FEATURE

NAV-igating New Money Fund Waters

What your plan sponsor clients don't know about money market reform, but should.

BY ELAYNE R. DEMBY

New money market fund rules don't take effect until October 2016, but now is the time that sponsors and fiduciaries have to start reviewing current money market fund holdings and make decisions as to what to do going forward. Advisors, therefore, need to be sitting down with clients to explain the rules and how they will impact retirement plans.

"The biggest impact is that things are changing," says Bruce Ashton, a partner with the Los Angeles law firm of Drinker Biddle & Reath LLP. Current money market holdings may not be optimal for plans going forward, so advisors, he says, have to understand what clients have now and what will be available, and provide recommendations.

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Background

In July 2014, the Securities and Exchange Commission (SEC) adopted rules designed to reduce the interest rate, credit and liquidity risk of money market portfolios. These changes classify money market funds as:

- Government funds — holding at least 99.5% of assets in cash and U.S. Department of Treasury securities;
- Retail funds — funds where beneficial ownership is limited to natural persons, including funds in participant-directed defined contribution plans; or
- Institutional funds — all other money market funds, including all money market funds held by defined benefit plans.

The biggest change will be that institutional funds that will no longer be able to use the historical stable net asset value (NAV) of $1 per share. Instead, they will be required to use a "floating" NAV. The fund's share price will be calculated at market value and rounded to $1 with share prices fluctuating daily. Government and retail funds will be allowed to retain the historical stable NAV of $1 per share.

Other significant changes are rules allowing liquidity fees and gates. If liquidity in institutional and retail money market funds drops below certain thresholds, fund boards of directors are permitted to impose liquidity fees and redemption gates. The rules are:

1. If the level of liquid assets falls below 30% of total assets, directors can impose a liquidity fee of up to 2% on all redemptions.
2. If the level of liquid assets falls below 10%, directors are required to impose a liquidity fee of 1% on all redemptions unless the directors determine that such a fee is not in the best interest of the fund or that a different fee, of up to 2%, should be imposed.
3. If the level of liquid asset falls below 30%, directors may temporarily suspend redemptions. A gate may be in place only for 10 business days. Funds are prohibited from imposing a gate for more than 10 business days in any 90-day period.

Impact of New Rules

It's widely expected that the new rules will result in fund companies changing fund offerings, including:

- Money market funds with both institutional and natural person holders may spin off institutional holders into a separate floating NAV fund.
- Some institutional funds may liquidate or merge into other funds.
- To avoid having a floating NAV and having to comply with the liquidity fee and gate rules, some prime money market funds may change investment strategies to operate as a government money market fund.

A number of firms have already announced changes:

- BlackRock Inc. in April 2015 announced changes to their fund lineup to comply, including the closing or consolidation of some funds, and adding new features to others. It's planning to convert its $2.4 billion "TempCash" fund to a new strategy limiting fund holdings to securities maturing in seven days or less.
- Fidelity Investments announced in January 2015 it was converting three money funds, including its $111 billion Fidelity Cash Reserves fund, from prime to a government-only fund.
- Federated Investors Inc. announced in February that it would convert some existing institutional prime and municipal funds to ones that invest in securities maturing in 60 days or less.

Retirement Plan Considerations

The new institutional fund floating NAV will mean that the value of non-government money market funds held by defined benefit plans will vary more than they have historically. Plan fiduciaries will need to assess whether or not these funds will now provide adequate cash stability. Additionally, if a defined benefit plan is using a money market fund as a liquidity source for annuities, then it needs to review whether the plan will be ready in the event of a freeze or hold on liquidity is imposed, says David N. Levine, a principal with the Groom Law Group in Washington, D.C. "It's a cash management issue," he says.

Defined benefit plan sponsors may limit cash equivalent holdings to government money market funds because they can still have a stable NAV and will not impose gates and fees, says Ashton. Government money market funds, however, presumably will have returns lower than retail or institutional fund returns, he points out, so that needs to be considered.

Additionally, since existing money market funds may reorganize into two separate funds — one for retail investors with a stable price, and another for institutional investors with a floating NAV — this could mean higher fees for the separate funds than under the combined funds. Plan fiduciaries will need to carefully monitor money market expenses in the upcoming year, says Ashton.

The new fees and gates can be problematic for defined contribution plans as well. For example, it's been suggested that the possibility of a fee or gate could violate QDIA rules. The SEC has stated that plans can avoid the issue by having the plan sponsors pay the fee for participants or lending the plan money. Since this is likely to be something sponsors will not want to do, fiduciaries may want to consider using another investment for the QDIA.

Furthermore, the rollover rules require that the IRA owner must be able to transfer funds to another investment within a reasonable period of time and without any penalty. So, if the plan currently automatically rolls over accounts into money market funds, they may want to reconsider. The SEC says a 10-day gate is a "reasonable period of time;" however, DOL indicates that additional steps need to be taken if liquidity fee is imposed. Again, SEC has suggested that plan sponsor could assume the payment of the fee to avoid the issue.

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Other issues arise if a money market fund is a plan investment option and the participant has to get a minimum or mandatory distribution, or a refund has to be processed in a timely manner. Again, SEC has suggested solutions that may not be acceptable to sponsors.

The fees and gates will also have to be explained to participants in the plan's summary plan description, says Levine. It shouldn't be a problem to address the issues, he says; they just need to be disclosed.

Provider Considerations

The liquidity fee and redemption gate rules will require record keepers to make technical changes in their operations. This includes adjusting systems to accommodate the new four-decimal pricing system. These operational changes could be expensive and time consuming to implement, particularly for smaller plans.

Additionally, many existing contracts between money market funds and intermediaries have restrictions regarding the imposition of redemption fees and may restrict a fund's right to delay effecting redemptions, putting them in conflict with the new rules. Contract changes will be needed to avoid these issues.

Advisors also need to review their contracts with plan sponsors, and perhaps seek modifications. Many advisory contracts, explains Ashton, provide that advisors don't advise on money market funds and don't receive fees for doing so. So to the extent that an advisor will get into the business to review and recommend money market funds, they may need to change their service arrangements, he says. "Presumably," he says, "advisors don't want to work for free, so they need to work out a compensation arrangement." Any such change, Ashton adds, will need to comply with 408(b)(2), requiring the advisor to disclose fee changes.

Another rule to not run afoul of if setting up a new compensation arrangement is to make sure levels of compensation are not different, he says. Advisors, he says, may want to set it up as a separate service with a fixed fee.

Advisors and fiduciaries have a fair amount of homework to do, says Levine, including getting information from current money market providers detailing what they are going to do to comply with the new rules, and what type of fund it will be going forward. With that information the advisor and plan fiduciaries will need to assess whether or not what will happen is appropriate for their plan. If the fund will be transformed into a government plan, he says, then everything may go forward as normal. If the fund will have liquidity fees, gates or a floating NAV, then fiduciaries have to assess if the fund is still prudent for the plan, or if other options need to be evaluated.

The key points that advisors should discuss with plan sponsors now, says Ashton are:

- The rules are changing. "It's not business as usual," he says.
- Plans need to start now to assess options because it will take time to gather information and go through the fiduciary process to evaluate them.
- Look at options now; if the plan sponsor wants the advisor to help, then the service arrangement will need to be modified.

Advisors and their clients should not rush the analysis, says Levine. "Don't act hastily," he says, "but go through the review thoroughly, then make recommendations."

Advisors will also need to make sure the record keeper can accommodate the changes, says Ashton, particularly the capability to get information to participants if the fund imposes fees or gates. If the plan makes a decision that going forward they will only have governmental funds, says Ashton, then they will have no worries. But if the plan has retail or institutional funds, then record keepers will have to be able to get the information out literally overnight, he says.

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