SEC's Proposed Reforms Impact Insurance Product Money Market Funds

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July 1, 2013 – Last month, the SEC proposed much-anticipated reforms to the regulation of money market funds (MMFs). The proposals include numerous substantive reforms and disclosure enhancements designed primarily to reduce any risks that MMFs pose for the economy and financial system. If adopted, the proposals would impact MMFs that insurers offer as investment options under variable annuity and variable life policies ("Insurance Products") in much the same way as any other MMFs. Yet, such Insurance Product MMFs differ from other MMFs in ways that are relevant to the proposed reforms and that may justify different treatment for such funds. This Alert summarizes some relevant considerations for Insurance Product issuers. The deadline for those wishing to submit comments on the proposals is September 17, 2013.   *Proposal for Floating NAVs* One of the SEC's proposals would require that MMFs -- except for "retail" and U.S. government MMFs -- abandon their stable per share net asset values (NAVs) in favor of NAVs that "float" based on daily fair market valuations. For this purpose, in order for an MMF to be deemed "retail" it must prohibit any owner from redeeming more than $1 million of the MMF's shares on any business day; and "U.S. government" means that the MMF invests at least 80% of its assets in cash and securities issued or guaranteed by the U.S. government or certain of its instrumentalities. In order for an Insurance Product MMF to be a "retail" fund, the SEC's proposal could be interpreted to require that the $1 million per day redemption limit be imposed separately on each policy owner participating in the MMF option (rather than being imposed on the day's aggregate redemptions by the insurer or its separate account).   Assuming that interpretation is correct (which is not entirely clear), each participating insurer would still need to consider the extent to which it has all contractual and other requisite authority to impose such a $1 million limit on each of its policy owners, and whether any other business considerations make imposition of such limits inadvisable. Because of the possible disadvantages of maintaining an Insurance Product MMF as a "retail" fund, insurers who currently are using "prime" Insurance Product MMFs, and who prefer not to have those funds commence to float their NAVs, may decide instead to use U.S. government MMFs or other funds (such as ultra-short-term bond funds). Many insurers, however, may be content to use MMFs whose NAVs float.

Although the income tax implications of floating NAVs would be a significant drawback for many MMFs, this may be less of a consideration for an Insurance Product MMF, to the extent that policy owners are not subject to current income tax on any redemption of such an underlying MMF's shares. In this regard, some Insurance Product MMFs historically have been offered with floating, rather than stable, NAVs. If the floating NAV requirement is adopted as proposed, affected MMFs would have two years thereafter to come into compliance. *Proposal for Liquidity Fees and Redemption Gates* The SEC is also proposing certain liquidity fees and redemption "gates" as alternatives, or in addition to, floating NAVs. This proposal would apply to all retail and institutional MMFs, other than U.S. government MMFs. MMFs subject to this proposal would be required to impose a "liquidity fee" of up to 2% on their customers' share redemptions at any time when the MMF's "weekly liquid assets" are less than 15% of its total assets. Even if an MMF crosses this threshold of reduced liquidity, however, the MMF's board, based on the circumstances at the time, could impose the fee at a lower rate (or impose no fee at all) if the board determines that the full 2% fee would not be in the MMF's best interest. In addition, the redemption "gates" contemplated by this proposal would permit an MMF -- except for a U.S. government MMF -- to temporarily suspend redemptions of its shares if its weekly liquid assets fall below the 15% threshold. In the case of an Insurance Product MMF, the SEC proposal contemplates that any liquidity fees or redemption gates imposed by the MMF could be imposed on each policy owner by the MMF's participating insurers on a "pass through" basis. Before implementing that approach, however, insurers would need to evaluate the extent to which they have all contractual and other requisite authority to impose such measures on their policy owners. Insurance Product MMFs may be relatively unlikely ever to impose liquidity fees or redemption gates. Even in times of financial stress, the MMF's board may conclude, for example, that the nature of the policy owners and the Insurance Products through which they are participating in the MMF reduce the likelihood of any "run" of redemption requests, so that imposing a liquidity fee or redemption gate would not be in the MMF's best interest. On the other hand, if the liquidity fee and redemption gate proposals are adopted, some insurers may decide instead to use other types of funds. The proposed compliance date for the liquidity fee and redemption gate proposals is one year after adoption. *Converting to Use of U.S. Government MMFs or Other Types of Funds* If the SEC's proposals are adopted, insurers that currently offer "prime" MMFs as investment options under Insurance Products may decide that they prefer instead to offer other types of funds -- such as U.S. government MMFs or ultra-short-term bond funds. There are various methods of converting prime funds into, or replacing them with, other types of funds. Where such transactions involve a "substitution" of funds by an insurance company separate account that is registered under the Investment Company Act, however, the transaction would generally require application to, and approval by, the SEC, unless the SEC staff provides "no-action" relief.

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