

New rules for money market funds

What they mean
to retirement
plan fiduciaries

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New rule changes impact money market funds in retirement plans

Money market funds (MMFs) are a popular and widely used capital preservation option within retirement plans, and it is important for plan fiduciaries to understand new legislation impacting these funds.

Since the credit crisis in 2008, regulators have been working hard to update laws to help promote the financial stability of the U.S. economy. In July 2014, the U.S. Securities and Exchange Commission (SEC) adopted amendments to money market fund rules intended to increase transparency and give investors additional protection. The amendments create a distinction between retail and institutional MMFs, and give fund managers new tools to curb heavy redemptions during market stress and tight liquidity, such as the ability to impose liquidity fees and/or suspend redemptions—known as “redemption gates.”

In this paper we:

- Examine the **fiduciary implications** posed by the rule revisions in light of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.
- Review the **structural changes** to MMFs mandated by the amendments.
- Provide plan fiduciaries with a list of **key factors to consider** when evaluating the specific implications of the fund rule amendments with respect to their retirement plans.

10-second take

What happened?

In July 2014, the SEC announced substantial revisions to the rules governing MMFs. The changes are being phased in over time, with the most significant provisions taking effect in October 2016.

Why?

The amendments are intended to help create more stability within MMFs in times of stress and to help protect shareholders.

What details affect retirement plans?

- There is a new distinction between “retail” and “institutional” MMFs.
- Institutional MMFs will be required to have a variable net asset value (NAV), while retail MMFs can continue to transact at a constant NAV.

- Participant-directed plan accounts in defined contribution plans can invest in retail MMFs; defined benefit plans and plan accounts where an institutional fiduciary has investment power will need to invest in institutional or government MMFs.
- Using liquidity fees and redemption gates, MMFs can impose greater restrictions on participants withdrawing money in times of market stress.

What are next steps?

Plan fiduciaries need to understand the implications of the new fund rule amendments with respect to their specific plans. They should evaluate their current capital preservation option in light of the changes. Most defined contribution plans will not be required to switch funds for plan accounts over which participants exercise investment direction. Defined benefit pension plans, along with any other institutional fiduciary-directed account, will no longer be eligible for retail MMFs and will be required to make a change.

Understanding the rule changes

The SEC's new amendments affect MMFs in three primary ways:

1. How the funds are defined and who can invest in them
2. How some funds are valued
3. How participants in some funds can withdraw their investments

1. New definitions for retail and government MMFs

How funds are defined and who can invest in them

Prior to the new rules, MMFs could be described as falling under three general categories: government/U.S. Treasury, municipal (tax-exempt), and prime.

For prime and municipal MMFs, the amendments now distinguish between "retail" and "institutional" MMFs. There will be a restriction on the type of clients that can invest in retail MMFs, and institutional MMFs will be required to convert to a variable net asset value (NAV).

Since municipal MMFs are not commonly used in qualified retirement plans due to their tax-advantaged status, this paper will focus on the changes made to government and prime categories. Please contact your Schwab* representative for more information on municipal MMFs.

Retail

When the amendments are implemented, only "natural persons" will be eligible to invest in retail prime MMFs. "Natural persons" covers individuals, certain trusts, and individuals in participant-directed retirement plans within the meaning of Section 3(34) of ERISA, including 401(k) plans. So participant-directed accounts within 401(k)s, profit-sharing plans, money purchase pensions, and other tax-qualified defined contribution plans will be permitted to invest in retail MMFs.**

Institutional

Under the new amendments, institutions, businesses, and other organizations will not be eligible to invest in retail MMFs. They will be eligible to invest in "institutional" MMFs and government MMFs. Defined benefit plans, as well as accounts within defined contribution plans that are directed by the plan sponsor/institutional fiduciary, fall into this category. Nonqualified plans will likely also be limited to government or institutional MMFs, pending any further clarifying guidance from the SEC.

Government

The amendments require that government MMFs and U.S. Treasury MMFs invest 99.5% or more of their total assets in cash, government securities, and/or repurchase agreements that are collateralized fully in cash or government securities. Government MMFs are exempt from the requirement to use a variable NAV.

Note that the amendments do not require institutional MMFs or government MMFs to limit shareholders to "natural persons."

Participant-directed accounts in defined contribution plans can invest in retail MMFs; defined benefit plans will need to invest in institutional or government MMFs.

*Schwab is defined as The Charles Schwab Corporation.

**Under recent SEC guidance, plan forfeiture accounts over which institutional fiduciaries retain investment discretion are not retail eligible. Schwab will continue to monitor regulatory guidance as it evolves, letting our clients know how it might affect their plans.

2. Portfolio valuation

How some funds are valued—constant vs. variable NAV

Retail and institutional MMFs will also be differentiated by another major change: the accounting method used for pricing fund shares.

Under current rules, all MMFs are permitted to transact at a constant NAV rounded to the nearest penny. The new amendments permit retail MMFs and government MMFs to continue to use this method and transact at a constant NAV.

Institutional MMFs, however, will be required to price and transact with a variable NAV that fluctuates from day to day. They must also round the NAV to the fourth decimal place (e.g., \$1.0000). In addition, the amendments state that institutional MMFs must be invested using the same risk-limiting conditions included in the current regulations, which restrict investments to short-term, high-quality, dollar-denominated instruments. Institutional MMFs are still considered a cash equivalent, just like retail and government MMFs.

3. Liquidity fees and redemption gates

How participants can withdraw their investments

MMFs currently have the ability to delay settlement of redemptions for up to seven days and even longer in unusual circumstances, such as:

- New York Stock Exchange closures or other external trading restrictions
- Periods of emergency when the sale of MMF securities is not reasonably practicable
- Any other periods permitted by the SEC for the protection of investors

The new amendments provide all MMFs—both retail and institutional—with new tools to curb heavy redemptions in times of market stress and tight liquidity. These new tools provide fund managers with the ability to impose fees on shareholder redemptions (“liquidity fees”) and/or suspend all fund redemptions (“redemption gates”) in rare periods of unusually heavy fund redemptions. Government MMFs are permitted, but not required, to implement liquidity fees and redemption gates.

The trigger for the imposition of liquidity fees or redemption gates will be the level of weekly liquid assets in an MMF. SEC rules require MMFs to hold at least 10% of total assets in securities that are convertible into cash within one business day, whether through maturity or exercise of a demand feature in one business day (“daily liquid assets”) and 30% of total assets in securities that are convertible into cash within five business days (“weekly liquid assets”).

Institutional MMFs will be required to have a variable net asset value (NAV), while retail MMFs can keep using a constant NAV.

Liquidity:

The speed and ease with which an asset can be converted to cash without affecting the value of the asset.

Gate:

A restriction placed on a fund to limit withdrawals or redemptions.

For a complete list of terms, see glossary at back.

Liquidity fees

The amendments permit an MMF's board of trustees to authorize the fund to impose a fee of up to 2% on shareholder redemptions if the fund's weekly liquid assets were to fall below 30%. If weekly liquid assets were to fall below 10%, a fund would be required to impose a 1% liquidity fee, unless the fund's board determines that a fee is not in the best interests of the fund, or that imposing a lower or higher fee of up to 2% would be appropriate. The fee would be removed when weekly liquid assets return to 30% or when the board determines a liquidity fee is no longer in the best interests of the fund.

Redemption gates

The amendments permit an MMF's board to halt all shareholder withdrawals for up to 10 business days if a fund's weekly liquid assets were to fall below 30%. The gate would be lifted when weekly liquid assets return to 30% or when the board determines a redemption gate is no longer in the best interests of the fund.

All retail and institutional prime MMFs must be capable of supporting the implementation of liquidity fees and redemption gates. However, government MMFs are permitted, but not required, to implement them.

When thinking about a retirement plan, these redemption restrictions could temporarily limit transactions such as distributions, exchanges, rebalancing, loans, and plan recordkeeping functions.

New amendments

Liquidity fees

Optional fee of up to 2% if fund's weekly liquid assets fall below 30%, if fund's board determines fee is in best interests of fund, and a required fee of 1% if they fall below 10%, unless the board finds that fee is not in best interests of fund or that imposing a lower or higher fee of up to 2% would be appropriate.

Nothing required for government MMFs.

Redemption gates

Suspension of all fund redemptions for up to 10 business days in any 90-day period may be imposed if the fund's weekly liquid assets fall below 30%.

Considerations for plan fiduciaries

Every retirement plan is unique, and plan fiduciaries will need to engage in their own separate evaluations of how the new rules impact their plans. At a minimum, a prudent evaluation process would likely seek to review and address the following key areas of consideration.

Plan provisions

First and foremost, fiduciaries will want to determine whether the final rules conflict with any existing provisions of the retirement plan document, including any investment policy statements.

The goal of capital preservation

Despite the fact that MMFs already have the right to delay settlement of redemptions for seven days or even longer in unusual circumstances, many retirement plans currently have an MMF as the capital preservation option. Considering that greater redemption restriction tools are allowed under the amendments, plan fiduciaries using MMFs may want to evaluate the alignment of the funds with their plan's capital preservation goals.

For example:

- How different are new liquidity fee and redemption gate options from the funds' existing right to delay the settlement of redemptions?
- What would be the implications to the plan and the participants should a liquidity fee be imposed?
- If an MMF instituted a 10-business-day redemption gate (the maximum allowable delay under the new rules), would this create a significant impact?

Plan fiduciaries who wish to consider institutional MMFs, as opposed to retail MMFs, as a capital preservation alternative need to evaluate the implications of the variable NAV:

- A variable NAV could result in small gains or losses to participants. Is this consistent with the stated goal of a capital preservation fund, even though these funds are still categorized by the amendments as a cash equivalent investment and will be managed under the same investment restrictions as retail MMFs?

Another factor to consider is participant comprehension. Plan fiduciaries may want to weigh the investment knowledge of their participants, and whether they can be reasonably expected to understand how a variable NAV works in a capital preservation fund.

Limitations of risk—finding good information

Plan fiduciaries have a vested interest in understanding and limiting participant risk.

MMFs post information relating to liquidity, NAVs, and fund holdings on their websites. A fiduciary will need to develop processes to review posted information and determine what action, if any, may be warranted for the plan.



ERISA's general fiduciary duty

ERISA generally requires a fiduciary to carry out its plan responsibilities:

- For the exclusive purpose of providing benefits, and
- With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct on an enterprise of a like character and with like aims (the "prudence" rule).

Courts measure prudence by focusing on the fiduciary's conduct in arriving at an investment decision, asking whether the fiduciary used appropriate methods to investigate and determine the merits of a particular investment. A "procedurally prudent" process involves:

- Following plan documents
- Gathering relevant information
- Considering all available courses of action
- Consulting with experts when necessary or helpful
- Making a reasoned decision based on all of the relevant facts and circumstances

Retail/institutional vs. government

Since there are new structural distinctions between prime MMFs and government MMFs, fiduciaries should consider the impact on participant and plan risk.

Upon implementation of the new amendments, defined benefit pension plans and other institutional non-participant-directed plans and accounts will be eligible only for government MMFs or institutional MMFs—which will have variable NAVs. Participant-directed defined contribution plan accounts will remain eligible for retail prime MMFs.

Retail and institutional MMFs are required to implement liquidity fees and redemption gates in certain circumstance under times of market stress. However, government MMFs will be permitted, but not required, to implement them.

Plan fiduciaries should evaluate the risk and yield differences between options to determine which is best for their plan.

Alternatives to money market funds

Depending on the answers to the questions posed above, a fiduciary may want to consider other non-MMF alternatives, such as a bank deposit product or other available options.

Note that alternatives carry implications as well. A bank, for example, typically retains broad discretion to delay withdrawal requests during market disruptions. Plan fiduciaries will still need to examine the underlying investment documents to understand the potential impact and likelihood of withdrawal restrictions. Armed with this information, the fiduciary then can make a meaningful comparison between the restrictions associated with these investments and the risks of a money fund imposing a liquidity fee or redemption gate under the amendments.

Employee Retirement Income Security Act of 1974 (ERISA), as amended:

Implements rules to protect the retirement assets of retirement plan participants, which qualified plans must follow.

For a complete list of terms, see glossary at back.

ERISA requirements for selecting and retaining MMFs

The selection and retention of a capital preservation fund is a fiduciary action that must be made in accordance with ERISA's fiduciary duty requirements (i.e., through a procedurally prudent process).

ERISA Section 404(c) does provide a special rule for individual account plans in which the participant exercises independent control over the assets in his or her account. Where the numerous requirements under the 404(c) regulatory safe harbor are met, plan fiduciaries do not bear liability for losses that result from the participant's actions. However, all of the fiduciary provisions of ERISA as relate to both the initial designation of investment options and to their ongoing suitability for the plan continue to apply.

Next steps

Plan fiduciaries need to understand the implications of the new amendments on their specific plans. They should evaluate their current capital preservation option in light of the changes.

Can a plan keep its current MMF?

Today, some retirement plans use government MMFs, but many lineups include what used to be categorized across the board as just a “prime” MMF. With the new distinction between retail and institutional prime MMFs, some plans and plan accounts will be ineligible for the retail category, and may need to make a fund change.

- Participant-directed accounts in defined contribution plans will be eligible for all types of MMFs (government, retail, and institutional), so a change will not be required. However, plan forfeiture accounts over which institutional fiduciaries retain investment discretion are **not** retail eligible.
- Defined benefit pension plans (and other institutional fiduciary-directed plans and accounts) may be including an MMF in their lineup that now becomes categorized as “retail.” These plans will need to make a switch.

Plans ineligible for retail MMFs could switch to a government MMF, institutional MMF, or another capital preservation alternative. Those considering institutional MMFs will need to consider the risk/reward trade-off of the variable NAV.

All plans, whether considering retail or institutional MMFs, will need to weigh the implications of the new liquidity fees and redemption gates.

With the variable NAV, is an institutional MMF a viable option under ERISA?

After considering the relevant risks and potential benefits to their plan, a prudent fiduciary under ERISA may ultimately conclude that an institutional MMF is an appropriate capital preservation option for their plan.

In the end, each plan fiduciary will need to come to their own conclusion, conducting their own process based on their plan’s unique facts and circumstances. Schwab is committed to complying with money market reforms and thinking through the implications alongside plan sponsors and fiduciaries.

We can help.

For more information

Contact your Schwab representative, or for general information visit:

www.csimfunds.com/public/csim/home/insights/money_market_fund_reform.html

New money market fund categories: Summarizing the impact

NEW > Retail prime money market funds

These funds invest primarily in short-term securities issued by corporations and financial institutions. The constant NAV aspect of these funds (and potentially higher yield than government money market funds) may make these funds an attractive capital preservation option for **eligible** plans. Under the new amendments, only “natural persons” will be eligible to invest in these funds.

| Portfolio composition | Eligible investors | Valuation structure | Subject to new liquidity fees? | Subject to new redemption gates? |
|---|---|--|---|--|
| Short-term securities issued by corporations and financial institutions | Shareholders must be “natural persons,” which include individuals, certain trusts, and certain retirement accounts, including those established under IRC Sections 408 or 408A, 408(k), and participant-directed defined contribution plan accounts such as those established under IRC Section 401(k)/401(a), 403(b)(7), and 457 | May continue to transact at a constant NAV | Yes, an optional fee of up to 2% if the fund’s weekly liquid assets fall below 30% (<i>if</i> the fund’s board of trustees determines the fee is in best interests of fund) and a required fee of 1% if they fall below 10% (<i>unless</i> the board finds that fee is not in best interests of fund or that imposing a lower or higher fee of up to 2% would be appropriate) | Yes, additional delays of up to 10 business days in any 90-day period may be imposed if the fund’s weekly liquid assets fall below 30% |

NEW > Institutional prime money market funds

These funds also invest primarily in short-term securities issued by corporations and financial institutions and will not limit shareholders to “natural persons.” However, unlike retail money market funds, which will be permitted to continue to transact at a constant NAV, institutional money market funds will be required to transact at a variable NAV. Fiduciaries will need to consider the implications of using a money market fund that transacts at a variable NAV in their plan.

| Portfolio composition | Eligible investors | Valuation structure | Subject to new liquidity fees? | Subject to new redemption gates? |
|---|--|---|---|--|
| Short-term securities issued by corporations and financial institutions | All investors, including “natural persons,” as well as those considered not “natural persons,” generally businesses, organizations, and certain retirement plans such as defined benefit plans | Must transact at a variable NAV displayed to four decimal places | Yes, an optional fee of up to 2% if the fund’s weekly liquid assets fall below 30% (<i>if</i> the fund’s board of trustees determines the fee is in best interests of fund) and a required fee of 1% if they fall below 10% (<i>unless</i> the board finds that fee is not in best interests of fund or that imposing a lower or higher fee of up to 2% would be appropriate) | Yes, additional delays of up to 10 business days in any 90-day period may be imposed if the fund’s weekly liquid assets fall below 30% |

Government money market funds

These funds invest primarily in securities issued by the U.S. Treasury, federal agencies, and government-sponsored enterprises. They may provide a lower yield than prime money market funds, but with lower risk, given the government backing of the underlying securities. This trade-off may make them an attractive capital preservation option for plans with low risk tolerance. There are no restrictions on the types of investors that can invest in these funds.

| Portfolio composition | Eligible investors | Valuation structure | Subject to new liquidity fees? | Subject to new redemption gates? |
|--|--------------------|--|--|--|
| Securities issued by the U.S. Treasury, federal agencies, and government-sponsored enterprises | No restrictions | May continue to transact at a constant NAV | Not required under the new amendments, but permitted | Not required under the new amendments, but permitted |

Know the terminology

Capital preservation fund: A low-risk, low-yield investment fund managed toward the primary goal of preserving capital and preventing loss, typically used by retirees or those nearing retirement.

Cash equivalents: A low-risk, low-return asset class made up of short-term, easily liquidated securities of high credit quality.

Employee Retirement Income Security Act of 1974 (ERISA), as amended: Implements rules to protect the retirement assets of retirement plan participants, which qualified plans must follow.

Gate: A restriction placed on a fund to limit withdrawals or redemptions.

Liquidity: The speed and ease with which an asset can be converted to cash without affecting the value of the asset.

Natural person: A human being, as distinguished from an artificial person created by law.

Net asset value (NAV): Describes a mutual fund's price per share, calculated by dividing the total value of a fund's securities less liabilities by the number of outstanding fund shares; computed daily based on close-of-day market prices of all securities in the fund's portfolio.

Variable NAV: A net asset value tied to the day-to-day market value of the securities contained within a fund, calculated to the fourth decimal point.

Weekly liquid assets: A fund's total cash, direct U.S. government obligations, government agency discount notes with 60 days or less until maturity, securities maturing or subject to a demand feature payable within 5 business days, and receivables scheduled to be paid within 5 business days.

The information in this paper is as of June 2015 and is subject to change. Please contact your Schwab representative to discuss the latest status before making any changes with respect to your retirement plan.

An investment in a money market fund is neither insured nor guaranteed by the FDIC or any other government agency. Yields will fluctuate, and, although the fund seeks to preserve the value of your investment at \$1 per share, it is possible to lose money by investing in the fund. Compared to the total return, the seven-day yield more closely reflects the current earnings of the fund.

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