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Using Money Fund Gates in a (and as a) Clutch

Many have found Question 28 of the SEC staff's [2014 Money Market Fund Reform Frequently Asked Questions](#) frustrating. The question is whether a money market fund's board of directors can determine to impose a liquidity fee or temporarily suspend redemptions ("gate" the fund) but delay the implementation. The delay would allow the fund to notify its shareholders and their intermediaries. Delay would also provide time to "close the gate" or start charging the fee. **An Ambivalent Response** The staff's initial view was that "a fund should begin to implement a fee or gate immediately after the board's determination to impose one." Moreover:

Given the potential for material developments to occur ..., directors should consider whether it would be consistent with their fiduciary duties to allow for a material lapse of time between their determination and implementation.

So the answer seems to be "no"—the directors cannot delay implementation of a liquidity fee or gate. On the other hand:

the staff recognizes that it may not be feasible for a fee or gate to take immediate effect. ... The staff [also] recognizes that a fund's board of directors may need to consider the practical limitations on the capacity of intermediaries and systems when implementing a liquidity fee or gate.

While it's nice to be "recognized," this is not quite the same as a statement that "the staff would not object," which was used in some nine places among the staff's responses (including twice—in Questions 3 and 39—after the staff indicated it "recognizes" a practical consideration). Still, I think this is a case of blaming the messenger. The point of a liquidity fee or gate is to stop a run, not start one. If you tell shareholders that redemptions will be restricted in the future then they will redeem now, thus starting a run. But it would be unreasonable to expect intermediaries to respond instantaneously to the change. Money fund directors are stuck between a fiduciary rock and an operational hard place. **Using Gates First** No one who knows how to drive a manual transmission would drop from overdrive to third gear without using the clutch. You have to disconnect the power-train to change the gears and then reapply power by letting off the clutch. The same is true of a money market fund that "shifts" to a liquidity fee. Shareholders cannot make informed redemption decisions before they receive notice of the liquidity fee that will be applied. The transfer agent and intermediaries will also require time to activate systems for implementing the liquidity fee. In the case of a sweep program, this may include shifting to a backup sweep option. Gating allows time for this to happen. Although gating will not be instantaneous, funds should be able to gate faster than they can implement a liquidity fee. With appropriate risk disclosure in advance, a gate may be imposed without prior notice to shareholders. Simply having the transfer agent stop wiring money and sending checks will halt most of the redemptions. The resulting disruptions to payment systems, such as debit cards, will need to be managed. But contingency plans in payment systems will need to allow for gates in any event. Gating disengages the redemption-train. According to Question 26, "when a gate is in effect, the fund rejects shareholder redemption orders, and any shareholders who submit a redemption order while a gate is in effect must submit a new redemption order after the gate is lifted for the order to be effective." So gating creates a clean break in the redemption process. Once the liquidity fee is announced, shareholders will have to reconsider whether to redeem. An effective fee will curtail redemption orders, making it easier to resume operations. Therefore, even when the board decides that a liquidity fee is in the fund's best interest, it will probably behoove them to consider whether to impose a brief (24- to 48-hour) gate to allow time to get the word out and "change gears."

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