The Systemic Risk of Money Market Funds: Another Approach

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Various federal regulators, including the Securities and Exchange Commission (SEC), appear ready to regulate money market funds further because these funds' susceptibility to runs, analogous to bank runs, is deemed to pose a systemic risk. This article describes why money market funds are perceived as posing a systemic risk and offers an alternative to mitigate this risk that differs from those proposed by the SEC and the President's Working Group on Financial Markets.

Money Market Funds Deemed to Pose Systemic Risk

In 2009, the Treasury Department proposed in its *Financial Regulatory Reform: A New Foundation*,[1] that the President's Working Group on Financial Markets (PWG) prepare a report assessing changes necessary to reduce systemic risk by reducing money market funds susceptibility to runs.[2] In October 2010, the PWG published its study,[3] containing possible reforms, extending beyond those effected by the SEC in February 2010,[4] that the PWG believes could mitigate systemic risk posed by money market funds. The source of money market funds' susceptibility to runs was described in the PWG Report as follows:

> Although the run on MMFs in 2008 is itself unique in the history of the industry, the events of 2008 underscored the susceptibility of MMFs to runs. That susceptibility arises because, when shareholders perceive a risk that a fund will suffer losses, each shareholder has an incentive to redeem shares before other shareholders.
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> Early redeemers are . . . more likely to receive the usual $1 [net asset value] than those who wait.[5]

In November 2010, the SEC issued a request for comment on the reforms proposed in the PWG Report.[6] The SEC's request for comment is not alone. In October 2010, the Financial Stability Oversight Council (Council), established under the Dodd-Frank Act, issued an advance notice of proposed rulemaking (ANPR) inviting public comment on the criteria it should use to identify systemically important nonbank financial companies, which will be made subject to prudential regulation pursuant to the Dodd-Frank Act.[7] Comments on the ANPR were due by November 5, 2010. If the Council determines that a nonbank financial company is systemically significant, that company will be regulated, which may include capital reserve requirements, by the Federal Reserve Board and by other agencies, including the Federal Deposit Insurance Corporation.

Therefore, money market funds may face additional regulation from the SEC, as well as new regulation by federal banking regulators.

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Reframing the Source of Systemic Risk

An alternative interpretation is offered here. Rather than attributing the systemic risk engendered by money market funds susceptibility to runs to the structure of money market funds, the systemic risk could be deemed to arise from institutional shareholders, which can demand liquidity when money market instruments in which money market funds invest are experiencing a period of exceptional illiquidity.

Beginning in the autumn of 2007, money market funds began experiencing difficulties when the problems in the residential mortgage market, for the first time, affected the portion of money market funds' commercial paper holdings that had been issued by special purpose vehicles (SPVs) to fund the SPVs' acquisitions of assets and liquidity requirements. Most SPVs did not have substantial exposure to *sub-prime* mortgages, but investors began to avoid all asset-backed commercial paper.[8]

Investors in non-U.S. Treasury money market funds became concerned that the funds would be unable to maintain a constant $1.00 a share net asset value (NAV), resulting in a redemption run by investors in favor of Treasury-only money market funds (*i.e.*, funds that invested primarily in U.S. Treasury instruments).[9]

Thus, in the week following September 15, 2008 — the day of the Lehman bankruptcy filing and the day before the Reserve Primary Fund broke the buck — investors redeemed approximately $300 billion from non-U.S. Treasury money market funds, much of which was reinvested in Treasury-only money market funds.[10] Most of these redemptions were made by institutional investors,[11] while retail money market funds experienced normal cash flows. Short-term credit markets froze, blocking corporate borrowers access to the short-term private debt markets.

Ultimately, the structure of money market funds, by itself, is not the source of systemic risk associated with those funds. Equally important are institutional investors — the investors that redeemed $300 billion from non-U.S. Treasury money market funds in September 2008 — that are a source of the systemic risk associated with money market funds. Viewed in this light, institutional money market funds and their investors are a classic tragedy of the commons — a situation in which independent actors, each acting rationally to maximize its own interest, deplete a shared, finite resource (*i.e.*, the limited liquidity available to their fund during a liquidity crisis), despite the fact that it is in each actor's interest to avoid the destruction of the resource.

A Proposed Solution to the Now-Reframed Systemic Risk

The PWG Report offers several reforms that individually or in combination could mitigate money market funds' susceptibility to runs and related systemic risk. These reforms include (1) mandating that money market funds have a floating NAV instead of a stable $1.00 NAV, (2) establishing private emergency liquidity facilities for money market funds, (3) regulating stable NAV money market funds as special purpose banks, and (4) mandatory redemptions in kind of large shareholders. As noted above, in November 2010, the SEC issued a request for comment on the reforms proposed in the PWG Report. None of the PWG Report's proposals, with the possible exception of mandatory redemptions in kind, focuses on the behavior of investors as a means of stopping or deterring a run on a money market fund.[12]

The alternative suggested here is that, during a period of illiquidity, as declared by a money market fund's board[13] (or, alternatively, the SEC or another designated federal regulator), a money market fund may impose a redemption fee on a large share redemption approximately equal to the cost imposed by the redeeming shareholder and other redeeming shareholders on the money market fund's remaining shareholders. For example, if redemptions in cash are expected to impact the market value of the fund's remaining portfolio securities by an estimated dollar value or percentage, then the redeeming shareholders would be entitled to receive their principal value (*i.e.*, the $1.00 NAV) minus the market impact that the redemptions have on the fund. Thus, during a period of declared illiquidity, a shareholder who insists upon making a large redemption of its shares would receive less than the full amount of its shares' NAV. As soon as the declaration is withdrawn at the end of the period of illiquidity, money market funds would no longer be permitted to impose a redemption fee on redeeming shareholders and, once again, share transactions would occur at the $1.00 NAV.

The redemption fee causes the large redeeming shareholder to internalize the cost of the negative externality that the redemption otherwise would impose on non-redeeming shareholders.[14] If the large shareholder redeems, it bears the full cost of the redemption. The "savings" to the fund arising from the fact that the large shareholder is redeemed for less than the principal value of its shares offsets the market impact of the sale of portfolio securities to satisfy the redemption.

This type of redemption fee is not unprecedented. In the 2001 Fidelity Korea Fund no-action letter,[15] the SEC staff permitted a closed-end fund that was reorganizing to an open-end fund to impose a 4 percent redemption fee on the newly reorganized fund's shares that were redeemed from the reorganized fund less than 200 calendar days after the reorganization.

In the Fidelity Korea Fund no-action letter, the fund-applicant relied on the fact that when closed-end funds, which frequently trade at a discount, are reorganized as open-end funds, arbitrageurs and other short-term traders traditionally purchase shares of the closed-end fund in anticipation of the reorganization. These short-term traders profit from the difference between the closed-end fund's discount to NAV and the proceeds received from redeeming the reorganized open-end fund's shares at NAV.

The applicant asserted, and the SEC staff apparently agreed, that without a redemption fee, certain costs would be borne by the new fund and its long-term investors rather than by the short-term traders who cause the costs to be incurred by the fund and its long-term investors. Specifically, the reorganized open-end fund would incur costs from being forced to sell a substantial portion of its portfolio holdings in order to satisfy arbitrage-related redemptions. These sales would have adverse impacts on the market price of the fund's portfolio securities, especially in emerging markets where the fund invested and securities were thinly traded.

If institutional money market funds can impose redemption fees, it could be argued that such funds would be less desirable investment vehicles and that, as a result, institutional investors would invest to a greater extent in unregistered funds or other investment vehicles. On the other hand, such a redemption fee would mitigate the possibility of runs on money market funds and, therefore, could attract new investors due to the mitigation of this risk.

Money market funds are an intermediary of short-term credit to the economy. They hold over 40 percent of outstanding commercial paper and approximately 65 percent of short-term municipal debt.[16] Money market funds also manage a substantial portion of U.S. business short-term assets (24 percent as of 2006).[17] As of December 29, 2010, money market funds had approximately $2.8 trillion of assets,[18] or approximately 25 percent of all

U.S. fund assets.[19] Of the $2.8 trillion in money market funds, more than $1.8 trillion was invested in institutional money market funds. If regulators ultimately determine that money market funds pose a systemic risk due to the funds' susceptibility to runs, the advantage of the redemption fee approach described here is that it focuses on the behavior of institutional investors to reduce the possibility that money market funds will suffer a run, instead of restructuring the funds to cope with runs. For this reason, it may warrant consideration along with the reforms proposed in the PWG Report that focus on fund structure.

Conclusions

Institutional money market funds' susceptibility to runs may pose systemic risk, and it is possible that the SEC's 2010 tightening of the regulations applicable to such funds does not sufficiently reduce the systemic risk. If that proves to be the case, in addition to the PWG Report's proposals that focus on restructuring funds to cope with or avoid runs, it may be worthwhile to consider the redemption fee proposal described in this article as an alternative or adjunct reform.

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[1] U.S. Treasury Department, *Financial Regulatory Reform: A New Foundation* (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[2] *See id*. at 38-39.

[3] *See* President's Working Group on Financial Markets, *Report of the President's Working Group on Financial Markets: Money Market Fund Reform Options* (PWG Report).

[4] *See* SEC Release No. IC-29132 (Feb. 23, 2010).

[5] PWG Report at 8-9.

[6] SEC Release No. IC-29497 (Nov. 3, 2010).

[7] *See* Financial Stability Oversight Council, *Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* (Oct. 6, 2010).

[8] SEC Release No. IC-28807 (June 30, 2009) (Proposing Release) at text accompanying note 38.

[9] *See* Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, 16 (Oct. 18, 2010), unpublished manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1676947.

[10] Investment Company Institute, *Report of the Money Market Working Group: Submitted to the Board of Governors of the Investment Company Institute* (Mar. 17, 2009) (ICI Report). From September through December 2008, $234 billion was redeemed from non-U.S. Treasury money market funds and there was a net cash inflow of $489 billion into Treasury money market funds.

[11] *See* Proposing Release at text accompanying note 47.

[12] The PWG Report concludes that mandatory redemptions in kind may be unsuccessful if the redeemed shareholder sells the in-kind distribution, and those sales depress the market value of securities remaining in money market fund's portfolio. *See* PWG Report at 26.

[13] Fund boards, with assistance from fund management, are well qualified to determine whether conditions warrant the imposition of a redemption fee for a money market fund. With respect to funds that are not money market funds, pursuant to Rule 22c-2 under the ICA, fund boards already are authorized to impose redemption fees of no more than 2 percent on share redemptions. Rule 22c-2 was promulgated in 2005 to assist funds in

combating market timing. *See* SEC Release No. IC-26782 (Mar. 11, 2005). Separately, as part of the 2010 amendments to the rules governing money market funds, the SEC adopted Rule 22e-3. *See* Release No. IC-29132. Rule 22e-3 permits a money market fund's board to suspend fund redemptions, provided the board has irrevocably approved the liquidation of the fund, and the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions.

[14] Such a "tax" on a shareholder's redemption proceeds is intended to function as a Pigovian tax, named after British economist Arthur Cecil Pigou.

[15] SEC No-Action Letter to Fidelity Advisor Korea Fund (Mar. 7, 2001).

[16] *See* Proposing Release at text accompanying notes 14 and 16.

[17] ICI Report at 29.

[18] *See* Investment Company Institute, *Money Market Mutual Fund Assets* (Jan. 13, 2011), available at http://www.ici.org/research/stats/mmf/mm_01_13_11.

[19] As of September 30, 2010 total net assets of U.S. mutual funds were almost $11.3 trillion. *See* Investment Company Institute, *Trends in Mutual Fund Investing* (Oct. 28, 2010), available at http://www.ici.org/research/stats/trends/trends_09_10.