Money market update for 2016: The rule that you should be aware of

Jeff Marzinsky, CPC, CIMA

BACKGROUND ON MONEY MARKETS

As of November 2015, the Investment Company Institute (ICI) estimates that there is about $2.7 trillion invested in money markets. A little over $1 trillion is invested in government money markets and the remainder in prime or non-government money markets. About 62% of money market holders could be affected by this.

Drilling down to retirement plans, the ICI further estimates that about 4% of the $4.4 trillion invested in 401(k) participant accounts have balances in money markets. This amounts to about $176 billion in 401(k) retirement plan assets that could be affected.

Following the global financial crisis in 2008, the government instituted a guaranteed stable net asset value (NAV) of $1.00 for money market funds. You may recall the term "breaking the buck," where a money market, facing losses, may fall to a NAV below $1.00, effectively meaning that investors could lose money in a money market. This is known as the stable NAV.

IA 1940 UPDATE: MONEY MARKETS SPECIFICALLY

The amendment to the Investment Advisors Act of 1940 (IA 1940), which will take effect on October 14, 2016, focuses on the ability of money markets to maintain adequate liquidity and manage redemptions, especially in times of market stress, such as we experienced back in 2008. Money markets are required to maintain a minimum weekly liquidity of 30% of assets held in cash, U.S. Treasuries, or other securities with maturities of 60 days or less.

The U.S. Securities and Exchange Commission (SEC) amendment removes the stable NAV and requires institutional prime money market funds to sell and redeem shares at the current market-based value. Rounded, as the SEC stated, to the fourth decimal, they will now transact at a "floating" NAV. However, the SEC is placing tools in the hands of institutional and retail money market managers and their boards to maintain their liquidity as needed through liquidity fees and redemption gates, which we will talk about later.

So who will this affect? Essentially anyone who is invested in a non-government money market. In particular, it will affect participants in retirement plans and individual investors that are invested in money market funds that are non-government.

The amendment defines two types of money market funds, those fully invested in government securities (normally called a "government" money market) and those not fully invested in government securities. Government money market funds are those with 99% of total assets in cash, government securities, and repurchase agreements that are based on cash or government securities. The IA 1940 amendment defined a "government money market" as a money market fund that principally holds obligations of the U.S. government, including obligations of the U.S. Treasury and federal agencies as well as repurchase agreements collateralized by government securities. A "prime money market" is defined as a money market fund that will hold a variety of taxable short-term obligations issued by corporations and banks as well as repurchase agreements and asset-backed commercial paper.

The amendment will essentially affect those types of money market funds that are non-government.

WHY IS THIS BEING PUT INTO PLACE?

There are a few reasons why the SEC has drafted this amendment to IA 1940:

- To provide more disclosures for investors. For example, money market funds will be required to release daily and weekly liquidity, cash flows, and daily NAV
- To remove the government from backing the stable NAV on money market funds
- To provide tools to the money market fund managers to maintain liquidity

The money market tools are called "fees and gates" and are liquidity fees and redemption gates.

The first tool created by the amendment will allow a non-government money market to impose a liquidity fee if the fund's weekly liquidity level falls below a designated threshold. The threshold is that 30% of the total assets of the fund must be in liquid investments. Under this threshold, the fund manager may be charged a liquidity fee of up to 2%.

The next tool is a redemption gate, in which a money market manager may impose redemption restrictions for up to 10 days in a 90-day period to maintain liquidity in a fund.

Again, the SEC calls these tools fees and gates and it feels they will "rarely be imposed in normal market conditions."

Figure 1 shows a table summarizing which type of fund will be affected by the "fees and gates" and also a floating NAV. The SEC indicated that the floating NAV for Institutional Prime Money Market Funds removes the incentive for institutional investors to redeem shares ahead of market movements—what they define as the "first mover advantage." Institutional investors are those who may have large amounts invested in money markets and resources for monitoring their money market holdings or may manage money for others. Retail investors generally have smaller holdings and may be investing for their own accounts.

FIGURE 1: FEES, GATES, AND FLOATING NAV BY FUND TYPE

FUND TYPE	INVESTOR	FLOATING NAV	REDEMPTION GATE	LIQUIDITY FEE
Prime Money Market Fund	Institutional	Yes	Yes	Yes
	Retail	No	Yes	Yes
U.S. Gov't and Treasury	Institutional	No	No	No
	Retail	No	No	No

HOW DOES THIS AFFECT US AS INVESTORS AND RETIREMENT PLAN SPONSORS?

The floating NAV may affect holders of funds in prime institutional money market funds—redemptions may occur at less than $1.0000 rounded to four decimal places. Again, the SEC feels that this will be limited based on the ability of managers to utilize fees and gates to maintain liquidity. But it could mean that redemptions could be less than $1.0000.

If your retirement plan offers a qualified default investment alternative (QDIA) that is a model portfolio and includes a money market fund, your model may no longer qualify as a QDIA. Within recordkeeping systems, if non-government money market funds are held, there is the potential for investment managers to charge liquidity fees and put into place redemption gates.

The liquidity fees may not be a transactional issue as they may occur at the management level within the fund, but they could affect the expense of the fund.

The redemption gates could be a potential recordkeeping system issue. They are not like other redemption restrictions on mutual funds that have more clear definitions as to when they may occur. System updates may need to happen and administrators will have to know if and when money market managers place redemption gates on their funds. Plan sponsors and their recordkeepers will need to watch out for money market funds susceptible to floating NAV and "fees and gates."

WHAT SHOULD YOU DO TO PREPARE?

- Look at your money market investments. If you find that you hold non-government money market funds, you may want to determine if your investments would be affected by the new regulations.
- Consider changing any prime or non-government money market funds to government money market funds if they fall within your investment strategy.
- Consider changing prime or non-government money market funds to stable value funds—again, if they have an acceptable level of risk and they fall within your investment strategy.
- Look at your vendor recordkeeping system to determine if it may currently have the ability to handle redemption restrictions that could be intermittent in nature or how your administrator will be handling these issues.
- Find out how fund managers, trust companies, or brokerage account holders will communicate when fees and gates may be put into place.

Jeff Marzinsky, CPC, CIMA, is a principal and investment consultant in the Albany office of Milliman. Contact him at jeff.marzinsky@milliman.com.