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“Preemptive Runs” and Money Market Fund Gates and Fees: Theory Meets Practice

By Sean Collins and Chris Plantier

A recent post on the blog of the Federal Reserve Bank of New York discusses the possibility that new rules by the Securities and Exchange Commission (SEC) allowing money market funds to temporarily impose fees or gates during times of market instability could increase the risk of preemptive runs on such funds during times of stress, rather than helping to limit destabilizing withdrawals, as the SEC intended. Although the Fed’s blog post provides an interesting theoretical insight, the discussion brings to mind the quote by Yogi Berra that “In theory, there is no difference between theory and practice. But in practice, there is.”

In “Gates, Fees, and Preemptive Runs,” the authors—Fed economists Marco Cipriani, Antoine Martin, Patrick McCabe, and Bruno Parigi—note that the academic literature on banks has traditionally seen “suspension of convertibility” (preventing the exchange of deposits at par for cash) as a means of preventing damaging bank runs. For example, by requiring a bank that cannot meet all depositors’ withdrawals to temporarily close its doors, regulators might prevent further and potentially destabilizing withdrawals.

The authors then compare this to the new SEC rule, which—among other things—allows a money market fund to impose a liquidity fee of up to 2 percent and to “gate” (temporarily suspend) redemptions for up to 10 business days during a 90-day period if the fund’s weekly liquid assets fall below 30 percent of its total assets, and if the fund’s board of directors determines that imposing a fee and/or gate is in the fund’s best interests. In addition, a money market fund will be required to impose a liquidity fee of 1 percent on all redemptions if its weekly liquid assets fall below 10 percent of its total assets, unless the fund’s board determines that this would not be in the best interests of the fund.

Cipriani et al. suggest that this could in theory lead to “preemptive runs” on money market funds because “investors who face potential restrictions on their future access to cash may run when they anticipate such restrictions may be imposed.” Theory and practice differ, however.

In practice, fees and gates are just one aspect of the nuanced package of money market fund reforms that the SEC adopted in July 2014 after long study. Most notably, the reforms require institutional money market funds—the kinds of funds that were most at risk of redemptions during September 2008—to move away from a fixed $1.00 net asset value (NAV) and adopt a floating NAV. All 12 Federal Reserve Bank presidents—including William Dudley, the president of the Federal Reserve Bank of New York—are on the record stating that money market funds are susceptible to runs because they seek to maintain fixed NAVs. If correct, the SEC’s new rule addresses this issue by requiring institutional money market funds to float their NAVs. Thus, by the Fed’s logic, it is unlikely that a money market fund with a floating NAV would need to adopt fees and/or gates. Alternatively, putting this in the language of the Fed’s blog post, requiring a money market fund to float its NAV means that a fund has *already* permanently suspended “convertibility at par”—rendering “suspension of convertibility” through a fee or gate redundant.

In addition, as the SEC pointed out in its rule proposal, gates and fees have in practice “been used successfully in the past by certain non–money market fund cash management pools to stem redemptions during times of stress.” Some hedge funds and European-domiciled mutual funds operating under the Undertakings for Collective Investment in Transferable Securities (UCITS) directives have provisions allowing them to impose gates. These provisions, which are disclosed to investors, have not caused runs. Moreover, since February 2010—when the SEC adopted its first postcrisis reform of money market funds—these funds have had the ability (again, disclosed to investors) to halt shareholder redemptions, albeit with the restriction that a money market fund would then liquidate (i.e., go out of business). This provision has not fostered “preemptive runs” on money market funds.

And, in a final way that practice would differ from theory, money market funds would almost certainly take strong measures to avoid ever having to impose fees or a redemption gate. Investors value money market funds as a cash management tool, and fund managers would work very hard—just as they have always done—to avoid reducing that value.

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