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Submitted via email to fsb@fsb.org

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

Re: MMF Policy Proposals

Vanguard[1] respectfully submits its comments to the Financial Stability Board (FSB) in response to its consultative report with policy proposals to enhance money market fund resilience (Consultation Report).[2] Vanguard has managed money market mutual funds (MMFs) since 1981. On behalf of our shareholders, who currently invest approximately $349 billion in our MMFs, we are deeply committed to working with U.S. and global financial regulatory authorities and standard-setting bodies to strengthen the money market industry for the benefit and further protection of investors. To accomplish this, we believe a combination of fund structural reforms and market structure reforms is necessary, as discussed in our responses to the Consultation Report, below.

Overall

Question 1. 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?

MMFs are an important choice for retail investors' cash management and principal preservation needs. In March 2020, the economic shock of the COVID-19 pandemic led to an unprecedented flight to liquidity and safety by investors and other market participants. Government MMFs had significant inflows as investors sought the principal preservation, stability, and safety that they offer (see response to question 3). Institutional prime MMFs, however, suffered significant outflows necessitating additional government support of prime funds and the underlying commercial paper (CP) markets in which they invest. Given the different dynamics between these funds and their underlying assets, we agree with regulators' desire to focus on reforming prime MMFs. We also believe underlying market structure reforms are essential to strengthening the short-term funding markets.

Disruptions in the short-term funding markets in response to the COVID crisis share some similarities and some notable differences compared to market disruptions during the global financial crisis. In both instances, (1) external shocks (Lehman bankruptcy, 2008, and COVID crisis, 2020) undermined

[1] Vanguard is one of the world's leading asset managers. As of June 30, 2021, Vanguard managed approximately $8 trillion in assets globally on behalf of more than 30 million investors. Vanguard's core purpose is to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success.

[2] FSB Consultation Report: Policy Proposals to Enhance Money Market Fund Resilience (30 June 2021), available at https://www.fsb.org/2021/06/policy-proposals-to-enhance-money-market-fund-resilience-consultation-report/.

market functioning which (2) was exacerbated by MMF structural weaknesses in prime MMFs (stable net asset value (NAV) in 2008, and fees and gates in 2020) and (3) highlight the need for prime MMF reform and market structure improvements. For example, in 2008, credit concerns in the financial sector and ultimately the bankruptcy of Lehman Brothers impaired the NAV of the Reserve Primary Fund. This "breaking of the buck" accelerated redemptions by institutional investors on the prime asset category and prompted intervention by both the U.S. Federal Reserve and the U.S. Treasury. March 2020 also saw investor redemptions on a category of MMFs. However, in this instance, it was triggered by corporations and pensions rapidly redeeming out of a subset of MMFs: institutional prime MMFs.

U.S. institutional prime MMFs experienced significant redemptions in March 2020 and the CP market froze. While U.S. *retail* prime MMFs experienced far fewer redemptions than U.S. *institutional* prime MMFs as a percentage of the market (see response to question 6), we agree with SEC staff analysis that the frozen CP market had ripple effects because of its connections to other participants in the financial system.[3] Moreover, because retail prime MMFs invest in the same universe of securities as institutional prime MMFs, these market conditions began to negatively impact fund valuations and constrain the ability of many retail fund managers to effectively manage liquidity.

Based on the significant redemptions experienced by prime MMFs during the COVID crisis, we recommend that additional reforms focus on risks inherent in prime MMFs and related vulnerabilities in the short-term funding markets. As explained in greater detail in the questions that follow, we recommend the following MMF structural reforms: floating the NAV for all (retail and institutional) prime MMFs, eliminating fees/gates to reduce the incentive for investors to run, and imposing higher liquidity requirements. In combination with these prime MMF structural reforms, we recommend market structure reforms that focus on improving the underlying fixed income market functioning in a crisis.[4]

Question 2. What policy options would be most effective in enhancing the resilience of MMFs, both within individual jurisdictions and globally, and in minimizing the need for extraordinary official sector interventions in the future?

See response above.

Question 3. How can the use of MMFs by investors for cash management purposes be reconciled with liquidity strains in underlying markets during times of stress?

Based on the challenges in prime MMFs in 2008 and 2020, Vanguard exited the prime MMF space in 2020 and converted our retail prime MMF into a government MMF. Though we no longer offer prime asset class products, we believe the reforms we have outlined will significantly improve the functioning of this market, though it may further reduce their use as a stand-alone cash management tool.

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[3] *See* SEC Division of Economic Risk and Analysis, *U.S. Credit Markets Interconnectedness and the Effects of the COVID-19 Economic Shock* (Oct. 2020), *available at* https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf. "The secondary trading in CP/CD generally is limited to the dealers marketing CP/CD programs. In March, because of the COVID-19 economic shock, these dealers were constrained in supporting these markets. This market characteristic also contributed to the lack of liquidity in this market." *Id.* at 23.

[4] *See* The Vanguard Group, Inc., *Comment Letter on the SEC Request for Comment on Potential Money Market Fund Reform Measures in President's Working Group Report* (Apr. 12, 2021), https://www.sec.gov/comments/s7-01-21/s70121-8662453-235301.pdf.

Forms, functions and roles of MMFs

Question 4. Does the report accurately describe the ways in which MMFs are structured, their functions for investors and borrowers, and their role in short-term funding markets across jurisdictions? Are there other aspects that the report has not considered?

N/A

Question 5. 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?

N/A

Vulnerabilities in MMFs

Question 6. 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?

Vanguard's MMFs fared well overall during the volatility associated with the onset of the COVID-19 pandemic in March 2020 but many prime MMFs did not. Vanguard Prime Money Market Fund, a retail prime fund, experienced a low percentage of redemptions (4% of assets in February 2020 compared with 10% for the broader retail prime category and 34% for the institutional prime category).[5] Our prime fund experienced less stress because we managed it conservatively with a higher allocation to government securities, lower credit risk exposure, and a higher liquidity level than institutional prime MMFs.

Based on our experience as a manager of retail prime MMFs, we believe the desire to "get out before the implementation of fees and gates" accelerated redemption activity by institutional investors. Being professional investors, holders of U.S. institutional prime MMFs were closely monitoring weekly liquidity levels in their funds, aware that as they approach the 30% regulatory threshold, the imposition of redemption fees and gates becomes a greater possibility. In response, managers of publicly-offered U.S. institutional prime MMFs looking to raise liquidity were forced to sell securities, which began to drive market prices to distressed levels. Though Vanguard Prime Money Market Fund fared well overall in March 2020, we looked closely at our MMF offerings and in August 2020 announced that Vanguard Prime Money Market Fund would be reorganized into a government MMF, as these funds proved much more resilient. We took this step due to significant reservations we have about prime MMFs being offered as a stable NAV product.

Policy proposals to enhance MMF resilience

Question 7. Does the report appropriately categorize the main mechanisms to enhance MMF resilience? Are there other possible mechanisms to consider? Should these mechanisms apply to all types of MMFs?

Given the repeated issues in prime MMFs deriving from their stable NAV (in 2008) and gates and fees (in 2020) – and exacerbated by market structure weaknesses – we believe that fund policy reforms should focus directly on the structural weaknesses of these funds, as well as broader market structure weaknesses. As described above, Vanguard supports a simple approach to prime MMF reforms – floating the NAV of both institutional and retail prime MMFs, eliminating gates and fees, imposing higher liquidity requirements, and implementing a combination of U.S. Treasury and other fixed income market structure

[5] *Id.* at 4.

reforms designed to improve market functioning in a crisis.[6] We believe this approach directly addresses the nature of the problems, and is far superior to other reform options, such as capital buffers, minimum balance at risk (MBR), or swing pricing – all of which would create a host of new challenges and unintended consequences.

It would be a mistake to impose bank-like policy measures, such as capital requirements and MBR, on mutual funds. Instead, we urge regulators to focus on addressing these core structural weaknesses and improving the underlying market functioning in a crisis. Imposing capital, MBR, or swing pricing requirements does not address that fundamental challenge.

Capital buffers are intended to address credit quality concerns and defaults on fund portfolio assets that may cause downward pressure on the NAV and may cause a MMF to break the buck (as occurred in 2008). Capital requirements do not address liquidity and do not effectively address the redemption stresses faced by institutional prime MMFs as a result of a market-wide liquidity crisis (as occurred in 2020). Policymakers previously considered and rejected imposing capital buffer requirements on funds. Unlike banks, MMFs do not use leverage or hold non-transparent assets, and they do not have operating assets, use off-balance sheet financing, or have deposit insurance. Moreover, banks are *principals* that use their own balance sheets to add and manage risk, while funds are *agents* operating on behalf of investors. Investors in mutual funds are shareholders, not creditors. Funds are subject to potential loss, in return for a market return on their short-term investments, and this fact is clearly disclosed in their offering documents. Imposing capital buffer requirements on a fund adviser would transform the essential nature of a mutual fund by interposing the adviser between the fund and its investors, requiring the adviser to guarantee a portion of the fund. Currently, fund advisers do not allocate capital to absorb losses because, as with all securities products, investors bear the risks of investing in funds. Furthermore, the cost of holding capital on a bank-like scale would either be borne by fund shareholders (who would bear higher fees and/or lower returns, making investments in these funds less attractive), or by fund sponsors who may elect to exit the MMF business. The result of a capital requirement would be to reduce the availability of MMFs, eliminate a cash management option for investors, and eliminate a source of financing for the short-term markets.

Minimum balance at risk (MBR) presents other legal, regulatory, and operational concerns and challenges. A delayed receipt of redemption proceeds on a regular basis likely would cause investors to seek out less complicated and, potentially less regulated, cash management options for their liquidity needs. MBR would raise tax concerns and create uncertainty as to available account balances, which would impede the use of MMFs. The disclosure necessary to inform shareholders about the structure and constantly changing size of the MBR would be cumbersome and complex, and it is unlikely that investors will be able to understand how an MBR works. Fund sponsors would need to undertake costly and resource-intensive changes to accommodate systems upgrades and implement new processes on funds subject to MBR requirements. Furthermore, share subordination under an MBR arrangement penalizes shareholders for exercising their right to access their funds.

Swing pricing. Though swing pricing has been used successfully in Europe, it is unclear how much it would have changed investor behavior in March 2020, given the numerous market challenges during that time, and particularly if there had not been gates and fees fueling redemptions. Moreover, implementing swing pricing would require significant changes to the U.S. mutual fund operating infrastructure and those challenges would be particularly acute for retirement plan assets invested in MMFs. Incorporating swing pricing into the NAV calculation would require funds to consider all shareholder activity each day, including transactions made through intermediaries and transactions in retirement plans, which likely would necessitate an earlier cut-off time for investor orders rather than 4:00pm. Swing pricing also presents

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[6] *See* Vanguard Research, *The dash for cash: Observations on the fixed income market ecosystem during COVID-19* (July 2021), *available at* https://advisors.vanguard.com/insights/article/howfixedincomemarketsrespondedtothepandemic.

challenges for funds-of-funds (*e.g.,* target date funds for retirement investors). It may be challenging to have sufficient, timely NAV information about each underlying mutual fund on a given trade date, impacting the pricing of the fund-of-fund and introducing unnecessary operational risk and cost into investors' retirement savings. In general, swing pricing also would create confusion for less sophisticated investors.

Question 8. Does the assessment framework cover all relevant aspects of the impact of MMF policy reforms on fund investors, managers/sponsors, and underlying markets? Are there other aspects to consider?

See responses above.

Question 9. Are the representative policy options appropriate and sufficient to address MMF vulnerabilities? Which of these options (if any) have broad applicability across jurisdictions? Which of these options are most appropriate for public debt and non-public debt MMFs? Are there other policy options that should be included as representative options (in addition to or instead of the current ones)?

For tax-exempt municipal MMFs, which hold short-term state and local government and municipal securities, we support further consideration of whether retail tax-exempt MMFs should adopt a floating NAV structure based on tradeoffs. We encourage policymakers to consider whether tax-exempt MMFs are more like government MMFs than prime MMFs based on their credit quality and contractual liquidity. We would recommend shorter weekly average maturities (WAMs) for tax-exempt MMFs to improve resilience and further protect investors from potential market price deterioration and liquidity pressures.

Question 10. Does the summary assessment of each representative option adequately highlight the main resilience benefits, impact on MMFs and the overall financial system, and operational considerations? Are there any other (e.g. jurisdiction-specific) factors that could determine the effectiveness of these options?

We believe in strong, simple reforms for all prime MMFs (*i.e.,* floating the NAV of both institutional and retail prime MMFs, eliminating gates and fees, increasing liquidity requirements, and implementing fixed income market structure reforms). Allowing optionality of MMF structural reform options at a fund sponsor's preference may be confusing for investors and complicated for fund companies.

Question 11. Is the description of variants and the comparison of their main similarities/differences vis-à-vis the representative options appropriate? Are there other variants to consider?

N/A

Question 12. Are measures to enhance risk identification and monitoring by authorities and market participants appropriate complements to MMF policies? Which of these measures are likely to be most effective and why? Are there other measures to consider?

We support measures to enhance risk identification and monitoring by regulators, including ensuring that regulators have all the data and transparency necessary to properly surveil the markets.

Considerations in selecting policies

Question 13. Are the key considerations in the selection of policies to enhance MMF resilience appropriate? Are there other considerations that should be mentioned?

Investor cost and confusion are significant considerations for policymakers as they consider MMF structural reforms. For this reason, we favor a mandatory floating NAV for prime MMFs and eliminating gates and fees for the protection of U.S. retail investors, to keep costs low for investors, and to ensure that investors have clarity and consistency in their experience when purchasing and selling MMFs.

Question 14. Which options complement each other well and could potentially be combined? What are the most appropriate combinations to address MMF vulnerabilities in your jurisdiction? Which combinations are most effective for different MMF types and their functions?

See responses above.

Question 15. To what extent should authorities seek to align MMF reforms across jurisdictions? Is there a minimum set of policies or level of MMF resilience that should be considered at the international level to avoid fragmentation and regulatory arbitrage?

N/A

Short-term funding markets (STFMs)

Question 16. Does the report accurately describe problems in the structure and functioning of STFMs and how these have interacted with MMFs in stress periods?

See responses above.

Question 17. What other measures should be considered to enhance the overall resilience of STFMs? How would those measures interact with MMF policy reforms and how effective are they likely to be in preserving market functioning in stress times?

See responses above. Policymakers should focus on fixed income market structure reforms that improve the underlying market functioning in a crisis.

Additional considerations

Question 18. Are there any other issues that should be considered to enhance MMF resilience?

N/A

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Vanguard appreciates the opportunity to comment on the Consultation Report, and we welcome the opportunity to further discuss any of the information or recommendations we have provided. If you have any questions, please contact Ricardo Delfin, Principal and Global Head of Regulatory and Public Policy, at ricardo_delfin@vanguard.com.