PRACTICAL MONEY MARKET FUND REFORM IMPLICATIONS FOR DC PLANS AND THEIR ADVISORS

In the six months since the U.S. Securities and Exchange Commission (SEC) voted to formally amend the rules governing money market funds (MMF), much of the focus among the institutional investment and qualified defined contribution (DC) retirement plan community has been directed towards the “what” and the “why” of the new rules, primarily for DC record keepers and MMF managers.

The new requirements are also likely to trigger a cascade of secondary effects for qualified DC plans and their advisors. Some are clear, such as the need for DC plan sponsors with a MMF included as a designated plan investment option to review the planned operational changes for the fund with its manager; others may be less so. These structural and operational considerations for DC plans may include some or all the topics on the following pages.

WHEN A MMF IS A DESIGNATED INVESTMENT ALTERNATIVE (DIA) —
POTENTIAL SPONSOR IMPLICATIONS AND ACTIONS:

Plan sponsors with a money market fund as a DIA in their lineup will need to determine what the fund’s managers intend on doing with their fund. For example, even if it will be designated a retail fund, they will need to consider doing the following:

- Review potential fee changes and investor concentration that may result from the new structure
- Discuss the manager’s philosophy regarding use of liquidity fees and redemption gates
- Review the manager’s experience, if any, with these restrictions for other asset classes
- Discuss whether, or to what extent, the manager will or can change its investment practices to address the eventualities under which fees or gates could be triggered
- For many sponsors, this should include a review of currently available capital preservation options
- Document the results of the review — even if there are no changes, the reason for making a MMF an element of the plan’s investments should be re-validated
- Plan participant communications should be updated to cover the potential for fees and gates to restrict normal participant DC transactions if a retail money market fund is retained
The “Retail” Exception is Narrow: The SEC included an exception to additional money market fund regulation for retail investors, whose definition included participants in participant-directed qualified retirement plans. The final regulation, however, is narrower than is generally supposed, and may well not extend to the considerable if less-obvious uses of MMFs in DC plan operations. Unresolved questions of interpretation on whether any basis exists for applying this exemption to uses of money market funds in DC plans other than a DIA selected by a participant include the following:

- Funds used for smooth DC plan operation, such as suspense accounts in which funds are awaiting allocation to a participant
- Sweep accounts
- Short term use as an employer-directed qualified default investment alternative (QDIA)
- Holdings classified as “cash equivalents” within other investment funds

While every dollar within a DC plan trust or similar arrangement is associated in some way with the class of participants covered by the plan, decisions affecting the funds used in the ways referenced above are being made by an institutional entity for the general benefit of the plan, which is not a natural person.

CONCLUSIONS

MMFs Will Be Restructured: Among the clearest conclusions reached since the new rules were adopted is that money market fund managers will need to restructure their offerings at the fund level, rather than at the share class level, and classify them as either “retail” or “institutional.” The former will be allowed to retain a stable $1 NAV; the latter will not. Both will be subject to potential fees and redemption gates in the event of a serious market disruption. Before the new regulations, the only significant differentiators among investors were the amount of money involved in the related fees for managing it, and the distribution model and its costs. These were both handled easily as share class distinctions that did not affect how the fund’s assets were managed, unlike the new rules.

Advisor and Plan Sponsor Considerations: Advisors and their plan sponsor clients should continue to be attentive to whether and to what extent the “retail fund” definition may be extended beyond direct allocation investment options in DC plans to include plan level holdings in sweep, suspense or similar accounts, as well as how MMF allocations made by underlying investment managers in other investment allocation options may be handled.

The Retail exception also serves as a reminder that MMFs, for the most part, were and are designed for general consumer investors, as when they were first developed. When considered within a qualified plan setting, they highlight that MMFs are not able to take into account the special characteristics of plan participant allocations, where fund movement is done virtually entirely through allocation rather than withdrawals. All of the regulatory changes will mean that plan participants who allocate to MMFs will be paying a higher price for liquidity they may not need and may not utilize. For sponsors with MMFs in their DC plan lineups, this may generate increased attention to other alternatives to satisfy the need for a principal protected plan investment option.

While an immediate reaction to the new MMF rules might be to conclude that shifting to Governmental MMFs for institutional purposes is a logical choice, doing so carries its own potential limitations. Among these is the possibility of negative real returns, after fees, which may — or should — trigger close consideration of what a reasonable “cost of liquidity” should be for an ERISA plan. This applies whether the fund is held directly or as an element within other plan investment funds.

These changes may lead to increased innovation in the institutional market to expanded uses of guaranteed funds with benefit responsive features for DB and DC plans’ institutional needs, which in the past have generally been limited to fixed fund or stable value investment uses in DC plan lineups.
Money Market Fund Reform: A Synopsis of New Rules

The U.S. Securities and Exchange Commission (SEC) adopted final rules for money market mutual funds (MMF), which are governed by the Investment Company Act of 1940, on July 23, 2014. The new rules were designed to make structural and operational reforms that would effectively address the risks posed by potential investor runs on money market funds, while preserving the essential nature of the funds to the extent possible within the reforms1. The amended rules are an extension of the MMF reforms the SEC adopted in March 2010. While the 2010 changes were intended to reduce MMF vulnerability to the type of interest rate, credit and liquidity risks that became apparent in the 2008 financial crisis, analysis since 2010 led the SEC to conclude that additional structural changes were necessary for potential future situations when credit losses may cause a fund’s portfolio to lose value or when the short-term financing markets more generally come under stress. Major changes, in brief, are summarized below.

<table>
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<th>Rule</th>
<th>What Does it Do?</th>
<th>Purpose</th>
<th>Effective Date</th>
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<tr>
<td>Floating NAV</td>
<td>• Institutional prime MMFs: Daily share value marked to market daily&lt;br&gt;• Governmental and Retail MMFs: No change to current amortized cost method and/or penny rounding to maintain a $1 NAV</td>
<td>• Reduce/remove “first mover” advantage&lt;br&gt;• Redemption disincentive in event of a loss&lt;br&gt;• Avoid unfair investor dilution&lt;br&gt;• Risk of loss lies with the investor</td>
<td>10/14/2016</td>
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<td>Fees &amp; Gates</td>
<td>• Institutional and Retail MMFs: if weekly liquid assets fall below 30% of total assets, a liquidity fee up to 2% and/or a 10-day redemption suspension could be activated&lt;br&gt;• Governmental MMFs: no change2</td>
<td>• Activated when a Fund’s Board decides it is in the best interests of the fund, both liquidity fees and gates are designed to stabilize the fund and avoid sustaining losses by selling assets under market stress to cover redemptions</td>
<td>10/14/2016</td>
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<td>Diversification, Disclosure &amp; Stress Testing</td>
<td>• Institutional and Retail MMFs: Affiliates aggregated for 5% diversification limit; 10% limit applies to all assets separately and ABS sponsors subject to the 10% rule&lt;br&gt;• Eliminate 60-day delay on public availability of portfolio holdings and new reporting for private liquidity funds&lt;br&gt;• Stress testing expanded to include MMF ability to maintain weekly liquid assets of at least 10% and minimize principal volatility</td>
<td>• Reduces MMF exposure to a single entity&lt;br&gt;• Strengthens diversification controls&lt;br&gt;• Increase transparency of fund exposures to investors&lt;br&gt;• Create transparency across the entirety of the liquidity fund market by including unregistered liquidity funds in reporting&lt;br&gt;• Increases risk management of MMF</td>
<td>4/13/2016</td>
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1 SEC Press Release, July 23, 2014
2 The Fund Board for a Governmental MMF would be permitted but not required to activate a fee or gate, if the Board’s ability to do so was previously disclosed to investors.
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