Money market fund reforms: Practical implications for qualified retirement plans

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 benefit (DB) and defined contribution (DC) retirement plan communities has been directed towards the "what" and the "why" of the new rules.

While there is no question that the MMF requirements, which went into effect in October 2016, directly affect the money market mutual fund industry, they have also triggered a cascade of secondary effects for the qualified plans community. While some of these implications are clear — such as the need for DC plan sponsors with a money market fund included as a designated plan investment option to review the operational changes for the fund with its manager — others are less so.

This Special Commentary has been developed to provide insight to plan sponsors and other industry practitioners into the practical implications of the rules for plan sponsors and their plans, and focuses on structural and operational considerations for DC plans and cash flow management considerations for DB plans.

Structural and operational considerations for DC plans: The "retail exception" is only the starting point

A broad array of interests — including money market mutual fund companies and qualified plan sponsors — advocated that the SEC include an exception to additional money market fund regulation for retail investors, and that "retail investors" be defined to include individuals in participant-directed qualified retirement plans. The final regulations do include a "retail exception." However, it is narrower than is generally supposed, and the balance of the rules has considerable, if less obvious, application to both DB and DC plan operations.

MMFs will be restructured — As a result of the rules, money market fund managers needed 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 is allowed to retain a stable $1 NAV; the latter is not. Both are subject to potential fees and redemption gates in the event of a serious market disruption. Before the regulations, the only significant differentiators among investors were the amount of money involved, 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.

Potential sponsor implications and actions — In light of MMF reform, plan sponsors with a money market fund as a designated investment alternative (DIA) in their lineup should have taken steps to determine what the fund's managers intended on doing with their fund. For example, even if it has been designated a retail fund, sponsors should do the following:

- Review potential fee changes and investor concentration that may have resulted from the new structure.
- Determine whether or not the right to recover fees waived during the period of low interest rates has been carried over to restructured funds.
- 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 has changed 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.
- Participant communications should have been updated to cover the potential for fees and gates to restrict normal participant DC transactions if a retail money market fund has been retained.

The retail exception is fairly narrow — The requirements are expressed as general rules that apply unless there is a specific exception. Open questions of interpretation include 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. Funds used for smooth DC plan operation, such as sweep accounts, suspense accounts in which funds are awaiting allocation to a participant, short-term use as an employer-directed qualified default investment alternative (QDIA), and holdings classified as "cash equivalents" within other investment funds are all examples of this type of use of money market funds in DC plans. On one hand, every dollar within a DC plan trust or similar arrangement is associated in some way with the class of participants covered by the plan; on the other, decisions affecting the funds used in the ways referenced above are not affected by individual participant investment allocation decisions. Rather, decisions are being made by an institutional entity, either a plan sponsor or money manager, for the general benefit of the plan, which is not a natural person.

Potential sponsor implications and actions — With the probable exception of the short-term QDIA use, without clarification that any use other than direct allocation by a specific natural person would qualify for the retail exception in a DC plan, money market fund managers should be providing, and plan sponsors should be accessing, only institutional or governmental MMFs for such uses. This means that each of these uses should have been re-evaluated by sponsors in light of the characteristics of governmental or institutional money market funds, and sponsors should determine whether other alternatives exist and include them in the re-evaluation. Such considerations include the following:

- Historically, money market funds had traditionally been selected for operational purposes because of their unique ability to maintain liquidity at all times, and maintain a stable NAV.
- While an institutional fund's floating NAV may be viewed as an acceptable trade-off, the lack of liquidity when it is needed most is potentially more serious. Sponsors should consider whether there are other equally liquid investment alternatives with comparable ease of use and returns to the plan.

- Sponsors should be acquainted with the strategies their other DIA managers are permitted to use for fund cash flow management purposes, and recognize that changes, such as revising investments that qualify as cash equivalents, may be appropriate or prudent. Two actions are indicated: first, sponsors should review the investment guidelines for the funds in their lineup and, second, they should discuss whether "cash equivalents" should continue to permit investment in money market funds and, if so, whether such use should be restricted to governmental funds.

Considerations for defined benefit (DB) plans: from benefit plan cash flows to sweep accounts

Money market funds have become embedded in DB plan administration and fund management in many ways as the industry has grown over the years. This goes well beyond the visible role they play when included as an allocation investment menu choice in DC plans. In part, this expansion contributed to the events that led to the SEC's additional precautionary regulations. Unlike DC plans, no use of a MMF by a DB plan is exempted under the new rules, and many DB sponsors hold direct and indirect positions in MMFs.

Direct holdings — Virtually all DB plan direct MMF holdings are in prime money market funds. Such funds were designated "institutional" under the new SEC rules and, as such, will be marked to market daily as well as having new fees and gates that will become operable in the event of a significant market event. Traditionally, many plans use such MMFs for short-term plan cash flows, which has a number of operational benefits; for example, this strategy enables plans' longer-term asset managers to focus on their investment goals without having to plan for the significant liquidity needed for plan benefits, leading to more consistent and better returns and less tracking error relative to investment goals. Prime MMFs have generally fulfilled this role well because they provided stable and highly reliable liquidity while protecting principal, and by enabling other asset managers to minimize allocations to cash. Plan benefits, on the other hand, are determined by plan design and retirement patterns, and will need to be met by the plan whether investment or interest rate markets are under stress or not.

Indirect holdings — DB plans may also have exposure to MMFs on an indirect basis. Two common examples are MMF holdings within the plan's separate accounts or investment funds, and plan assets held in overnight sweep accounts. With the exception of index funds, investment guidelines for most institutional investments held as plan assets by DB plans provide for a small allocation to cash equivalents. Historically, any 2(a)(7) fund has qualified as a cash equivalent investment, and is a convenient holding for many asset managers. Sweep accounts may be maintained either through the plan trust or within the investment funds. Traditionally, such use by DB plans has been in institutional share classes and, as such, are affected by the rules.

Potential sponsor implications and actions — The rules raise questions for both direct and indirect MMF holdings for DB plan sponsors, regarding whether they are still a viable — or the most effective — strategy. Sponsors should consider the following steps:

- Review and discuss the current fund manager's plans for complying with the rules, including potential changes to fees and investment strategies, as well as whether the manager plans to continue the fund or transition it to become a municipal or retail MMF.
- Discuss the asset manager's history and philosophy with regard to the application of fees and gates.
- Evaluate and consider whether other alternatives for plan cash flows are available.
- Investment guidelines' cash equivalents provisions should be reviewed by plan investment committees for possible revision, which could range from excluding these funds as permissible cash equivalents, or capping the permissible allocation to them within the asset class.
- Review current or potential use of cash sweep accounts with the plan trustee and underlying fund managers, and determine whether changes are required, or if planned changes are acceptable to the plan.
- Document both the decisions made and the basis for the decisions.

Conclusions

There remain a number of items that are presently open to interpretation, and to which the plan sponsor and service provider communities should continue to be attentive. These include whether — and the extent to which — 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. Also open to interpretation is whether it includes MMF allocations made by underlying investment managers in other investment allocation options, funded participant-directed nonqualified deferred compensation plans, and in abandoned plan cases.

In the meantime, the effect of the rules will be to limit the special characteristics of MMFs, for the most part, to retail investors, as when they were first developed. When considered within a qualified plan setting, however, the rules highlight that MMFs are designed for general retail use, and 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 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.

For institutional investors, MMFs used for institutional purposes will be treated, for the most part, like other institutional holdings. In addition, institutional MMFs will also share some characteristics that sponsors are most familiar with in alternative asset classes, which are expected to operate with fees and gates as a direct consequence of their structurally constrained liquidity. In these investments, however, the potential for significantly higher returns, and the availability of other plan assets to provide liquidity when needed, justify both the higher fees and the lower access to the funds.

While an initial 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, 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 rules

The U.S. Securities and Exchange Commission (SEC) adopted final rules for money market funds (MMF), which are governed by the Investment Company Act of 1940, on July 23, 2014. The 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 reforms.[1] 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 on the next page.

Rule	What does it do?	Purpose	Effective-date
Floating NAV	• Institutional prime MMFs: Daily share value marked to market daily • Governmental and retail MMFs: No change to current amortized cost method and/or penny rounding to maintain a $1 NAV	• Reduce/remove "first mover" advantage • Redemption disincentive in event of a loss • Avoid unfair investor dilution • Risk of loss lies with the investor	10/14/2016
Fees & gates	• 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 • Governmental MMFs: No change[2]	• 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	10/14/2016
Diversification, disclosure & stress testing	• 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 • Eliminate 60-day delay on public availability of portfolio holdings and new reporting for private liquidity funds • Stress testing expanded to include MMF ability to maintain weekly liquid assets of at least 10% and minimize principal volatility	• Reduces MMF exposure to a single entity • Strengthens diversification controls • Increases transparency of fund exposures to investors • Creates transparency across the entirety of the liquidity fund market by including unregistered liquidity funds in reporting • Increases risk management of MMF	4/13/2016

[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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