

Final SEC Rules to Usher in Floating NAV, Fees, and Gates for Money Market Plan Investments

New SEC rules for money market funds aim to address risks faced by the funds but will impose additional recordkeeping burdens for employer-sponsored plans. The new SEC rules require certain types of money market mutual funds to use a floating net asset value, and impose fees and restrictions on redemptions in certain circumstances. Fiduciaries will need to evaluate the merits of continuing to use these funds, given the changes to plan operations that may become necessary if they are retained.

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Background

In 1983, the Securities and Exchange Commission (SEC) codified a rule allowing money market mutual funds meeting certain risk-limiting conditions to maintain a stable net asset value (NAV) — typically \$1 per share — based on using the “amortized cost” method of valuation, and “penny rounding.” Under the amortized cost method, money market mutual funds value securities based on acquisition cost, with gradual mark-ups or mark-downs to reflect differences between the prices of securities when acquired and their value at maturity. In addition, “penny rounding” enabled these funds to ignore any fluctuations in NAV of less than ½ of 1%, but required the fund’s board of directors to promptly consider taking action to abandon these conventions if the NAV (based on fair market value) “broke the buck” by dropping below this threshold.



The price stability that these rules afforded over the years made money market mutual funds popular with investors — including retirement plans. Money market funds are used by employer-sponsored defined benefit and defined contribution plans for liquidity needs and as a safe and stable investment. Federal Reserve statistics report that private and public plans hold \$197.3 billion of money market funds, with IRAs holding another \$228 billion. Private defined contribution plans invest \$115.4 billion in money market funds, while \$31.6 billion is held by private defined benefit plans.

After the failure of Lehman Brothers caused a large money market fund to “break the buck” during the September 2008 financial crisis, the US Treasury announced a one-year “Temporary Guarantee Program for Money Market Funds” that allowed money market mutual funds to purchase insurance against fund share price drops. At that time the Federal Reserve Board also introduced its “Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility” that lent money to banks to buy back asset-backed commercial paper from money market funds through February 1, 2010. These measures were largely successful in restoring investor confidence in money market funds and preventing a “run” on the funds by their investors.

In March 2010, after both of these temporary programs expired, the SEC adopted a number of amendments to make money market funds more resilient by reducing the interest rate, credit and liquidity risks of fund portfolios, and by imposing mandatory stress testing. At the time of the changes, the SEC noted that more fundamental changes to money market funds might be warranted given that investors may have come to inappropriately expect future bailouts, from the government or fund sponsors, should a similar crisis recur.

In 2013, to increase transparency and address future situations in which credit losses might cause further “runs” on money market funds, the SEC proposed rules for moving to a floating NAV for institutional prime funds and permitting liquidity fees and redemption gates (redemption prohibitions during specified time periods) for money market funds. The proposal also would have expanded stress testing requirements, established new SEC reportable events, and shortened the time frame for making the monthly fund portfolio reports (Form N-MFP) publicly available.

Final Rules Include Floating NAV, Fees, and Gates

The SEC received approximately 1,400 comments on the proposal. After reviewing the comments, the SEC adopted [final rules](#) for money market funds that include both the floating NAV and fees and gates at their July 23 meeting.

Floating NAV

Institutional prime money market funds, which generally hold a variety of taxable short-term obligations issued by corporations and banks, as well as repurchase agreements and asset-backed commercial paper, will be obligated to transact at a floating NAV rounded to the fourth decimal place (e.g., \$1.0000 for a fund that uses \$1 as its stable share price). They will no longer be permitted to use “amortized cost” and penny rounding to value their securities in a manner that allows the fund to maintain a stable \$1 per share NAV. The new floating NAV requirement does not apply to government or retail money market funds.

Government money market funds under this rule are funds that require at least 99.5% of assets to be invested in cash, government securities, or repurchase agreements that are collateralized solely by government securities or cash. (The proposed regulation would have limited this percentage of assets requirement for government funds to 80%.) For this purpose, “government securities” include only securities backed by the full faith and credit of the US government (including Treasuries) but not municipal securities issued by state and local governments.

Retail funds are those that adopt and implement procedures reasonably designed to restrict beneficial ownership to “natural persons.” (This differs from the proposed regulations, which defined retail funds as those limiting daily redemptions for each shareholder to \$1 million dollars per day or less.) Natural persons are defined to include participant-directed defined contribution retirement plans, IRAs, SEPs, SIMPLE accounts, governmental 457(b)

plans, 403(b) custodial accounts, health savings accounts, and similar arrangements. Money market funds held in other plans where investment decisions are not made at an individual level, such as defined benefit plans, are not eligible for the retail fund exception. Retail funds will be required to develop procedures to determine whether their defined contribution plan clients are participant-directed, and whether the underlying beneficial owners of omnibus accounts are natural persons.

Comment: Since money market funds haven't had to distinguish between shareholders who are "natural persons" and other types of shareholders before, we anticipate that existing money market funds that wish to maintain a stable share price will reorganize into two funds — one with a stable share price for their retail shareholders (who meet the definition of "natural persons" — including participant-directed defined contribution plans) and the other with a floating share price for their institutional shareholders. The additional reorganizational expenses may pose a challenge for money market fund sponsors, some of whom have already been waiving expenses to avoid "breaking the buck" in this unprecedented period of low short-term interest rates.

Non-government funds that do not wish to reorganize may instead opt to involuntarily redeem the accounts of those who are not "natural persons" prior to the date when the floating NAV would be required. Plan fiduciaries need to monitor whether a significant drop in a fund's size (as a result of a reorganization, or mass redemptions ahead of these rules going into effect) could lead to higher fees — since investment management expenses for money market funds often decline as fund size increases.

Liquidity Fees and Redemption Gates

In addition to the floating NAV change, the final regulation provides that boards of non-government money market funds may impose new liquidity fees and/or redemption gates in certain circumstances. Two scenarios are illustrated in the final rules, along with the associated fees and gates.

- If the fund's level of weekly liquid assets falls below 30%, a liquidity redemption fee of up to 2% **can be** imposed or redemptions **can be** temporarily gated (suspended) for up to 10 business days within a given 90-day period. At this level, the fees and gates would be optional, subject to the discretion of the fund's board.
- If the fund's level of weekly liquid assets falls below 10%, the fund **would be required** to impose a fee of 1%, unless the board of the fund determines it is in the interest of the fund not to impose the liquidity fee (or to impose a liquidity fee at a different level, not to exceed 2%).

The liquidity fees and gates apply to both institutional and retail money market funds and, on an optional basis, for government funds. Like other money market funds, a government money market fund that decides to adopt fees or gates (subject to board discretion) must reflect the fund's decision in its prospectus. The fees and gates must be discontinued once the fund's level of weekly liquid assets reaches 30% or greater.

Other Requirements

Money market funds will also be subject to additional diversification requirements, enhanced stress testing, and increased information reporting.

There will also be new SEC reportable events for money market funds. Under these requirements, money market funds must promptly and publicly disclose to the SEC when liquidity fees or gates are initiated or removed, when

the fund sponsor intervenes to prop up the NAV, when a fund's NAV drops below its intended stable price by $\frac{1}{4}$ of 1% or more (e.g., below \$0.9975 for a fund that is intended to maintain a stable \$1.00 share price), or when a fund's level of weekly liquid assets falls below the 10% and 30% thresholds.

Timing

Starting July 14, 2015, the new SEC reportable event rules go into effect. Funds will be required to comply with the increased diversification, stress testing, and informational reporting requirements by April 14, 2016.

The SEC final rule provides a two-year transition period up until October 14, 2016 to allow funds and investors to adjust systems and investing practices to implement the floating NAV rules and the liquidity fees and gates.

Challenges for Participant-Directed Defined Contribution Plans

Many funds in a typical plan's investment line-up currently impose redemption fees — for example, less liquid funds such as international equity funds. Recordkeepers can build these fees into systems because they are fixed and applicable at all times. However, with the new money market rules, fees, and gates will be imposed on an ad hoc basis and must be implemented on short notice. That will be difficult to administer in a daily valued plan. In addition, the imposition of gates could interfere with timely processing of plan activity, both participant requested (such as transfers or distributions), and legally required transactions (such as required minimum distributions). Thus, the new requirements may make it administratively impractical to continue using money market funds within participant-directed plans. While a plan fiduciary is likely to be presented with alternative investment options to address these administrative concerns, it will be necessary to weigh those alternatives carefully.

Participant-directed defined contribution plans that are covered by ERISA's fiduciary requirements must also provide blackout notices whenever a participant or beneficiary is temporarily restricted (for more than three consecutive business days) from exercising his or her right to diversify investments, or to take distributions or loans under the plan. Normally the plan administrator must provide 30-60 days of advance notice of any such restriction, although the regulations allow the plan administrator to provide notice as soon as practicable when the plan administrator is unable to provide at least 30 days of advance notice due to unforeseen circumstances or outside the plan administrator's control. Unless the DOL issues guidance exempting liquidity gates from the blackout notice requirements, plans that offer money market funds must be prepared to monitor when gates are put into effect, and to issue blackout notices on short notice when they do. In addition, since the end date of the gate may not be known, it would be helpful if the DOL issued guidance on how a plan administrator can comply with the blackout notice requirement to include the date when it is expected that the restriction will be lifted.

Plan administrators of plans that decide to retain funds that will either move to a floating NAV or may be subject to fees or gates must examine other investment-related communication pieces to determine whether they need to be updated. This includes quarterly participant statements, and the investment-related fee and performance related disclosures provided upon enrollment and annually thereafter.

Plan administrators of plans that retain money market funds that have the ability to impose liquidity fees will also be required to disclose the liquidity fees to participants and beneficiaries 30-90 days before the change goes into effect.

Challenges Not Specific to Participant-Directed Plans

Although defined benefit plans and welfare benefit trusts are less dependent on money market funds, those that do include these funds in their portfolio generally do so for distribution liquidity. The prospect of 2% fees and redemption gates imposed when liquidating funds to pay benefit distributions may drive these funds to consider other investment options that are more predictable even though the impact is not directed at the individual participant level. More predictable investments for distribution processing will generally be non-interest bearing accounts that will produce less income, but avoid gates and fees.

Plan sponsors that decide to retain a fund with redemption gates will need to adjust timeframes for processing certain transactions with compliance deadlines (such as required minimum distributions or ADP/ACP refunds) to ensure that such transactions can be processed in time if the gates go into effect.

If the plan specifies that the administrator will automatically roll over automatic cashouts (such as when a participant has a vested accrued benefit or account balance greater than \$1,000, but less than \$5,000), and the plan fiduciary has selected a money market fund as the investment vehicle for such rollovers, the plan fiduciary may consider switching to an investment vehicle without a floating NAV and without a liquidity fee. The DOL safe harbor for selecting rollover IRA investments requires the investment vehicle selected for the rollover IRA to be designed to preserve principal, in addition to providing liquidity. Although it is arguable that a money market fund with a floating NAV or a liquidity fee is still designed to preserve principal, the plan fiduciary may want to review whether other investment vehicles would be better suited to meeting that objective.

In Closing

Although a floating NAV does not necessarily pose a significant operational challenge, other aspects of the new SEC rule for money market funds could serve to be problematic and could steer plan sponsors away from these funds. Presumably, the investment community will do everything possible to prevent a mass exodus from the funds, particularly since such an exodus is exactly what the new rules are attempting to avoid. Given that money market interest rates have been close to zero for all types of money market funds for several years, it remains to be seen whether retirement plan fiduciaries will replace floating NAV money market funds and those that may impose liquidity fees and gates with investment alternatives that will not be subject to these rules.

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