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July 5, 2023

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

Re: Comment Letter of Federated Hermes, Inc. on the U.S. Securities and Exchange Commission's Proposed Amendment to Rule 2a-7 Requiring the Use of Swing Pricing in Institutional Prime and Tax-Exempt Money Market Funds (SEC File No. S7-22-21)

Dear Ladies and Gentlemen:

This letter[1] is provided to clarify and support the recommended use of discretionary liquidity fees provided by Federated Hermes, Inc [2] ("Federated Hermes" or "FHI") in recent meetings with SEC Commissioners and the Staff. These comments are presented with respect to the Securities and Exchange Commission (the "SEC" or the "Commission") release proposing reforms to Rule 2a-7 that require, among other things, that all non-government and retail money market funds (i.e. institutional prime and tax-exempt money market funds, "MMFs") use "swing pricing" in some circumstances and to create new requirements related thereto; the proposed amendments are collectively referred to herein as the "Release" or the "Proposal." [3] This letter will focus primarily on swing pricing and a proposed alternative that we believe achieves the benefits sought by the Commission while avoiding the pitfalls of swing pricing as proposed.

We will address three topics:

- **The problems with swing pricing as proposed**
- **The serious unintended consequences of mandatory requirements**
- **The superiority of discretionary liquidity fees in addressing potential dilution**
- **The SEC's concerns regarding the willingness of MMF boards to impose discretionary liquidity fees**

Our conclusion is that discretionary liquidity fees: (1) can be implemented when necessary; (2) will not disrupt the significant benefits of the existing Know Your Customer regime practiced by MMF advisers;

[1] Federated Hermes July 2023 Comment Letter II dated July 5, 2023. Available from Federated Hermes, Inc.

[2] Federated Hermes manages over $300 billion in U.S. registered money market fund assets and over $500 billion in cash management products as of March 31, 2023. Federated Hermes provides comprehensive investment management to more than 8,400 institutions and intermediaries including corporations, government entities, insurance companies, foundations and endowments, banks and broker/dealers.

[3] https://www.sec.gov/rules/proposed/2021/ic-34441.pdf Release No. IC-34441.

(3) preserve the proper role of MMF boards to act in the best interests of shareholders and resolve potential conflicts of interest; (4) are far less costly to implement than swing pricing; (5) could be implemented by the MMF board based on a combination of both public and non-public data; and (6) are less easily gamed by first-movers because there is not a fixed triggering event.

Game theory analysis of the decision process of independent directors concludes that: when a MMF is at the point where meeting redemptions would reduce the fund NAV, and entail material dilution for remaining shareholders, the independent directors' optimal strategy is to implement a liquidity fee. Failing to do so would entail significant risk and potential cost to the directors without any compensating benefit as a result of there being a fixed fee for their services. Moreover, independent directors typically are advised by their own independent counsel on these and other matters, further reducing the likelihood that they would fail to act in the best interest of shareholders.

Under the assumption that there are other similarly situated MMFs, the independent directors are motivated to "do the right thing" and be first-movers in imposing a liquidity fee. The reason is that being "second" could entail a run on the fund (by shareholders anticipating that the fund is in similar circumstances as the first – mover fund and seek to avoid a fee), at which point the fee would then be implemented before redemption proceeds are distributed.[4] But being a "second-mover" also entails significant risk for the directors.[5]

In general, to minimize the risk of a run, shareholders must understand that the MMF's disclosed liquidity fee policy will not permit redemptions having the effect of a reduction in fund NAV that materially dilutes remaining shareholders. 1940 Act funds already have the requirement to establish policies and procedures reasonably designed to prevent material dilution or other unfair results to shareholders. The proposed liquidity fee policy should be disclosed to shareholders and should be stated as a requirement of Rule 2a-7. This would further insure timely action by MMF directors.

I. The Disadvantages of Swing Pricing as Proposed

Federated Hermes has already provided detailed comments opposing swing pricing as proposed [6]; and we will not repeat all of those points here. However, we summarize below the main points that are dispositive of the issue.

1. The Release justified swing pricing primarily on the basis of investor protection.

If the purported harm that swing pricing would cure existed, then we should observe a systematic decline in MMF NAVs as net redemptions in excess of 4% of AUM occur. In fact, the data does not support this supposition. In our view, this lack of observed impact on fund NAVs due to net redemptions is a result of the success of both Know Your Customer practices, that the Commission has championed over many years, and prudent liquidity management by investment professionals. Through experience with client liquidity practices over time, MMF managers anticipate periods of high redemptions, typically related to corporate actions such as payroll or tax payments, etc, and maintain ample liquidity in advance of these withdrawals. In other circumstances, when a significant unpredicted redemption occurs, the MMF does not sell a pro-rata slice of the fund on the redemption date as the Release imagines. Instead, selected liquid securities are

[4] Failing to impose a liquidity fee at this point would subject the directors to the same significant risks referenced above.
[5] For instance, if shareholders are not allowed to rescind redemptions, they would be subject to an unanticipated fee.
[6] Federated Hermes Comment Letter II dated April 11, 2022. *Available at* https://www.sec.gov/comments/s7-22-21/s72221-20123456-279701.pdf.

used to meet redemptions and the fund is rebalanced to a normal allocation over the ensuing days using internal and external cash flows.

2. **Swing Pricing as proposed (including the hard close) cannot work without costly changes to infrastructure that the industry is unlikely to undertake and would harm investors.**

Because a large volume of shareholder activity is transmitted through the NSCC, the advisor does not have adequate information to determine net flows and the swing factor at the time of the share purchase and redemption cut-off. Implementing a "hard close" would entail significant reworking of industry plumbing. Upon inquiry, none of our omnibus clients would commit to implementing the necessary changes. Given that we are in a world where many omnibus clients put retail customer cash in insured bank deposit products and keep most of the yield pick-up over the lowest deposit rates, it is unrealistic to think that they would spend significant amounts to help clients earn the spread of prime funds over government funds. Thus, the changes would not be made, just as they were not made after Rule 22c-1 became effective (and swing pricing was allowed by not required). Moreover, the new investment uncertainties associated with mandatory swing pricing will further reduce the utility of these MMFs to investors; and would likely lead to an exodus from these funds as was seen when the 2014 reforms became effective in 2016.

3. **Swing Pricing as proposed cannot be justified by any reasonably constructed cost/benefit analysis.**

While not delivering the purported benefit, but having significant costs, swing pricing as proposed is not cost/benefit justified. However, the Release also appeared to contain an additional motivation on which public comment was not solicited: a reduction in systemic risk by reducing potential redemptions in a financial or liquidity crisis. FSOC appears to provide this motivation, but it resorts to false or exaggerated claims regarding effect of redemptions from MMFs to pressure the SEC to take action at the expense of its own statutory mandate:

> As described in the Overview of Recent Events and Potential Reform Options for Money Market Funds released by the President's Working Group on Financial Markets in December 2020, significant outflows from MMFs during the early stages of the COVID-19 pandemic ***destabilized short-term funding markets*** [emphasis added]. As in 2008, taxpayer-backed government intervention was necessary to support MMFs and short-term funding markets more broadly and to restore market functioning. These events underscored that MMFs have structural vulnerabilities that can create or transmit stress to short-term funding markets.
>
> The SEC recently proposed reforms that would increase the minimum liquidity requirements for MMFs, require some MMFs to adopt swing pricing, and remove MMFs' ability to impose liquidity fees and redemption gates when funds fall below certain liquidity thresholds. These measures should help reduce the financial stability risks posed by MMFs. The Council supports the SEC's efforts to reform MMFs and strengthen short-term funding markets. [7]

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[7] https://home.treasury.gov/news/press-releases/jy0587 (citing https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf [lnks.gd]). In fact, the text in the President's Working Group Report ("Report") to which FSOC refers states: "MMF sectors faced significant outflows and increasingly illiquid markets for the funds' assets. As a result, prime and tax-exempt MMFs experienced, and began to contribute to, general stress in short-term funding markets in March 2020." Report at 3. Similarly, the Report continues: "Pricing and liquidity concerns at MMFs were driven by, and began to contribute to, these market stresses. Widening spreads in short-term funding markets put downward pressure on the prices of assets in prime MMFs' portfolios, and ***redemptions from MMFs likely contributed to stress in these markets,*** [emphasis added] as prime funds reduced their CP holdings disproportionately compared to other holders." Report at 11. Thus FSOC's allegation regarding the impact of MMFs intentionally overstates the Report's findings and amounts to propaganda. The Commission itself does not engage in

Yet the economic analysis of section III.C.4 on the costs and benefits of swing pricing makes no reference to systemic risk. The Commission is then forced to adopt the premise that swing pricing would have the effect of dissuading redemptions – an objective quite different from investor protection per se:

> We do not agree that, as some commenters suggested, a swing pricing requirement would encourage investors to pre-emptively redeem and seek a first-mover advantage. Investors do not necessarily know whether the fund's flows during any given pricing period will trigger swing pricing or, if so, the size of the swing factor for that period. In addition, redeeming investors would bear the cost of liquidity under the proposed rule even when net redemptions are small, meaning that there would not be a clear advantage to redeeming earlier versus later.[8]

We disagree with this conclusion. Any mandatory fee that can be anticipated by investors will be gamed by first – movers in hopes of avoiding the fee (for instance, when investors can anticipate large redemptions due to payroll payments, tax dates, quarter ends, etc.) Crisis circumstances will not alter this dynamic and are more likely to accelerate it in any "Dash for Cash".[9] It should be recalled that the 2014 amendments to Rule 2a-7 tied board consideration of fees and gates to Weekly Liquid Asset ("WLA ") levels; and that, MMF managers recognized, as did SEC Commissioner Kara Stein when she voted against the 2014 amendments, the linkage of fees and gates and WLAs would act as a trigger for redemptions. Writing on behalf of the regional Federal Reserve Bank presidents, Eric Rosengren had arrived at the identical conclusion.

> Stand-by liquidity fees and temporary redemption gates do not meaningfully address the risks to financial stability posed by MMMFs. This option does not eliminate run risk as investors could have an incentive to redeem before their fund breaches the WLA threshold …[10]

With regard to the proposed swing pricing, the Office of Financial Research ("OFR") 2022 Annual Report comes to a similar conclusion:

> While the proposed rules bolster liquidity and shift the liquidity costs of redemptions to redeeming investors, the proposals may not discourage outflows in the tail scenarios that prompted the proposed rules. … swing pricing may not avert run risk if investors preemptively redeem to benefit from disposing of their shares at the initial net asset value (NAV). [11]

These analyses and the experience of March 2020 amply support the Release's proposal to remove the linkage of weekly liquid assets and mandatory board action – and argue against any other mandatory board actions that investors can attempt to front – run.

II. Discretionary Liquidity Fees Are A Realistic Alternative To Swing Pricing

Unlike a swing pricing regime that: (1) is imposed daily based on redemption volumes (or predicted redemption volumes); and (2) requires more infrastructure investment, discretionary liquidity fees need not be continuously imposed and can be tailored to the market circumstances when they are required. For

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these falsehoods: "**…**where money market funds were able to sell commercial paper during this period, increased selling activity from institutional prime funds may have contributed to stress in these markets …" Release at 23 – 25.

[8] Release at 58.

[9] Also see *Supra* note 6 at 7 – 9.

[10] See https://www.sec.gov/comments/s7-03-13/s70313-111.pdf at 6-7.

[11] This statement presumes that shareholders will attempt to redeem before others in order to avoid a price swing. See https://www.financialresearch.gov/annual-reports/files/OFR-Annual-Report-2022.pdf at 69

instance, they can be imposed when markets exhibit stress and bid/ask spreads are wider than normal – (targeting any potential material dilution). They also have a smaller infrastructure lift.

1. **Mandatory liquidity fees have significant disadvantages**

If swing pricing is not adopted by the Commission, it appears that the preferred alternative would be mandatory liquidity fees. Mandatory fees have a significant disadvantage: investors will know, or eventually determine, the triggering event.[12] Pre-emptive runs become inevitable when first – movers anticipate the triggering event and redeem.

By contrast, discretionary liquidity fees would fees would be triggered by a combination of both public and non-public information known only to MMF directors, and not the public. This would include the ability of the adviser to meet fund redemptions without impacting the fund's shadow NAV. However, the Commission appears to doubt the integrity of independent MMF boards to act in the best interest of shareholders or the funds themselves:

> … even if all institutional money market funds recognized the benefits of charging redeeming investors for liquidity costs, we believe there is a collective action problem in which no fund would want to be the first to adopt such an approach. We believe past experience with the existing liquidity fee regime supports a mandatory approach to dilution mitigation for institutional funds.[13]

This argument is highly conjectural. Moreover, the "past experience" evidently refers to the failure of any MMFs to implement a liquidity fee in March 2020.

> For example, while money market funds were permitted to impose liquidity fees on redeeming investors under Rule 2a-7 if a fund had less than 30% of its assets invested in weekly liquid assets ***no money market fund imposed such fees during the March 2020 market turmoil*** [emphasis added]. [14]

Yet just 10 pages earlier, the Release provides:

> In March 2020, no money market funds imposed liquidity fees, despite the fact that many institutional prime and tax-exempt funds were experiencing significant outflows and some were selling portfolio holdings to meet redemptions, sometimes at a significant loss due to wider spreads given liquidity conditions in the market at that time. ***In part, this is due to the design of the current rule, given that only one institutional prime fund had weekly liquid assets below the 30% threshold and could have therefore imposed a liquidity fee*** [emphasis added]. [15]

Exhibit 1 demonstrates that this particular MMF's weekly liquidity exceeded 30% on the following day by action of the adviser. Moreover, the fact that "***some*** were selling portfolio holdings to meet redemptions, ***sometimes*** at a significant loss due to wider spreads given liquidity conditions in the market at that time" was a likely consequence of the desire to avoid the effective 30% WLA floor (that if pierced could instigate larger redemptions), that has now been eliminated in the current rule proposal.[16]

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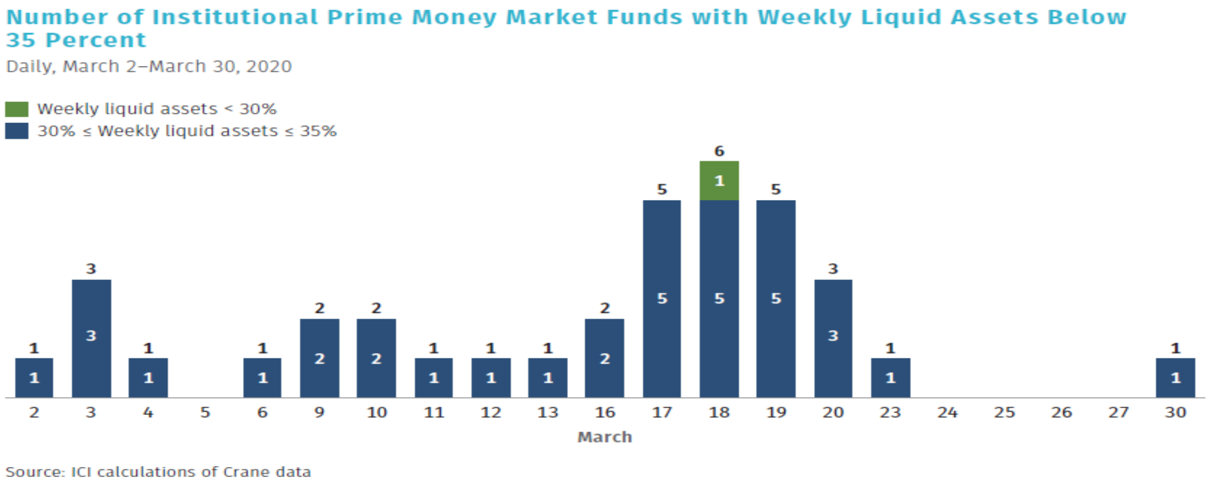
[12] Assuming it is based on public information or estimable private information.
[13] Release at 47.
[14] *Ibid.* It should be noted that prior to the 2014 Rule 2a-7 amendments, MMFs would periodically dip below 30% WLA without adverse consequences for redemptions, thus illustrating this design flaw that turned a liquidity buffer into a hard floor.
[15] Release at 36 – 37.
[16] Also see *Supra* note 6 at 25 – 26.

Exhibit 1 [17]



2. Independent MMF directors would timely implement a discretionary liquidity fee

Basing an entire regulatory regime on that one data point is casual empiricism at best.[18] More fundamentally, if this underlying view regarding fund directors is reasonably extrapolated to other similar board decisions, then the Commission is faced with justifying the entire governance structure of 1940 Act funds – after a history of reliance on fund boards to timely fulfill their fiduciary duty, including prompt action.[19] Federated Hermes disagrees with these conclusions in every respect and the SEC should not further enshrine doubts about the integrity of fund boards in Rule 2a-7 or any other rule amendments.

Beyond setting a damaging precedent, we believe that the Commission's argument regarding a "collective action problem" is flawed. Just as banking regulators have come to the conclusion that, under certain conditions, "running" is the optimal strategy for bank deposit holders or MMF shareholders, a similar analysis can be performed for MMF trustees to determine whether or not they would timely implement a discretionary fee. That is, the analysis can and should be rigorous and not conjectural.

Federated Hermes believes that the Commission's conclusion fails to differentiate between the interests of the independent directors and what the Commission perceives to be the interests of the adviser. When this distinction is correctly taken into account, and "risk/return" attitudes of the independent trustees are critically evaluated, the optimal strategy of the board is to make a timely decision to impose a liquidity fee.

A rigorous paper on this subject by Treasury Strategies, Inc. ("Treasury Strategies") has already been provided to the Commission in support of the finding that the optimal decision of a MMF board is to take action to prevent a run on the fund.[20] The conclusion of that analysis is that shareholders would not run if they understood that there was no first – mover advantage. This would require an understanding that the

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[17] https://www.sec.gov/comments/credit-market-interconnectedness/cll10-8026117-225527.pdf at 31.
Exhibit 1 illustrates institutional prime MMF WLA levels in March of 2020. The vast majority of the 41 prime institutional MMFs in the marketplace had weekly liquid assets in excess of 35% throughout March. Indicated in blue are the number of funds with WLA between 30% and 35%. Only one MMF, on March 18th, had a WLA below 30%, and its value was 27.4%.

[18] It should also be recalled that the fatal flaw in the 2014 amendments was not the discretionary authority given to MMF boards; it was the improper linkage which transformed the 30% WLAs from a liquidity buffer into a hard floor.

[19] See for example Rule 2a-7(g)(1)(i)(B) "*Prompt consideration of deviation*"

[20] Treasury Strategies,Inc., "Proposed Money Market Mutual Fund Regulations: A Game Theory Assessment", March 31, 2014. *Available at* https://www.sec.gov/comments/s7-03-13/s70313-332.pdf

fund would implement a liquidity fee before allowing redemptions that would have the effect of a material reduction in the fund's NAV. In the present case, it is also relevant to understand that MMF directors have risk/return preferences that are as prescribed in behavioral economics. [21, 22]

We find that, in the scenario of a MMF being at the point of material reduction in NAV, if a fund sold securities to meet redemptions, the optimal Nash Equilibrium strategy [23] for independent board directors is to timely implement a discretionary liquidity fee. Consequently, the Commission's conjecture referenced above is a flawed basis for determining that either a mandatory liquidity fee or mandatory swing pricing is required to protect shareholders and the fund.

3. Game theory demonstrates that directors would timely implement a discretionary liquidity fee

To demonstrate our analysis, assume that there are N (N $\geq$ 5) similar MMFs in the market, and that an individual MMF board believes that at least several other MMFs own similar securities, subject to the same pricing/liquidity conditions; and that all MMFs have institutional investors with similar risk/reward preferences. In this scenario, the defining moment for any MMF is the point at which selling securities (or using daily liquidity) to fund redemptions would cause a decline in the fund's NAV that imposes a material dilution on remaining shareholders. If during this period, a MMF permitted redemptions that reduced the fund NAV and imposed material dilution, there would be severe penalties for the directors including SEC enforcement actions (particularly if failing to impose a liquidity fee in this circumstance is an explicit violation of Rule 2a-7), shareholder litigation, and severe reputational harm. The role of independent counsel, that is retained by the independent directors, includes advising them on precisely these and other matters.

We now ask: even if the MMF did not process redemptions in this circumstance, would the independent directors proactively announce that a liquidity fee is in effect (before a potential surge in redemptions)? If a MMF were not to announce a liquidity fee under these conditions, the independent directors face the likelihood that another similar fund will. In this case, other investors are likely to assume that other MMFs face similar conditions, contagion would likely develop and a run on the funds not announcing fees could ensue. These funds would be forced to be "second-movers" and impose liquidity fees before redemptions are processed.[24, 25] The Commission may find the scenario of second-movers to be problematic:

> The proposed amendments are intended to reduce run risk, mitigate the liquidity externalities transacting investors impose on non-transacting investors, and enhance the resilience of money market funds. … The proposed amendments may also reduce the probability that runs would result in future government interventions, ….[26]

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[21] For instance, as in the landmark "Prospect Theory" and related work for which Daniel Kahneman won the Nobel Prize in economics: Daniel Kahneman and Amos Tversky, "Prospect Theory: An Analysis of Decision under Risk", Econometrica ,Vol. 47, No. 2 (Mar., 1979), pp. 263-292, *Available at* https://doi.org/10.2307/1914185

[22] Moreover, these may differ from those of the adviser, which are implied by the Release to be served by having a larger fund or to not admit any concerns.

[23] A Nash Equilibrium optimal strategy is characterized by the condition that a decision-maker will adopt that strategy regardless of the strategies of adopted by other decision-makers, even if known to the decision-maker.

[24] That is, they would be in the circumstance of having to impose a liquidity fee on a potentially large volume of redemptions. This possibility would likely need to be disclosed as a risk within the fund's liquidity fee policies.

[25] Of course, it is possible that some well-run funds would not be in this same condition and would not face a run; or could experience elevated redemptions due to contagion effects without the need for a fee or gate. In this instance, the fund should proactively communicate with shareholders as to their liquidity position and why such action is not required.

[26] Release at 265.

In this case, while not imposing dilution on remaining shareholders, being a second-mover subjects the trustees and the adviser to significant adverse investor reaction for not having declared a discretionary fee before a large volume of redemption orders were submitted.[27] The MMF, the independent trustees and the adviser are then subject to lesser, but nonetheless significant litigation and reputational harm by their actions. Under the risk/return preferences of behavioral economics, the penalties of not proactively imposing a fee far outweigh the benefits to independent directors who earn a fixed fee for their services and do not enjoy the economic benefits of a larger fund. Consequently, it is optimal for the board to be a first – mover in implementing a liquidity fee. Since this analysis is performed by every MMF under the assumed circumstances, it will be optimal for all MMFs, at the point of incurring material market impact costs to fund redemptions, to also implement a liquidity fee. Hence, all boards whose MMFs are in this circumstance are motivated to be first – movers.

Thus far we have discussed the motivation and behavior of the MMF's independent directors. But what is in the mind of the shareholder? To reduce the likelihood of a run, we are returned to the conclusion of Treasury Strategies: shareholders must know in advance that a liquidity fee will be assessed before redemptions could materially harm remaining shareholders.[28] Consequently, this must be a publicly disclosed policy of the MMF and a requirement of Rule 2a-7.

If despite the inability to know with certainty, an individual MMF board believed that all other MMFs would not impose liquidity fees, that fund is still in the assumed circumstance of incurring material dilution for remaining shareholders to fund redemptions. The related penalties to fund directors still apply for any ensuing harm to shareholders. Consequently, the individual MMF board in that circumstance would still determine to impose a liquidity fee. In this instance, the MMF is not motivated to be a "first – mover", but that strategy is optimal nonetheless. Thus, whether other MMFs are expected to implement a fee or not, it is still optimal for the individual fund to timely do so. Because the independent directors' optimal strategy is to impose a fee regardless of what other MMFs do, this strategy represents a Nash Equilibrium for that fund.

Skeptics of this argument should consider this: if the independent directors failed to impose a liquidity fee in the above scenario, particularly if they disregard the advice of their independent counsel, then by construction the MMF will be selling securities or otherwise funding redemptions in a manner that materially reduces the fund's NAV.[29] This will be captured in a clear and unambiguous evidence trail that leads directly back to the independent directors – one that is subject to immediate examination/enforcement by the SEC and litigation by the plaintiffs' bar. Behavioral economics and common sense dictate that: trustees, who are paid a fixed fee for their services, and who generally retain their own independent counsel that advises independent directors on their legal responsibilities and related risks, would impose a fee rather than risk the inevitable litigation and destroyed reputation that failure to act would entail.[30]

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[27] If investors are unable to rescind their redemption orders, then they are subject to an unanticipated liquidity fee, even though this scenario would be disclosed in the MMF prospectus.

[28] *Supra* note 20.

[29] Security sales, or otherwise using daily liquidity to meet redemptions in a manner that reduces the shadow NAV of the fund, would be known to the adviser before the event and should be a mandated communication to fund directors. Moreover, the SEC can examine funds' policies and procedures soon after a final rule that establishes these requirements.

[30] Throughout their 50 year history, there has been one case where MMF independent directors were subject to an SEC enforcement action for the failure to fulfill their fiduciary duty. This involved a fund owning ineligible investments in 1994 (structured securities with embedded derivatives that did not present, among other things, "minimal risk") that materially declined in value when the Federal Reserve increased interest rates that year. However, for a period of time, the MMF continued to value these instruments at amortized cost. This case is a well-known reminder that the SEC will enforce the requirements on MMF directors to fulfill their fiduciary duties; and a significant

III. The Need For Discretionary Gates To Complement Discretionary Liquidity Fees

We have thus far focused on discretionary liquidity fees: if processing net redemptions would cause a reduction in fund NAV (that represents a material dilution to remaining shareholders), then MMF boards should timely implement a liquidity fee on the redeeming shareholders. We have argued that independent MMF directors are highly motivated to timely apply a discretionary fee.

However, there are circumstances when a discretionary liquidity fee will not be a feasible solution due to market or other environmental factors. The notable recent example is the freezing of short term markets during March 2020. Relatively few market transactions occurred in the money markets due to the reduced intermediation provided by broker/dealers and the contagion resulting from government mandated shutting down of economies around the world. In particular, the MMF adviser, directors and regulators seek to avoid "fire sales" of MMF securities. Federated Hermes believes that selling high quality short term securities held by the fund with a transaction cost in excess of 2% would constitute a fire sale. Swing pricing as proposed in the Release is silent on this topic, as if future market liquidity events or financial crises will never occur. In such cases, gating a MMF may be the only realistic option available to a fund board when faced with significant redemptions. There can be other circumstances requiring a gate as well. For instance, if there were a loss of critical infrastructure necessary to process redemptions, then a gate would be appropriate. This could occur either on a systemic basis or be limited to a single fund.[31] These are force majeure scenarios that can overtake one or more MMFs for which no form of liquidity fee or swing pricing can provide a solution.

In this regard, the Release was issued in the aftermath of the March 2020 market events and was endorsed by FSOC as a means of reducing systemic risk. In particular, the Release primarily justifies swing pricing on the basis of investor protection, but also claims systemic risk benefits: it first argues that swing pricing would not encourage first – movers [32]; but goes on to the stronger claim that swing pricing would actually discourage redemptions:

> Rather than encourage pre-emptive redemptions, we believe the proposed swing pricing requirement would discourage excessive redemptions, particularly in times of stress, by requiring redeeming investors to bear liquidity costs. For example, investors may determine not to redeem during stress periods, or to redeem smaller amounts over a longer period of time, which could help reduce concentrated redemptions and associated liquidity pressures that institutional funds can face in times of stress. [33]

This claim appears to suggest that swing pricing could have prevented or reduced the need for Fed action in March 2020 to implement the MMLF, as one of an array of programs designed to address the ongoing liquidity crisis. FSOC's endorsement appears to agree.[34]

Federated Hermes strongly supports reforms that improve the resiliency of MMFs, without impairing their utility to investors. However, in section I.3 of this letter we have already stated our disagreement with the

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precedent in the minds of independent legal counsel to MMF boards. See https://www.sec.gov/files/litigation/admin/33-7626.txt

[31] An event unique to an individual MMF could be a non-systemic business continuity event or a credit event.

[32] *Supra* note 3 at 58.

[33] *Ibid*.

[34] *Supra* note 7. In fact, this inference is incorrect. The improper linkage of 30% WLA and board action was a primary factor behind the redemptions faced by institutional prime and tax exempt MMFs in March 2020.

premise that swing pricing would deter redemptions from institutional prime and tax exempt MMFs; and particularly in crisis conditions such as in March 2020, when a "Dash for Cash" dynamic is at play.[35]

More generally, while FSOC seeks to work with primary regulators to impose macroprudential regulation on financial activities or entities (to protect the financial system from market events that can adversely impact those entities)[36], the March/April 2023 banking crisis [37] makes it apparent that there are limits to what such regulation can achieve.[38] The Fed and FDIC action with respect to the affected banks was to essentially "gate" deposit outflows until the banks were resolved; and the Fed implemented the system-wide Bank Term Funding Program (and further temporary liberalization of discount window terms) to assist those banks and prevent the crises from spreading.[39]

By analogy, severe market events can overwhelm MMF regulation, such as discretionary liquidity fees, that are designed for conditions when markets are illiquid but still functioning [40]; and gates can be necessary, for example, to protect shareholders in these cases while banking regulators address the root cause market issues as part of their financial stability mandate.

Federated Hermes has already submitted a comment letter and companion paper [41] that describe and encourage use of the Fed discount window for addressing market liquidity crises – without the need for emergency facilities such as the MMLF. We are also providing an additional comment letter and updated paper [42] that address the potential misunderstanding within the Commission regarding whether the Fed discount window can be used in the manner proposed. That letter documents the fact that the discount window was precisely intended for this purpose by the Federal Reserve Act of 1913 [43] – and today – as a standby facility to, among other things, restore liquidity in the short term markets.

IV. Enhanced Discretionary Liquidity Fee / Gate Procedures And Stress Testing

In order for MMF directors to fulfill their fiduciary obligation to shareholders, the fund board must promptly receive information from the adviser that is sufficient to meet the requirement of a timely imposition of a

[35] The OFR appears to concur. See *Supra* note 11.

[36] FSOC's claim that "significant outflows from MMFs during the early stages of the COVID-19 pandemic destabilized short-term funding markets" (*Supra* note 7) and the Commission's claim that swing pricing would discourage redemptions (*Supra* note 3 at 58) together imply a rationale that the Release constitutes macroprudential regulation that would prevent the need for Fed intervention, such as the MMLF.

[37] There are also impending local and regional bank credit risks that are likely to arise from soured commercial real estate loans in addition to the effects of the rapid increase in interest rates since the start of the current Fed rate hike cycle. Secretary Yellen has recently predicted weaker bank earnings and increased bank merger activity. See https://www.wsj.com/articles/yellen-says-more-bank-mergers-likely-this-year-96f69e73?mod=economy_lead_pos2

[38] In particular, we note the OFR's doubt that swing pricing would have prevented redemptions in March 2020 (See *Supra* note 11) and FSOC's recently proposed guidance (See https://home.treasury.gov/system/files/261/FSOC-2023-Proposed-Nonbanks-Guidance.pdf) that appears to set the stage for requiring heightened Fed supervision of entities such as MMFs or their advisers notwithstanding SEC rulemaking.

[39] https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm

[40] The scope of conditions that regulation can anticipate is primarily determined through cost/benefit assessments required under administrative law. As a result, burdensome regulation intended to address more extreme scenarios will typically fail a cost/benefit test.

[41] [1]Federated Hermes Supplemental Comment Letter II dated April 18, 2023 and [2] A companion paper: Granito, Michal R., *Liquidity Crises and the Fed: The Need for Standing Facilities as a First Line of Defense Against Market Liquidity Events*, April 1, 2023 *Available at* https://www.sec.gov/comments/s7-22-21/s72221-20164400-334257.pdf

[42] [1] Federated Hermes July 2023 Comment Letter I dated July 3, 2023 and [2] Granito (July 1, 2023) *Liquidity Crises and the Fed* (abbreviated title). Available from Federated Hermes, Inc.

[43] *Available at* https://fraser.stlouisfed.org/title/federal-reserve-act-966

liquidity fee or gate in order to prevent material dilution or other unfair result for remaining shareholders.[44] In a previous comment letter [45], Federated Hermes suggested a form of amendment to current Rule 2a-7 (the "Current Rule") [46] that: (1) provides for the implementation of liquidity fees or temporary gates; (2) requires reporting the basis for applying such fee or gate to the SEC; and (3) sets forth key elements that should be incorporated into an enhanced liquidity management procedure. Compared to the Current Rule, these procedures, and related 2a-7 amendments, should entail an increased focus on transaction costs and the potential need for frequent board reporting in stressed market conditions. Procedures, and related amendments to Rule 2a-7, to ensure a prompt determination to impose a liquidity fee or gate by MMF boards should require that, in times of stress, MMF advisers provide MMF boards with readily available information on:

- **Portfolio composition and trading activity including:**
    - Daily and Weekly liquid assets and related trends
    - Sub-asset class composition and related trends
    - Fund NAV and related trends
- **Current and expected market conditions including:**
    - General liquidity conditions in the differing sub-asset classes held by the fund
    - Trends and anticipated/potential changes in credit spreads for such sub-asset classes
    - Estimated transaction costs in each such sub-asset class for varying trade sizes
- **Shareholder activity including:**
    - Recent net redemptions and related trends
    - Shareholder transaction intentions as developed through KYC outreach
    - Potential redemption scenarios
- **Stress Test results including:**
    - The currently required stress test results
    - Stress tests illustrating the combined impact on fund NAV of:
        - Anticipated and potential net redemptions of varying % of AUM magnitudes and;
        - Varying transaction cost levels associated with expected portfolio activity [47]
        - In stressed markets, such Stress Test results to be provided on a one or same day horizon (as necessary)[48]

[44] Other unfair results could mean, for example, a fund portfolio that has a materially reduced liquidity, credit or diversification profile compared with the profile before meeting anticipated net redemptions.
[45] See Federated Hermes comment letter dated September 13, 2021 ("Third Federated Hermes Comment Letter"), *available at* https://www.sec.gov/comments/s7-01-21/s70121-9232417-250529.pdf
[46] https://www.sec.gov/rules/final/2014/33-9616.pdf.
[47] Amendments to the Current Rule must keep in place requirements that the portfolio activity necessary to fund net redemptions do not (materially) adversely impact portfolio composition for remaining shareholders.
[48] Amendments to the Current Rule should contemplate that, in stressed market conditions with significant (actual or potential) net redemptions, the fund adviser may need to be be reporting stress test results with high frequency, including daily.

- “Any additional combinations of events that the adviser deems relevant” [49]
    - Stress tests that focus on particular sub-asset classes that may be impacted
    - Stress tests that are oriented to the potentially unique circumstances of current stressed market conditions

Alternative liquidity sources:

- Availability
- Costs

- **Adviser assessment regarding the imposition of a liquidity fee or gate**

    - The MMF adviser is already required to provide the fund board an assessment of the ability of the MMF to withstand likely future market or shareholder activity events, among other things. [50]

    - Liquidity fee policies and procedures should require that, particularly in stressed market conditions, the adviser provide directors with an analysis, supported by stress test results, that illustrates the likely impact on the fund NAV and portfolio composition of processing varying levels of net redemptions through portfolio activity (using security sales or daily liquidity) having transaction costs that are reasonably expected to be in incurred in current market conditions.

    - Such analyses must be provided at such time of day, in such frequency, and in such timely manner as are dictated by the fund board’s obligation to impose a discretionary liquidity fee or gate reasonably designed to prevent remaining shareholders from experiencing material dilution or other unfair results.

    - Gate policies and procedures should require the same board reporting as for liquidity fees; and in addition require:

        - Data and analysis provided by the adviser regarding current market conditions with particular reference to whether:

            - Such conditions are likely to persist or worsen

            - Short term markets of relevance to the MMF have “stopped functioning”; which is interpreted to mean the point that liquidity has deteriorated to the extent that current or potential redemptions cannot be processed through security sales with reasonable liquidity discounts of up to a maximum of 2%.

        - Reporting on the existence of any market or non-market interruption having already occurred, or that is likely to occur, that prevents redemptions from being processed, such as market closure, an material adverse credit event, or a systemic (or fund-specific) loss of critical infrastructure necessary to process redemptions.

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[49] Current Rule at 836.

[50] Current Rule 2a-7 requires that the MMF board be provided with “An assessment by the fund’s adviser of the fund’s ability to withstand the events (and concurrent occurrences of those events) that are reasonably likely to occur within the following year, including such information as may reasonably be necessary for the board of directors to evaluate the stress testing conducted by the adviser and the results of the testing. The fund adviser must include a summary of the significant assumptions made when performing the stress tests.” Current Rule at 836 – 837.

V. Conclusions

MMFs are one of the SEC's greatest innovations and one of the best financial products ever created for investors. MMFs play a critical role for stakeholders, including shareholders, issuers, and those that benefit from the deeper and more liquid short-term funding markets that MMFs make possible. As the Investment Company Institute ("ICI") rightly noted in its comment letter on the Proposal[51], MMFs are critically important for: (1) over 50 million retail investors, as well as corporations, municipalities, and other institutional investors, who rely on the MMF industry as a low cost, efficient, transparent, cash management investment vehicle that offers market-based rates of return; and (2) governments (federal, state and local), businesses, and financial institutions who utilize MMFs as an important source of financing.

The analysis we have provided demonstrates that a discretionary liquidity fee or gate is strongly preferred to either mandatory swing pricing or a mandatory liquidity fee. Mandatory swing pricing does not achieve its stated objective of protecting investors from transaction costs, is unnecessary in all but extreme market conditions, and is the most costly to implement. Mandatory liquidity fees based on a defined trigger can be implemented when needed, but would likely be gamed by first – movers who work to determine proximity to the trigger. This has been amply demonstrated when the trigger is 30% WLA and its current level is published. Moreover, in the Commission's rendition, mandatory fees are predicated on the apparent doubt that independent directors will act in the best interests of shareholders and the funds – a stunning proposition that undermines the SEC's approach to shareholder protection; and invites citation in future litigation as evidence of SEC doubt regarding the effectiveness of fund directors in fulfilling their fiduciary obligations to shareholders.

Discretionary liquidity fees would typically be based on both public and non-public data. In our illustration, this was the point at which processing net redemptions would cause a material decline in the MMF's NAV. In some instances, investors may try to predict the proximity to an assumed trigger. But this is by no means reliable. For instance, in a credit crisis, corporate spreads will typically widen, but the general level of rates will typically be lower. So the effect on the NAV resulting from security sales to meet redemptions is not easily predicted. As part of a final rule allowing discretionary liquidity fees, the SEC could articulate the anti-dilution requirement in Rule 2a – 7 and examine the fund's related disclosures, policies and procedures to be confident that future outcomes will both protect investors and diminish first – mover opportunities.

Therefore, our recommendation is to remove the mandatory linkage of WLA and board action and to permit discretionary liquidity fees or gates to prevent material dilution to remaining shareholders. Moreover, disclosure should clearly state the MMF's policy for applying discretionary fees or gates. No other aspect of the Proposal should be adopted, as they will be harmful to both investors and issuers. Investor returns will be reduced and systemic risk will increase, as institutions increase direct holdings of commercial paper (even as the CP market again shrinks in aggregate), use unregistered vehicles or uninsured bank deposits – that will increase systemic risk. As such, they conflict with the statutory mandate of the SEC to promote capital formation, efficiency and competition. In addition, the other aspects of the Proposal are based on conjecture or are contrary to empirical evidence and are not supported by any meaningful cost/benefit analysis. It therefore would be arbitrary and capricious for the SEC to adopt the other aspects of the Proposal.

Federated Hermes has managed MMFs since their inception and remains a leader in the management and distribution of MMFs around the globe. We continue to strongly support reforms that improve the resiliency of these fund, while opposing unnecessary measures that impair the utility of these funds to investors and

[51] Comment Letter of Investment Company Institute Re: Money Market Fund Reforms dated April 11, 2022, *available at* https://www.sec.gov/comments/s7-22-21/s72221-20123254-279522.pdf

issuers. We appreciate your continued consideration of our views on this important subject and look forward to working with the Commission to enhance the safety and resilience of MMFs. We welcome any questions you may have and are happy to meet to discuss any matters in further detail at your convenience.

Very truly yours,

/s/ Michael R. Granito

Michael R. Granito
Chief Risk Officer

/s/ Gregory Dulski

Gregory Dulski
Chief Regulatory Officer and Head of Governmental Affairs