Money Market Fund Reform Complicates Insurance Product Fund Offerings

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In July 2014, the SEC adopted amendments to Rule 2a-7 under the Investment Company Act of 1940 that impose new requirements on money market funds (MMFs). The amendments may have unexpected consequences and impose unique costs for issuers of variable insurance products and for underlying insurance product funds that provide investment options under those products. **New Rule Requirements**

The amendments divide MMFs into three general categories: institutional funds, retail funds, and government funds. The amendments require that:

- institutional prime MMFs use a floating net asset value (NAV);
- retail MMFs be limited to beneficial owners who are natural persons; and
- government MMFs invest at least 99.5 percent of their assets in cash, U.S. government securities, and/or fully collateralized repurchase agreements.

The amendments also:

- provide for MMFs to impose liquidity fees or redemption gates (as discussed further below) if the amount of “weekly liquid assets” that they hold falls below certain levels;
- require MMFs to include certain legends in advertisements and prospectuses;
- require MMFs to disclose certain price and liquidity information daily on their websites;
- require MMFs to report certain price and liquidity events on new SEC forms; and
- require MMFs to conduct periodic stress tests.

Considerations for Choosing a Fund Type

The amendments create several problems that are making it difficult for some insurance product funds to decide whether to offer an institutional MMF, a retail MMF, a government MMF, or some combination of the three. Insurance product funds considering offering an ***institutional MMF*** must consider factors including:

- whether a floating NAV is compatible with the actuarial assumptions of issuers of insurance products for which the MMF serves as an investment option;
- any impact of a floating NAV on insurance product issuers' reserving requirements or ability to hedge;
- the extent to which regulatory positions permitting use of a MMF for purposes such as "free-look" period investments and investment of proceeds from unaffiliated fund liquidations also apply to a floating-NAV MMF. (Note: Historically, some insurance product MMFs have operated on a floating, rather than a stable-NAV basis, and we are not aware that such funds have been considered precluded from the uses we refer to.);
- transition issues related to the conversion or reorganization of an existing stable-NAV MMF; and
- possible complications related to the administration of any fees and gates (see below).

Insurance product funds considering offering a re***tail MMF*** must consider factors including:

- the need to offer an alternative MMF for institutional investors due to the unavailability of retail MMFs to institutional investors (such as owners of bank-owned and other corporate owned life insurance products);
- transition issues related to reorganization of an existing stable-NAV MMF to remove institutional investors; and
- possible complications related to the administration of any fees and gates (see below). Insurance product funds considering offering a ***government MMF*** must consider factors including:
- whether investors will expect/demand higher yields than a government MMF is likely able to produce;
- whether insurance product issuers will expect/demand a higher yielding MMF (based on actuarial assumptions or otherwise); and
- potential complications for meeting applicable federal tax law diversification requirements.

Some insurance product funds have considered offering an ultra-short bond fund as a MMF alternative. However, using an ultra-short bond fund may also involve unique considerations, including:

- investors' and insurance product issuers' perception of risk;
- possible unavailability of the fund for free-look period investments and investment of proceeds from unaffiliated fund liquidations;
- tax issues (e.g., the absence of any exemption from the "wash" sale rule); and transition issues (including possible loss of prior performance history).

Considerations Relating to Fees and Gates
The amendments require non-government MMFs to impose a default 1 percent redemption (liquidity) fee if the fund's weekly liquid assets fall below 10 percent of its total assets (unless the fund board determines it is not in the fund's best interests). The amendments also give all MMFs the flexibility to institute liquidity fees (up to 2 percent) and/or redemption restrictions (gates) for up to 10 business days if the fund's weekly liquid assets fall below 30 percent of its total assets and the fund board determines that doing so would be in the fund's best interests. The considerations relevant to insurance product funds and issuers in deciding whether to offer a MMF that may impose liquidity fees include:

- the insurance product issuers' authority under the applicable variable annuity or life insurance contract to pass on liquidity fees to customers;
- the insurance product issuers' administrative capacity to implement liquidity fees (of up to 2 percent); and
- possible questions regarding how liquidity fees will be treated under variable contracts (e.g., in calculating excess withdrawals and required minimum distributions).

The considerations in deciding whether to offer a MMF that may impose redemption gates include:

- any impact on the variable contract owner's redemption rights under the contract; and
- any other impact on contract or rider functioning (e.g., how to assess contract or rider fees, or implement required asset rebalancing when redemption gates are imposed).

Given the issues and complications the amendments raise, the compliance deadlines of April 2016 (for diversification, stress testing, disclosure, and certain form filings) and October 2016 (for floating NAV and liquidity fees and gates) do not seem overly accommodating.

Related Practices

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