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Money Market Fund Rule Amendments: Implications and Options

The Securities and Exchange Commission (SEC) recently voted to approve changes to Rule 2a-7 and other provisions of the Investment Company Act of 1940 that govern money market funds. These changes present a prime opportunity to review principal preservation options to ensure they are providing participants the optimum balance of safety of principal, return, and liquidity. While these regulatory changes have varying impacts on different segments of the money market asset class, they do not impact the stable value asset class.

As of year-end 2013, mutual fund money market assets totaled $2.7 trillion, with approximately $149 billion in defined contribution (DC) plans, compared to $719 billion of stable value assets in DC plans.[1]

Principal Preservation Options

Before reviewing the amendments and their implications, it is helpful to survey the current landscape of principal preservation options potentially available to DC plan participants. These options play a vital role for participants who are nearing retirement, are conservative investors, or who seek attractive, risk-adjusted returns as part of a diversified asset allocation strategy. The chart below includes some of the most popular options and illustrates their performance in terms of yield, liquidity, and safety of principal. This is a particularly useful assessment at a time when we can expect to see adjustments in the money market space, potentially prompting a search for comparable alternatives.

FUND NAME	YIELD AS OF 12/31/2013	SAFETY OF PRINCIPAL	PARTICIPANT LIQUIDITY
Stable Value	2.63%[2] low volatility	Book value and accumulated earnings are guaranteed by issuer	Yes, at book value
Government Money Market Funds	0.02%[3] low volatility	Yes	Yes, at book value
FDIC Bank Demand Deposit	0.18%[4] low volatility	Yes	Yes, at book value
Non-Government Money Market Funds	0.01%[5] low volatility	Subject to possible liquidity fee	Subject to liquidity fees and/or redemption gates
Short-Term Bond Funds	0.57%[6] moderate volatility	No	Yes, but not at book value
Bank Time Deposits (CDs)	0.23%[7] low volatility	Yes, if held to maturity (premature withdrawal subject to penalty)	Yes, at book value
Intermediate Bond Funds	1.61%[8] moderate volatility	No	Yes, but not at book value

As the chart demonstrates, there are alternatives to money market funds that may demonstrate superior returns while maintaining a desirable level of protection and liquidity.

The Amendments

In 2010, Rule 2a-7 was amended to require shorter durations and stricter risk-limiting conditions, potentially limiting money market fund yields. The 2010 amendments were introduced in the wake of the 2008 market crisis, in which the Reserve Primary Fund, a large money market fund, was forced to "break the buck" and reprice its shares below $1. This, in turn, led to a run on prime money market funds generally, followed by the U.S. Treasury stepping in and creating a temporary guarantee program.

In the shadow of this crisis and subsequent amendment, the current regulatory changes may add questions about an already challenged asset class. Although the amendments touch on all three categories of money market funds, we will focus on the changes as they affect retail and institutional prime money market funds.

Liquidity Fees and Redemption Gates

Retail money market funds, defined as funds that limit beneficial ownership to natural persons (this includes DC plans, 529 plans, and IRAs), will still have a net asset value (NAV) fixed at $1 per share; however, they will now be subject to new liquidity fees and redemption gates.

Fund boards of directors will be able to impose liquidity fees of up to 2% and drop "gates" if a fund's weekly liquid assets drop under 30% of its total assets. Gates can only be used for 10 business days and not more than once in a 90-day period. It's possible that this could result in the need for shorter durations and more liquidity, which will challenge already low yields, even if rates should rise in the future.

While these rules are designed to prevent mass exodus from funds like the one that occurred in the market crisis of 2008, the effect of the rules, once put into place, remains to be seen. It's possible that certain market stress scenarios might compel funds to impose the liquidity fees and gates, causing a departure from immediate payment at $1.*

Non-government institutional money market funds are the other type of money market funds affected. Rather than maintain a stable $1 share price, they will now use market-based value to determine the daily share prices, resulting in a floating NAV. This could have an impact on several types of plans, including defined benefit plans, cash management, VEBA, nonqualified deferred compensation plans and foundation. For example, if the plans guidelines state that they cannot use a floating NAV for their cash reserves, they will be forced to seek an alternative.

There is speculation that the amendments may cause many money market funds to shorten their durations even more in order to further limit risk, helping to both reduce fluctuations in NAV (for institutional prime funds) and, for non-government funds, to reduce the chances of ever having to impose a liquidity fee or gate. In shortening durations, already low yields will likely be further reduced.

The Future

The SEC is allowing 18 months to two years to implement these changes; however, many money market funds will likely soon begin to make decisions around the recomposition of their portfolios to be in line with new regulations, including repositioning to address potential liquidity stress scenarios.

While opinions may differ on the potential ramifications of these regulatory changes, it's worth keeping in mind that there are alternative asset classes, like those laid out above, which may not face these hurdles. A stable value-like option may offer principal preservation without compromising on return or liquidity.

**While in the ordinary course stable value products allow unrestricted DC participant withdrawals and transfers for benefit responsive purposes at book value on any business day, money market funds could subject withdrawals to possible liquidity fees and/or gates.*

[1] MoneyNet, Dec. 2013 SVIA 18th Annual Stable Value Investment & Policy Survey, 2013.

[2] SVIA 18th Annual Stable Value Investment & Policy Survey, 2013.

[3] S&P 'AAAm' Money Fund Index/Government Index, Dec. 31, 2013.

[4] Retail Rate National Averages - Money Market $50k, iMoneyNet, Dec. 31, 2013.

[5] Taxable 7-Day Net Simple, iMoneyNet, Dec. 31, 2013.

[6] Barclay's 1-3 Yr U.S. Government/Credit Term Bond, Dec. 31, 2013.

[7] National Avg - 1 Yr Maturity, BankRates.com, Dec. 31, 2013.

[8] Barclay's Intermediate U.S. Government/Credit Term Bonds, Dec. 31, 2013.

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