

FSB consultation report on money market fund reform

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The Financial Stability Board has issued a consultation report with policy proposals to enhance money market fund resilience that are largely consistent with those under consideration in the United States. The FSB has also requested comment on certain potential reforms to short-term funding markets more broadly.

On June 30, 2021, the Financial Stability Board (FSB) published a [consultation report](#) (the FSB Consultation) setting out policy options to enhance the resilience of money market funds (MMFs). The issuance of the FSB Consultation is a key part of the FSB's work program on non-bank financial intermediation, and follows a [review](#) published by the FSB in November 2020 of the March 2020 market turmoil.¹

The policy options included in the FSB Consultation are broadly consistent with policy proposals that have been floated elsewhere, including in the December 2020 [report](#) released by the President's Working Group on Financial Markets² discussing MMF reform options in the United States (PWG Report).³ Like the PWG Report, the FSB Consultation generally avoids taking a position on which reform options are best. Instead, the FSB Consultation aims to inform jurisdiction-specific reforms, recognizing that appropriate policy approaches may vary from jurisdiction to jurisdiction.

Comments on the FSB Consultation are due August 16, 2021, with a final report from the FSB to come in October 2021.

MMF vulnerabilities

MMFs serve a critical intermediation role in the short-term funding markets. By providing investors with pro-rata interests in pools of short-term, high-quality money market instruments, they provide investors with a relatively safe cash-like instrument that generally provides a better return than most bank deposits. At the same time, MMFs provide borrowers, such as broker-dealers (through repo), banks (through purchases of certificates of deposit (CDs), particularly from U.S. operations of non-U.S. banks who need dollar funding), corporations (through purchases of commercial paper (CP)) and governments (through purchases of government securities), with relatively cheap short-term funding.⁴

However, as seen in the 2008 financial crisis and 2020 COVID market turmoil, MMFs are vulnerable to shocks in the economy and to runs, similar to banks and other players in the short-term funding markets.⁵ The FSB Consultation describes those vulnerabilities in detail, dividing them into (i) sudden and disruptive redemptions and (ii) challenges in selling assets, particularly under stressed conditions. These vulnerabilities both emanate from the fact that MMFs engage in liquidity transformation—they are open-ended mutual funds that take in cash and permit immediate redemption of shares, while the assets they hold (in particular, for prime funds that invest in CDs and CP) are not completely liquid. Thus, in the face of sudden and disruptive redemptions and challenges in selling assets, as occurred in 2008 and 2020, MMFs may not be able to redeem all shares or may need to do so at a reduced price, which fuels further panic and redemptions (runs and possible contagion).

As a result of these persistent MMF vulnerabilities, there have been a number of calls for reform of MMFs globally, including in the United States, where MMFs are required to be registered under the Investment Company Act of 1940 (the 1940 Act). The SEC adopted reforms in 2010 and 2014 to 1940 Act Rule 2a-7, including by, for example, requiring institutional prime MMFs to float their net asset value (NAV) rather than adhering to a constant NAV (generally \$1), which

provides some flexibility in times of stress and is intended to reduce the potential for an adverse signaling effect from “breaking the buck.” At the time, the SEC [explained](#) that it was adopting these reforms rather than certain other reform recommendations put forward by the Financial Stability Oversight Council (FSOC), including capital buffers and minimum balance at risk (MBR) rules, because the SEC had concluded that FSOC’s recommendations “generally would not achieve our regulatory goals as well as the reforms we are adopting today.”⁶

Now, there is general agreement that more needs to be done. The FSB Consultation is an important step in that process.

Mechanisms to enhance MMF resilience

The FSB Consultation sets out policy proposals to enhance MMF resilience in light of these vulnerabilities. These are organized into four categories of mechanisms: (1) imposing on redeeming investors the cost of their redemptions, (2) absorbing losses, (3) reducing threshold effects and (4) reducing liquidity transformation. Within each category, the FSB Consultation describes what it refers to as “representative options,” as well as certain “extensions and variants” of that option which the FSB believes may be more appropriate than the representative option in certain jurisdictions, based on the specific circumstances and characteristics of the jurisdiction.

The table below sets out the policy proposals included in the FSB Consultation, the majority of which are consistent with the reform options discussed in the PWG Report.

Mechanism to enhance resilience	FSB options	Notes
<p>Impose on redeeming investors the cost of their redemptions</p>	<p>Representative Option: Swing pricing</p> <p>Extension and Variant: Authorities mandating macroprudential swing pricing</p>	<p>Swing pricing refers to a mechanism that allows a fund manager to reduce a fund's NAV when net redemptions exceed a certain threshold. The reduction in NAV is meant to impose on the redeeming person or entity the transaction costs resulting from selling assets to fund the redemption (an anti-dilution provision). While there are a number of approaches to implementing swing pricing, the FSB Consultation notes that swing pricing, if adopted, "must be implemented in a manner that is likely to fully pass on to redeeming investors the costs they impose on the fund." The FSB observes that "authorities may need to establish certain requirements to ensure such an implementation."</p> <p>As noted in the PWG Report, in the United States, an optional swing pricing framework is currently permissible for certain mutual funds, but not MMFs. In a March 2021 speech, Federal Reserve Governor Lael Brainard specifically noted swing pricing as a policy reform that "could significantly reduce the run risk associated with money funds."^[1]</p> <p>Under the macroprudential swing pricing variant, swing pricing would be left to the discretion of fund managers during normal times, but could be mandated by authorities during stress periods. The authorities would set the swing pricing parameters (the threshold for the swing pricing to kick in) and the minimum factor (the amount of the decrease in NAV through swing pricing) would be determined based on both fund-specific and systemic factors.</p>
<p>Absorb losses</p>	<p>Representative Option: MBR</p>	<p>An MBR rule would require that a small fraction of each MMF investor's shares not be immediately available for redemption, but instead be reserved to absorb losses. As a result, even redeeming MMF investors would remain partially invested in the MMF for a period of time and would share losses incurred by the MMF whether based on credit or liquidity risk over that time frame, thus reducing the first mover advantage.</p> <p>MBR rules were noted in the PWG Report as a potential reform option in the United States and, like swing pricing, were cited by Governor Brainard as a reform that could reduce the run risk associated with MMFs.</p>

<p>Absorb losses</p>	<p>Representative Option: Capital buffers</p> <p>Extension and Variant: Sponsor support</p> <p>Extension and Variant: Liquidity exchange bank</p>	<p>Requiring MMFs to maintain a capital buffer is an idea included in both the FSB Consultation and the PWG Report. In her March 2021 speech, Governor Brainard offered support for capital buffers – if properly calibrated – as a way to absorb losses and reduce the incentive for investors to exit a fund early. Similarly, the FSB Consultation notes several potential benefits of capital buffers, such as reducing the incentive for investors to run due to concerns about the credit quality of the MMF, while also acknowledging that capital buffers would make it costlier for MMFs to operate, which could lead to greater industry concentration. The FSB also observes that calibrating the appropriate size of the buffer could be challenging.</p> <p>The FSB Consultation includes sponsor support in stress periods (currently forbidden in the EU and UK, but permissible in the U.S. under certain circumstances) as a potential variant. It notes a variety of potential risks to this option, including that sponsor support could increase contagion effects between MMFs and sponsors as investors in the sponsor’s other MMFs would be likely to run, increase interconnectedness between MMFs and other financial institutions or favor MMFs with bank-affiliated sponsors. MMFs may also be incentivized to take on more risk in the knowledge that sponsor support will be available in a period of stress. The PWG Report’s discussion of sponsor support is slightly different, in that it contemplates clarifications to the regulatory framework governing sponsor support that would establish the circumstances under which a sponsor would be required to provide support, although it acknowledges some of the same drawbacks to sponsor support as those identified by the FSB.</p> <p>The idea of a liquidity exchange bank, like a lender of last resort, which would stand ready to purchase assets from MMFs to provide liquidity during stress periods, is mentioned in both the FSB Consultation and the PWG Report. Each expresses a degree of skepticism about the idea. For example, the FSB Consultation notes that the liquidity exchange bank business model is untested and could institutionalize moral hazard as MMF sponsors will make decisions on the assumption that they can always access the liquidity exchange bank to exchange less-liquid instruments.</p>
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<p>Reduce threshold effects</p>	<p>Representative Option: Removal of ties between regulatory thresholds and imposition of gates and fees</p> <p>Extension and Variant: Authorities approving activation of fees and gates</p> <p>Extension and Variant: MMF investor concentration limits</p> <p>Extension and Variant: Countercyclical liquidity buffer</p>	<p>Some MMFs are authorized to impose redemption fees or gates (i.e., temporarily suspend redemptions) if a liquidity threshold is breached. These fees and gates are meant to reduce shareholders' incentives to redeem or, in the case of gates, to stop redemptions entirely for a period of time, but may have the unintended consequence of incentivizing investors to rush to redeem as MMFs approach the applicable fee or gate threshold. Both the FSB Consultation and the PWG Report suggest as a potential reform the removal of the ties between fees/gates and regulatory requirements, and would instead allow fund managers to activate fees and gates when in the best interest of the fund, irrespective of liquidity levels.</p> <p>The PWG Report also includes as a separate reform idea the adoption of countercyclical liquidity requirements, which would automatically decline in certain circumstances, with any fee or gate thresholds also declining along with the minimum requirement. The FSB Consultation describes this idea as a broader variant of the representative option and notes potential benefits, such as permitting MMFs to sell liquid assets in times of stress to meet redemptions, and drawbacks, such as the difficulty of calibrating the countercyclical liquidity requirements.</p> <p>The other variants included in the FSB Report – authorities approving activation of gates and fees and MMF investor concentration limits – are among the few ideas discussed in the FSB Consultation not also discussed in detail in the PWG Report. The FSB Consultation describes authorities approving activation of gates and fees as “less effective” than simply allowing the fund’s management to determine when and whether to impose fees and gates, as requiring regulatory approval would increase uncertainty and take longer in times of stress. The FSB consultation also notes that MMF investor concentration limits could “raise operational challenges” and “could also lead to higher correlation/contagion between MMFs with similar investor bases.”</p>
<p>Reduce threshold effects</p>	<p>Representative Option: Removal of stable NAV</p>	<p>This reform would require all MMFs to have a variable NAV in order to reduce investors' incentive to redeem when they believe the underlying value of the assets in a fund's portfolio has fallen below a stable NAV. Similarly, the PWG Report included, as a policy option, requiring all prime and tax-exempt MMFs to have a floating NAV. Currently, U.S. retail prime MMFs and retail tax-exempt MMFs can use a rounded NAV, and the PWG Report notes that these funds experienced large outflows in March 2020.</p> <p>The FSB Consultation notes that by requiring funds to have a variable NAV, the use of MMFs as a cash substitute would be diminished, thus reducing overall MMF demand and increasing demand for cash management alternatives, such as bank deposits or public debt MMFs. The FSB believes that, on balance, “these shifts would enhance financial stability, although funding sources for borrowers would become less diverse and more costly.”</p>

<p>Reduce liquidity transformation</p>	<p>Representative Option: Limits on eligible assets</p> <p>Extension and Variant: Limit MMFs to government MMFs</p> <p>Extension and Variant: Redemption in kind</p> <p>Extension and Variant: Non-daily dealing</p> <p>Extension and Variant: Liquidity-based redemption deferrals</p>	<p>The FSB Consultation's representative option to reduce liquidity transformation would limit eligible assets to shorter-dated and/or more liquid instruments, and would reduce MMFs' exposures to less liquid assets such as CP or CDs. This option is generally not discussed in the PWG Report.</p> <p>Variants and extensions discussed in the FSB Consultation contemplate going even further, for example by prohibiting all MMFs other than government MMFs, by permitting redemption in kind (i.e., redemptions would be paid through a transfer of the MMF's noncash assets themselves, rather than cash), by allowing only a fraction of redemption requests to be met on the same day based on the liquidity of the MMF and by making redemptions weekly or monthly, rather than daily.</p>
<p>Reduce liquidity transformation</p>	<p>Representative Option: Additional liquidity requirements</p> <p>Representative Option: Escalation procedures</p>	<p>The first of these representative options would require MMFs to hold minimum amounts of assets that could readily be converted to cash over a two-week horizon or less. Along somewhat similar lines, the PWG Report discusses the creation of a new category of liquidity requirement in addition to daily and weekly liquid asset requirements, noting that "creating an additional category for assets with slightly longer maturities (e.g., biweekly liquid assets) could strengthen funds' near-term portfolio liquidity when short-term funding markets become stressed."</p> <p>The second representative option, described by the FSB as "escalation procedures," would require MMFs to first use price-based tools such as liquidity fees or swing pricing, and then to use quantity-based tools (notice or settlement periods), before finally being permitted to impose gates. For its part, the PWG Report discusses an array of potential reforms to the conditions for imposing gates, including by requiring MMFs to consider liquidity fees before gates.</p>

The FSB is not, at this stage, endorsing any specific reform or sets of reforms. The FSB Consultation notes that each jurisdiction, in determining the optimal prioritization and combination of policy measures, should take into account jurisdiction-specific circumstances and policy priorities, as well as cross-border considerations like the potential for regulatory arbitrage and spillover effects.

Complementary reforms

In addition to the MMF-specific reforms described above, the FSB Consultation discusses potential complementary reforms that could further enhance MMF resilience.

First, the FSB Consultation discusses potential reforms that could make it easier for MMF managers to manage risk, while also making it easier for regulators to monitor MMFs. Potential reforms in this category include stress testing (both fund-level and sector-wide), additional MMF reporting requirements to regulators, and disclosure and reporting requirements on other elements of the short-term funding ecosystem, including granular data on CP and CD markets. CP

and CDs are among the less-liquid assets commonly held by MMFs due to the lack of a robust secondary market for these instruments, which are generally held by their investors to maturity.

Second, the FSB Consultation discusses potential reforms to underlying short-term funding markets, given that “MMF reforms by themselves will not solve the structural fragilities” in these markets. Potential reforms in this category, particularly as they relate to CP and CDs, include changes in market microstructure that would reduce the need for dealer intermediation (e.g., increased standardization of underlying instruments, faster settlements, all-to-all trading platforms), increased market transparency and enhanced regulatory reporting. The FSB Consultation acknowledges, however, that even if these reforms were implemented, “it is not clear that such measures would alter the characteristics of these markets that give rise to illiquidity during stress times.”

Next steps in the reform process

Comments on the FSB Consultation are due to the FSB by August 16, 2021, and the FSB expects to publish a final report in October 2021. Meanwhile, in the United States, the SEC’s request for comment on the reform ideas in the PWG Report has now closed.⁷ In prepared testimony before the U.S. House of Representatives Appropriations Committee, SEC Chair Gary Gensler recently noted that “early in the pandemic, we witnessed some system-wide issues affecting critical parts of our short-term funding markets, including treasury, repo, and money market funds markets I am directing staff to look into these issues, in coordination with other federal agencies.”⁸ The timing of any proposed rule is uncertain, although the SEC’s most recently released [regulatory agenda](#) targets April 2022 for a notice of proposed rulemaking. In a [statement](#) released in June 2021, FSOC noted that it was “encouraged” by the SEC’s engagement on MMF reform, and stated that FSOC would “continue to monitor [the SEC’s] initiative in the broader context of efforts by financial regulators to strengthen short-term funding markets and support orderly market functioning, including during periods of heightened market stress.”

Law clerk Mary Jane Dumankaya contributed to this update.

⁹ See the FSB’s [Holistic Review of the March Market Turmoil](#) (November 2020).

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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- ¹ The President's Working Group on Financial Markets is chaired by the Secretary of the Treasury and also includes the Chair of the Board of Governors of the Federal Reserve System (Federal Reserve), the Chair of the Securities and Exchange Commission (SEC) and the Chair of the Commodity Futures Trading Commission.
- ² The SEC requested comment on the PWG Report in February 2021, as discussed in an earlier Davis Polk [client update](#).
- ³ Prime MMFs may invest in any of these instruments, while government MMFs invest overwhelmingly in government securities, such as Treasuries. Tax-exempt MMFs invest in state, local and municipal securities, thereby providing a tax advantage to investors.
- ⁴ In response to these market dislocations, U.S. regulators have taken various actions on an emergency basis to help stabilize the MMF markets. In March 2020, the Federal Reserve established a Money Market Mutual Fund Liquidity Facility to provide liquidity to MMFs by accepting high-quality assets purchased from MMFs as collateral for loans to eligible financial institutions, as discussed in an earlier Davis Polk [client update](#). For another example, in 2020, the SEC staff provided no-action relief permitting bank affiliates of MMFs to purchase securities from their MMF affiliates despite a general prohibition on such affiliate purchases and conditions in a regulatory exception to that general prohibition that were not consistent with Sections 23A and 23B of the Federal Reserve Act. See Investment Company Institute, SEC Staff No-Action Letter (March 19, 2020), available [here](#).
- ⁵ SEC, Money Market Reform; Amendments to Form PF, Release No. IC-31166 (July 23, 2014), available [here](#).
- ⁶ The PWG Report also acknowledges, however, that "[e]ligible U.S. mutual funds have yet to implement swing pricing, largely because implementation would require substantial reconfiguration of current distribution and order-processing practices."
- ⁷ Comments received by the SEC may be viewed [here](#).
- ⁸ SEC Chair Gary Gensler, Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee (May 26, 2021), available [here](#).