, the threshold appeared to serve as a disincentive for the very sales it was meant to facilitate.

For these reasons, we have urged the SEC to decouple the WAL threshold from gates and fees,⁵² and we would caution other authorities from linking liquidity thresholds with gates or fees in any jurisdiction.

⁴⁷ Such fees were capped at 2%. The gates would stop redemptions for up to ten business days. See PWG Report 2020 *supra* note 16 at 8.

⁴⁸ See FSB Consultation Report *supra* note 2 at footnote 39 and PWG Report 2020 *supra* note 16 at 8.

⁴⁹ SEC, Statement of Commissioner Kara M. Stein (July 23, 2014), available at <https://www.sec.gov/news/public-statement/2014-07-23-open-meeting-statement-kms>. Likewise, experts made the same argument in 2015. See Sheila Bair, The Systemic Risk Council, Comment Letter to the SEC on Proposed Rule Regarding Money Market Funds (Sept. 16, 2103) and Hanson *et al* 2015 *supra* note 3 at 1009.

⁵⁰ See the Investment Company Institute (ICI), Experiences of US Money Market Funds During the COVID-19 Crisis, Report of the COVID-19 Market Impact Working Group (“ICI Report”) (November 2020) at 27, available at www.ici.org/pdf/20_rpt_covid3.pdf (“ICI Report”), at 30, available at www.ici.org/pdf/20_rpt_covid3.pdf; SEC staff report, “U.S. Credit Markets Interconnectedness and the Effects of COVID-19 Economic Shock,” (October 2020) (“SEC Staff Interconnectedness Report”), at 27 and 30, available at https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf (“SEC Staff Interconnectedness Report”) at 25-26.

⁵¹ See PWG Report 2020 *supra* note 16 at 22-23. The PWG was chaired by the Secretary of the Treasury and included the Chairs of the Board of Governors of the Federal Reserve System, the SEC, and the Commodity Futures Trading Commission.

⁵² See CFA Institute Comment Letter 2021 *supra* note 45.

Requiring a Floating NAV

We recognize that a floating NAV will not necessarily eliminate the first-mover advantage or prevent or stop a run, as the March 2020 experience demonstrated.⁵³ Nonetheless, a floating NAV offers decisive advantages over a stable NAV. By removing the accounting fiction of a stable dollar even when the NAV deviates from \$1.0000, a floating NAV makes the valuation of fund assets more accurate. CFA Institute has long advocated for fair-value reporting for financial reporting and with regard to financial instruments. We believe it provides investors with a more accurate picture of an entity's financial condition.⁵⁴ In addition, the enhanced transparency can better align investors' expectations with the risks of portfolio holdings.

A stable NAV, in contrast, can create an incentive for shareholders to redeem their shares if they believe the MMF portfolio asset value will fall below a certain threshold and thereby force the fund to "break the buck."⁵⁵ A floating NAV removes this incentive.⁵⁶

We believe that authorities also should be cautious about permitting certain MMFs to use a stable NAV while requiring others to use a floating NAV. In the U.S., this disparate treatment of NAVs has led to shifts that have produced unintended consequences that pose new risks to financial stability.⁵⁷

Reducing Liquidity Transformation

The Consultation identifies two potential reforms to reduce the maturity mismatch vulnerabilities of MMFs. The first option would limit eligible assets and require MMFs to invest a higher portion of their assets in instruments that are shorter dated, more liquid, or both. This would lower MMFs' exposures to less liquid assets such as commercial paper and certificates of deposit. The objective would be to make it easier for funds to meet large redemptions with the proceeds from maturing assets or by disposing of assets without a material price impact.

In the U.S., reforms adopted in 2010 have had a similar objective of making MMFs more resilient to credit, liquidity interest rate risks. For example, at the time an MMF acquires an asset, it must hold at least 10% of its total assets in daily liquid assets ("DLA") and at least 30% of its total assets in weekly

⁵³ See PWG Report 2020 *supra* note 16 at 29 ("Institutional prime MMFs with floating NAVs still experienced runs in March; floating NAVs do not prevent runs.").

⁵⁴ See Kurt N. Schacht and Linda L. Rittenhouse, CFA Institute Comment Letter to the SEC on Money Market Fund Reform and Amendments to Form PF (Sept. 19, 2013).

⁵⁵ In the U.S., MMFs with a stable NAV do not reprice shares to take account of small fluctuations in asset value. But funds must consider repricing their shares, however, if the market-based value of the portfolio falls below the stable NAV by more than 50 basis points. Thus, the stable NAV has a cliff-like quality that subjects the fund to the potential risk of "breaking the buck."

⁵⁶ See, e.g., PWG Report 2020 *supra* note 16 at 28 ("Stable NAVs can create an incentive to redeem when MMF portfolios assets lose value because redeeming investors can receive more for their shares than they are worth, while losses are concentrated among non-redeeming investors. In contrast, a floating NAV mitigates that incentive to redeem as losses are spread across all shareholders on a pro rata basis whether they redeem or not.").

⁵⁷ The disparate treatment has caused changes that have led indirectly to increasing reliance of the Federal Home Loan Bank (FHLB) on MMFs as a source of short-term funding. The Office of Financial Research (OFR) and the SEC's Division of Economic and Risk Analysis (DERA) are among those who have called attention to the emergence of this risk to the U.S. financial system. See Kenechukwu Anadu and Viktoria Baklanova, "The Intersection of U.S. Money Market Reforms, Bank Liquidity Requirements, and the Federal Home Loan Bank System," OFR, Working Paper 17-05, (Oct. 31, 2017), and SEC Staff Interconnectedness Report at 27 ("After the 2008 GFC and the various money market and banking sector reforms that followed, the FHLB system has become increasingly dependent on MMFs as a source of short-term funding.").

liquid assets (“WLA”).⁵⁸ If an MMF’s portfolio dips below the minimum standards, the fund is not in violation of the rule. However, the fund may not acquire any assets other than DLA or WLA until it meets the minimum standards.⁵⁹ Notably, tax-exempt MMFs are not subject to DLA standards due to the nature of the markets for tax-exempt securities and the limited supply of securities with daily demand features.⁶⁰

We believe that these liquidity requirements enhance the resilience of MMFs, but are not enough in themselves to reduce the financial stability risks posed by MMF to acceptable levels. This is why the SEC saw the need to adopt further reforms in 2014 and is considering new measures in light of the stresses of March 2020.

The Consultation presents two other policy options that raise concerns to us. The first would effectively restrict MMFs to government MMFs. This policy option risks tipping the balance against the viability of MMFs. While we support reasonable limits on the asset eligibility of MMF portfolios, we would urge authorities to consider carefully the impact of this policy on the business model of MMFs.

The second option would mandate that MMFs hold minimum amounts of assets that can be readily converted to cash over a two-week horizon or less. If a fund fell below the thresholds, it would be required to implement an escalating series of steps, up to and including the imposition of a gate on redemptions. This option would link liquidity thresholds to fees and gates.⁶¹ The report asserts that the escalation procedures can be considered a variation of the option that would decouple fees and gates from the breach of regulatory thresholds.⁶² It is difficult for us to understand how this option would sever the linkage between a liquidity threshold and gates and fees. On the contrary, we are concerned that this option could produce the same perverse incentives discussed above; i.e., encouraging first-mover redemptions by investors and hoarding by fund managers of their most liquid assets.

Conclusion

The events of March 2020 show that MMFs continue to pose potential systemic financial risks, notwithstanding numerous reforms that various jurisdictions, including the U.S., have adopted over the past decade. In the U.S., heavy outflows from MMFs prompted intervention by the Federal Reserve. Authorities should take a holistic approach to address the fragilities and vulnerabilities of MMFs and reduce the need for future government or central bank intervention.

⁵⁸ See PWG Report 2020 *supra* note 16 at 7.

⁵⁹ *Id.* at 7.

⁶⁰ *Id.* at 7.

⁶¹ MMFs would be required to use price-based tools such as liquidity fees or swing pricing first, then quantity-based tools (notice or settlement periods), before finally being able to use gates. See FSB Consultation Report *supra* footnote 2 at 38.

⁶² *Id.* at note 43 (“Instead, escalation procedures can be considered a variation of the option that would decouple fees and gates from the breach of regulatory thresholds.”).

On behalf of CFA Institute, we thank you for your consideration and welcome the opportunity to discuss our letter with you. Please do not hesitate to contact us.

Sincerely,

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