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Money Market Fund Redemption Restrictions Would Drive Investors and Intermediaries Away from Money Market Funds

By Kathleen Joaquin

If you're like most investors, money market funds mean stability, liquidity, and convenience.

Yet, some of these hallmark features could become a thing of the past if the Securities and Exchange Commission (SEC) imposes redemption restrictions on money market funds.

How would these redemption restrictions work?

The SEC's contemplated redemption restrictions would essentially deny investors full use of their cash by escrowing a portion of a shareholder's money market fund account on an ongoing basis. In the unlikely event that the fund breaks the dollar, the restricted shares would then be used to absorb first losses.

These restrictions could be implemented in a variety of ways, but public statements indicate that regulators appear to be focusing on a restricted share balance approach. This approach would require funds and intermediaries to calculate the number of shares that would be restricted in each investor's account on a daily basis. The restrictions would apply to all money market funds and to all investors at all times, under all market conditions.

Proponents of redemption restrictions will tell you that we need these restrictions to prevent or mitigate redemption pressure. They believe redemption restrictions would do this by removing investors' incentives to be the first to redeem.

However, as we've shown in a recent paper, these restrictions would do more harm than good by creating significant operational issues that would restrict or eliminate the usefulness of money market funds in many services that funds, firms, and financial providers extend to investors.

Throughout their 40-year history, investors have benefited from the liquidity, stability, and convenience of money market funds. Individual investors often use money market funds to hold cash temporarily for future purchases, as transaction accounts, and as stable value investments in their retirement or other investment portfolios. Institutional investors—including businesses, state and local governments, securities brokers, and investment managers—use money market funds as a cost-effective way to manage and diversify credit risk, while providing same-day liquidity with market-based yields. These offerings depend on a complex operational infrastructure that allows investors to transact smoothly and efficiently.

The SEC's proposed freeze on investors' assets would require changes to a myriad of systems that extend well beyond those under the control of the funds themselves. Funds, intermediaries, and service providers have developed intricate and complex systems that allow them, on a daily basis, to seamlessly communicate and process significant volumes of money market fund transactions on behalf of investors, often with same-day settlement.

To apply daily redemption restrictions accurately across all investors in money market funds, almost everyone involved in processing money market fund transactions, as well as many institutional investors, would need to undertake intricate and expensive programming and other major, costly system changes.

Our research with investors shows that a large majority of money market fund investors would be likely to eliminate or cut back their use of these funds if restrictions are imposed. Fund complexes, intermediaries, and service providers will be hard-pressed to justify undertaking the significant costs of compliance with restrictions in the face of rapid shrinkage of money market fund assets.

In short, any sort of redemption restriction would not only impair investor liquidity, but would create serious operational issues that would restrict or eliminate the usefulness of money market funds to investors and intermediaries. The total effect would be to drive users away from money market funds, which could in turn disrupt short-term financing for the economy and increase use of less-regulated, less-transparent alternatives.

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