Rocaton

INSIGHTS

Money Market Reform: An Update for Defined Contribution Plans

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On July 23, 2014, the Securities & Exchange Commission (SEC) approved amendments to Rule 2a-7 of the Investment Company Act of 1940 which governs U.S. money market funds. The introduction of the amendments followed a multi-year process and was designed to help money market funds address the risks associated with heavy redemptions during times of market stress while also attempting to preserve the benefits of money market funds. Shortly after the announcement, Rocaton circulated a memo to clients summarizing these reforms and noted that investors should revisit the objectives and risk tolerance for their money market vehicles, especially those invested in prime money market funds which are most affected by the new amendments. The reforms have implications for all money market fund investors; however, this paper focuses on certain unique implications for plan sponsors of defined contribution plans. Recent communications from money market fund managers on changes to their respective funds and the SEC money market reform FAQs released at the end April 2015 provide ample reason to revisit this important topic.

Executive Summary

- Starting in October 2016, all prime money market funds will be subject to liquidity fee and redemption gate provisions and some must also adopt a floating net asset value (NAV). Prime money market funds will have to designate themselves as either retail or institutional.
- Defined contribution plans will be eligible investors for retail prime funds, which will be subject to the liquidity fee and redemption gate provisions, but will continue to transact at a constant NAV.
- Rocaton believes that government money market funds, which are largely unaffected by the SEC reform, represent an appropriate capital preservation option for defined contribution plans.
- SEC money market reform provides a strong impetus for plans with a prime money market fund to reevaluate the option. In addition to the impact of potential gate and fee provisions on a plan participant, plan sponsors should consider the operational complexities of implementing gates and fees and more arcane issues such as how a plan's forfeiture account is invested, a topic addressed in the recent SEC money market reform FAQs.
- Money market investment managers are in the process of communicating changes to their respective funds including fund mergers and planned designations of retail and institutional prime funds. Additionally, investment managers may present alternative capital preservation options for clients to consider. Rocaton will be happy to provide guidance to clients regarding such options.
- Rocaton encourages plan sponsors who desire to make the switch from a prime money market fund to a government fund to start the process soon if they have not already. Government money market funds may face capacity issues as the expected transition from prime to government funds occurs. Further, waiting until October 2016 to make the switch may place plans in a queue at their respective recordkeepers.

Introduction

As previously communicated to clients, the SEC reform adopted in 2014 addressed several topics including enhanced diversification requirements, new disclosure and reporting obligations, and increased stress testing. Notably, the amendments also introduced floating net asset values (NAVs), liquidity fees, and redemption gate provisions for certain types of funds starting in October 2016. A description of how floating NAV, liquidity fee, and redemption gate provisions will affect different fund types as well as a summary table is below:

- **Government Money Market Funds,** defined as funds that invest 99.5% or more of their assets in cash, government securities, and/or repurchase agreements that are collateralized solely by government securities and cash, were largely unaffected by the reforms. They will transact at a stable NAV and are not required to implement liquidity fee and redemption gate provisions.
- **Retail Prime Money Market Funds,** defined as funds that have policies and procedures reasonably designed to limit beneficial owners to natural persons, will transact at a stable NAV. However, they will be subject to the liquidity fee and redemption gate provisions. Defined contribution plans are considered retail investors subject to certain nuances that will be addressed later.
- **Institutional Prime Money Market Funds** will transact at a floating NAV and will also be subject to the liquidity fee and redemption gate provisions.

Money Market Fund Type	NAV	Liquidity Fee	Redemption Gate
Government	Constant	No	No
Retail Prime	Constant	Yes	Yes
Institutional Prime	Floating	Yes	Yes

Defined Contribution Plan Considerations

Money market funds are frequently used as a capital preservation option within defined contribution plans. A capital preservation option appeals to defined contribution participants that are highly risk averse, expressing a market view, preparing to take withdrawals in retirement, or investing outside the plan such that a capital preservation option is appropriate. Other than the aforementioned uses, Rocaton believes that capital preservation options should not play a significant role in participant's long-term investment strategy. Additionally, we believe it is reasonable to position the capital preservation option within a plan as the "sleep at night" option with maximum liquidity and as little credit risk as possible. As such, Rocaton generally recommends that plans that have selected a money market fund as a capital preservation option adopt a government fund over a prime fund. Philosophically, we view the yield "give-up" as an acceptable trade-off when considering objectives of a plan participant utilizing a capital preservation option.

The implementation of SEC reforms in October 2016 provide another impetus for plan sponsors to review the money market option within their plans and Rocaton encourages those plans that currently utilize a prime money market fund to consider the implications of the upcoming changes. We highlight several considerations relevant to defined contribution plans below.

- All prime funds, both retail and institutional, will be subject to the liquidity fee and redemption gate provisions. The fee and gate provisions, no matter how remote the possibility of being implemented, are likely outside of the range of expectations for participants investing in a capital preservation option. Rocaton believes that plan sponsors are compelled to communicate these provisions to participants.
- Some industry participants have expressed concerns regarding the operational difficulties facing recordkeepers as they seek to develop the technology and processes required to implement fees and gates. For example, recordkeepers are grappling with the challenge of implementing gates and fees on a participant by participant basis if such provisions were announced intraday.
- To our knowledge, no recordkeeper has stated that it will not make prime funds available as an investment option as a result of the gate and fee provisions. However, based on our discussions with a sampling of recordkeepers, there is significant work required of them including working out details with the SEC. Additionally, one recordkeeper noted that plan sponsors will have a role to play. For example, recordkeepers may seek input from plan sponsors on how to direct participants' planned purchases of a money market fund that has been gated.
- The SEC rule stated that defined contribution plans will be eligible to invest in retail prime funds. However, FAQs released by the SEC in April 2015 have introduced an additional wrinkle for plans seeking to utilize a retail prime fund in their lineup. Forfeiture accounts, which typically invest in the same money market fund available to plan participants, would not likely be permitted to invest in a retail money market as the accounts do not meet the natural persons test.
- In addition to forfeiture accounts, money market funds may appear in defined contribution plans outside the core lineup. Plan sponsors should also examine the default money market option within the brokerage window if applicable. Also, plans with a stable value option managed as a separate account should also review guideline provisions related to eligible money market options embedded within the portfolio.
- The October 2016 implementation date is causing some investors to push off discussions and decisions on how to handle their current investment in a prime money market fund. Rocaton encourages clients to start the process now. Several money market providers have expressed concerns regarding the available capacity in government funds due to a potential shortage in short-term government paper if significant assets flow out of prime funds. Additionally, one recordkeeper noted that waiting until October 2016 to make a change from a prime fund to a government fund may put a plan sponsor in a queue at their respective recordkeeper.

Alternative Capital Preservation Options

Money market managers are responding to the SEC reform and many have announced changes to their respective funds including mergers and planned designations of retail and institutional prime funds. Clients should expect notifications from their respective money market fund managers in the upcoming months if they have not received one already. While responses have varied, the larger providers of money market funds are generally providing a broad array of products to meet the varying needs of clients. It comes as no surprise that many investment managers are expecting that investors may move from prime money market funds due to the reforms and are launching or highlighting existing alternative options. Some alternatives to prime money market funds, outside of government money market funds, include cash separate accounts, private money market funds that are not registered with the SEC, ultra-short bond funds, and stable value strategies. These solutions seek to provide a comparable or improved expected return versus prime money market funds while avoiding the gate and fee provisions. Additionally, a limited number of recordkeepers also offer an FDIC-insured savings account option.

There is no perfect solution and the aforementioned options present additional considerations for plan sponsors including asset minimums, potential future regulation, and risk profile vis-à-vis money market funds. We can guide plan sponsors who would like to explore such options through the decision-making process.

Conclusion

The introduction of floating NAVs and provisions for gates and fees represents a fundamental change for prime money market funds. For those plans with a prime money market fund in their current lineup, we encourage plan sponsors to consider the implications of money market reform to reevaluate the option. For most defined contribution plans, we believe that a government money market fund represents an appropriate capital preservation option. For those plan sponsors seeking to make a change to a government fund, we encourage them to start the process immediately as there may only be a handful of committee meetings between now and October 2016. Additionally, the potential for capacity issues within government funds, possible queues at recordkeepers, and the time necessary to communicate any changes to participants provide additional incentives to begin the process sooner rather than later.

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Performance Information and Return Expectations

The analysis contained in this document may include projections of long-term return and risk expectations. There is no guarantee that the projected returns or risk will be realized. The projections are based in part on historical performance of various asset classes, and past performance is no guarantee of future performance. The projections include assumptions, including those regarding risk and return. These assumptions are used for modeling purposes only and may not be realized. Because the analysis is based on assumptions and projections, there can be no warranties or guarantees.

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