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February 10, 2022

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

Re: Money Market Fund Reforms
File Number S7-22-21; Release No. IC-34441; RIN 3235-AM80

Dear Ms. Countryman:

My name is Norbert Michel and I am the Vice President and Director at the Cato Institute's Center for Monetary and Financial Alternatives. I appreciate the opportunity to provide input to the Securities and Exchange Commission (SEC) for its proposed rule on money market funds (MMFs). The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace, and the Center for Monetary and Financial Alternatives today's centralized, bureaucratic, and discretionary monetary and financial-regulatory systems and to identifying, studying, and promoting alternatives more conducive to a stable, flourishing, and free society. The opinions I express here are my own.

The rules that govern MMFs under the Investment Company Act of 1940 should be amended to improve the resilience and transparency of MMFs. To achieve such a goal, the amendments from 2010 and 2014 should be repealed. The Commission should finalize a rule that is more like the 1983 version of rule 2a-7 than it is to the current version.

Introduction

The conventional story about the 2008 financial crisis is that, after the so-called "shadow banks" made too many risky bets, trouble at one large MMF ignited a contagious run on other MMFs, and it quickly spread throughout short-term credit markets. This story is highly misleading, and both the regulations that have been implemented and those that have been proposed in the name of mitigating future systemic risks are highly misguided.[1] Nonetheless,

[1] For a comprehensive critique of the conventional story, including its pervasive use and a detailed explanation of why it does not justify implementing widespread bank-like regulations throughout financial markets, see Norbert J. Michel, "The Contagion Concoction: The Truth about Runs and the Great Financial Crisis," CMFA

federal officials relied heavily on the conventional story about the 2008 financial crisis to finalize new MMF rules in both 2010 and 2014. Overall, the 2010 and 2014 rule changes were not a success because they failed to create the stable MMF industry that supporters envisioned, and because they drastically reduced the funds available for financing commercial activity. For instance, the 2014 amendments caused a massive shift out of prime MMFs when shareholders moved more than $1 trillion into *government* MMFs ahead of the effective date (2016), dwarfing any of the outflows from prime MMFs during the 2008 crisis.[2]

The Commission's latest rule proposal partly acknowledges the failures of the previous MMF amendments, and the Commission deserves credit for recognizing those failures. Still, many of the same misguided views toward MMFs that drove many earlier rule amendments appears to be driving those in the new proposal. In 1981, for instance, Fed Chairman Paul Volcker testified before a Congressional committee that the Fed would prefer "money market funds be subject to regulations that would make them more competitive with banking institutions and less attractive to investors."[3] Volcker proposed that Congress give MMFs reserve requirements, as well as rules that prevented investors from redeeming their shares on demand.[4]

In 2009, Volcker counselled the Obama administration that "Banks remain the functioning heart of the financial system, and they are protected and regulated," and to the extent that banks have competitors with "different ground rules," it "weakens the financial system."[5] In 2012, Treasury Secretary Timothy Geithner chastised the SEC for failing to implement stricter MMF regulations and urged the newly created FSOC to formally recommend that the SEC implement new MMF rules. Ultimately, those FSOC recommendations included proposals such as a floating net asset value (NAV), a NAV capital buffer, a separate capital/reserve requirement, and a provision requiring funds to withhold 3 percent of a shareholder's redemptions from any accounts over $100,000.[6]

Even where it is no longer antagonistic, regulators have increasingly crafted rules to mitigate the supposed systemic risks of MMFs. Multiple government reports, in fact, justify these types

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Working Paper no. 006, February 2, 2022, https://www.alt-m.org/2022/02/02/the-contagion-concoction-the-truth-about-runs-and-the-great-financial-crisis-cmfa-working-paper-no-006/.

[2] Michel, "The Contagion Concoction: The Truth about Runs and the Great Financial Crisis," p. 68.

[3] Karen Arenson, "Volcker Proposes Money Funds Be Subject to Rules On Reserves," the *New York Times*, June 26, 1981, https://www.nytimes.com/1981/06/26/business/volcker-proposes-money-funds-be-subject-to-rules-on-reserves.html.

[4] Arenson, "Volcker Proposes Money Funds Be Subject to Rules On Reserves."

[5] Reuters staff, "Volcker: Money Funds Weaken Financial System," Reuters, August 25, 2009, https://www.reuters.com/article/us-volcker-mutualfunds/volcker-money-funds-weaken-financial-system-idUSTRE57O1RS20090825. For a different perspective, that MMFs reduce systemic risks, see Jonathan Macey, "Reducing Systemic Risk: The Role of Money Market Mutual Funds as Substitutes for Federally Insured Bank Deposits," SEC Comment letter, https://www.sec.gov/comments/4-619/4619-34.pdf.

[6] Martha L. Cochran, David F. Freeman, and Helen Mayer Clark, "Money Market Fund Reform: SEC Rulemaking in The FSOC Era," *Columbia Business Law Review*, 2015, p. 19, https://journals.library.columbia.edu/index.php/CBLR/article/view/1763.

of regulations by arguing that MMFs exhibited an inherent vulnerability to destabilizing runs during the 2008 crisis. Nonetheless, MMFs have displayed such an excellent safety record that many of these same government reports—as well as other government agencies and research reports—have had no choice but to acknowledge it. For example, a 2010 President's Working Group on Financial Markets (PWG) report acknowledges that in "the twenty-seven years since the adoption of [the SEC's] rule 2a-7, only two MMFs have broken the buck. In 1994, a small MMF suffered a capital loss because of exposures to interest rate derivatives, but the event passed without significant repercussions."[7] The report also states that although "the run on MMFs in 2008 is itself unique in the history of the industry, the events of 2008 underscored the susceptibility of MMFs to runs."[8]

Naturally, the uniqueness of the 2008 run suggests that MMFs are *not* inherently susceptible to such problems. Likewise, a 2010 Federal Reserve paper notes that from "the introduction of the rules specifically governing these funds in 1983 until the Lehman bankruptcy in September 2008, only one small MMF lost money for investors," and even though "MMF prospectuses and advertisements must warn that 'it is possible to lose money by investing in the Fund', investors virtually never lost anything."[9]

Moreover, basic evidence from the 2008 crisis demonstrates that even the turmoil in the MMF sector during that period did not result in major losses for shareholders. Of the more than 800 MMFs that existed at the end of 2007, only one broke the buck during the crisis.[10] In fact, shareholders of that fund—the now infamous Reserve Primary Fund—ultimately received more than $0.98 cents on the dollar.[11]

According to the conventional narrative, this success rate is only because the federal government stepped in to guarantee MMFs. A major problem with that theory, however, is that the Treasury guarantee program was never called on to cover *any* losses, a remarkable fact given that the program required participating funds to have a NAV greater than or equal to $0.995 and to liquidate if their share price fell by only one half of a percent.[12] As reported in the

[7] "Money Market Fund Reform Options," President's Working Group on Financial Markets, October 2010, p. 8, https://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf.
[8] Ibid.
[9] Patrick McCabe, "The Cross Section of Money Market Fund Risks and Financial Crises," *Finance and Economics Discussion Series,* Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C., 2010-51, https://www.federalreserve.gov/pubs/feds/2010/201051/201051pap.pdf.
[10] Investment Company Institute, 2009 Investment Company Fact Book, 2009, p. 146, https://www.ici.org/system/files/attachments/pdf/2009_factbook.pdf.
[11] U.S. Securities and Exchange Commission, "Reserve Primary Fund Distributes Assets to Investors," Press Release, January 29, 2010, https://www.sec.gov/news/press/2010/2010-16.htm.
[12] See U.S. Department of the Treasury, "Treasury Announces Temporary Guarantee Program for Money Market Funds," September 29, 2008, https://www.treasury.gov/press-center/press-releases/pages/hp1161.aspx#:~:text=All%20money%20market%20mutual%20funds,to%20participate%20in%20the%20program.; U.S. Department of the Treasury, "Treasury Announces Expiration of Guarantee Program for

Wall Street Journal, one reason for the success of that program was that "the problems were relatively simple and contained," because MMFs "held high-quality and short-term assets, so the risk of guaranteeing them wasn't high for the government."[13]

Proponents of stricter MMF regulation also argue that because many fund sponsors stepped in to support their share values, typically by purchasing assets at par and waiting to resell them, the damage in the MMF industry was much worse than it appeared.[14] A major problem with this argument, though, is that MMFs were explicitly designed with such sponsor support mechanisms in mind, meaning that they worked exactly as they were supposed to work. The truth is that it should be very rare for a MMF to ever return less than $1 per share to its shareholders, and indeed it has rarely happened. The overall evidence demonstrates that MMFs are not inherently unstable or vulnerable to destabilizing runs.

As difficult as it may be for the average American to believe, given the pervasiveness of the conventional story about the 2008 financial crisis, many prime MMFs *gained* assets around the time of the Lehman Brothers failure and the Reserve Primary Fund's breaking of the buck. As an SEC report confirms, "the mean prime money market fund experienced large weekly net redemptions, and many individual funds experienced weekly net redemptions that exceeded 10 percent; nevertheless, there were many individual prime funds that experienced weekly net purchases that exceeded 5 and 10 percent of fund assets during the Crisis Month [defined as the time between September 2, 2008 and October 7, 2008]."[15]

More broadly, the view that MMF share redemptions cause market stress is fundamentally incorrect. Short-term capital flows *through* MMFs, meaning that share redemptions represent flows that occur in reaction to (among other things) market stress. There is virtually no evidence of MMF share redemptions *causing* stress or contagious runs on other credit markets, but a great deal of evidence linking those redemptions to (among other things) government-mandated rules and regulations, such as capital and liquidity requirements.[16]

Recommendations

The MMF outflows in 2020 are just the latest example of prescriptively designed rules and regulations that fail to work as the designers intend. Just as decades of increasingly strict bank regulations have failed to produce financial stability, so too have increasingly strict MMF rules.

Money Market Funds," September 18, 2009, https://www.treasury.gov/press-center/press-releases/Pages/tg293.aspx.

[13] Shefali Anand, "Treasury Pads Coffers in Bailout," *Wall Street Journal*, February 17, 2009, https://www.wsj.com/articles/SB123483112001495707.

[14] Michel, "The Contagion Concoction: The Truth about Runs and the Great Financial Crisis," p. 63.

[15] Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher, Division of Risk, Strategy, and Financial Innovation U.S. Securities and Exchange Commission, November 30, 2012, P. 7, https://www.sec.gov/files/money-market-funds-memo-2012.pdf.

[16] Michel, "The Contagion Concoction: The Truth about Runs and the Great Financial Crisis."

The failure of the recent MMF rule amendments even fulfilled one of the harmful scenarios (reducing the funds available to finance commercial activity) that was supposedly so dangerous in the first place. Rather than acknowledge the total failure of this top-down regulatory approach in short-term capital markets, the Commission's 2021 rule proposal doubles down, with even more prescriptive rules, such as *mandatory* swing pricing and explicit restrictions on how funds can use fees and gates.

As a starting point for a new rule 2a-7, the Commission should use the 1983 regulatory framework for MMFs as a baseline. From there, the SEC should pare down the prescriptive rules to the bare minimum, so that they include little more than an average maturity restriction. The rule should give fund boards maximum discretion on how to design and operate their funds, including which *money market* instruments they invest in. The discretion should include methods for reporting NAV and for implementing gates and fees. The Commission should not require any particular methods or operating restrictions but should require relevant disclosures.

Rather than trying to improve financial markets by saddling MMFs with more operating restrictions, the SEC should allow fund managers and investors to figure out what works best for them. This approach would foster more competition in short-term credit markets and make them more resilient by decreasing the uniformity of investment options. Currently, the increasingly prescriptive regulatory framework for MMFs has drastically limited investors' options, making government funds more attractive than short-term private market funds.

If some MMF investors want more risk, with a higher proportion of their funds invested in longer-duration money market securities, and others want less risk, then the SEC should foster more of such options with a flexible framework based on preventing fraud and promoting transparency. Given regulators' track record, it makes sense that fund managers and shareholders—not federal officials—should shoulder the responsibility of figuring out what investment structures provide the right incentives and options.

Federal officials have repeatedly failed to design the stable and vibrant markets that they profess they can design. A less prescriptive regulatory framework for regulating MMFs will not guarantee a more stable financial system, but a highly prescriptive framework has already been proven to produce a fragile system. The Commission should admit that they cannot design vibrant capital markets that are always perfectly stable if they also want to allow investors to take the risks that create vibrant capital markets.

Sincerely,

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