Blogs
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Asset Management ADVocate

Why Intermediaries Can Stop Worrying About Money Fund Liquidity Fees—Part Three

Currently, managers and directors of money market funds are wrestling with the question of how to make certain that every intermediary selling their funds can implement a liquidity fee. Intermediaries, in turn, are worried about implementing different fees for different funds that may change continuously. This series of posts asks a different question: How would intermediaries adapt to receiving redemptions proceeds net of any liquidity fee? Part One explained how prorating redemption proceeds would properly account for the liquidity fee (which would be the difference between the client's redemption order and its pro rata share of the net proceeds). Part Two explained how to avoid problems raised by an intermediary netting purchases and redemptions by either (1) suspending sales while a liquidity fee is in place or (2) requiring intermediaries to settle with the transfer agent ("TA") on a gross basis (*i.e.*, providing the aggregate shares purchased and redeemed before netting the order). But what if the board decides to continue selling the fund and intermediaries refuse to provide the underlying redemption data? The simple, if perhaps troubling, answer is that netted shares are not redeemed. **Netting Transfers, Rather than Redeems, Shares** Understanding the implications of netting requires us to delve into the mysteries of Article 8 of the Uniform Commercial Code. Article 8 creates an "indirect" holding system: clients of a securities intermediary own security entitlement to the shares credited to their securities account. Clients do not own the shares themselves. UCC §8?504(a) requires the securities intermediary to "promptly obtain and thereafter maintain a financial asset [*e.g.*, money market fund shares] in a quantity corresponding to the aggregate of all security entitlements it has established." A securities intermediary uses shares held in its omnibus account with the TA to satisfy this obligation. The intermediary, not the clients, owns the uncertificated mutual fund shares held in the omnibus account. Under this indirect holding system, when an intermediary nets a purchase and redemption order, it does not purchase or redeem any shares from the fund. Instead, the intermediary reduces the security entitlement of the redeeming entitlement holder and increases the security entitlement of the purchasing entitlement holder. In effect, the claims of the redeeming entitlement holder to shares already held in the omnibus account are transferred to the purchasing entitlement holder. To use an extreme example, if an intermediary's clients buy and redeem an equal number of shares on a given day, the intermediary does not have to buy or redeem any shares in its omnibus account. The intermediary can complete the transactions by transferring cash and security entitlements to shares held in the omnibus account among the clients' securities accounts. The fund neither issues nor redeems any shares. **No Redemption, No Liquidity Fee** Rule 2a-7 only permits a fund to charge liquidity fees on redemptions—not on transfers of entitlements to outstanding shares. Thus, to the extent an intermediary nets its clients' redemption orders against purchases, the fund cannot lawfully impose a liquidity fee on the netted shares. This result may be troubling in several respects. First, it allows a redeeming shareholder to avoid the liquidity fee. But the purpose of a liquidity fee is to "deter shareholder redemptions so that funds can recoup costs of providing liquidity to redeeming shareholders in a crisis and so that the fund's liquidity is not depleted …." A netted redemption does not deplete the fund's liquidity or incur any costs of providing liquidity. Second, the purchaser pays full value for a share, but will have to pay the liquidity fee on any subsequent redemption. But this happens regardless of whether the purchaser acquires the shares from the fund or from a redeeming shareholder. If you find this troubling, why allow the fund to continue selling shares after imposing a liquidity fee? Third, the intermediary would not have redeemed shares, despite receiving a redemption order from its client. If you find this troubling, keep in mind that this is happening already in any netted order. Switching to gross settlement would create a record of the intermediary having executed all of the underlying redemptions and purchases and receiving/remitting the net proceeds thereof.

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