WHITE PAPER

REGULATORY REFORM CHANGES IN EFFECT: ARE YOU PREPARED?

Trust Organizations Find Compelling Alternative in Insured Deposit Sweep Programs

As final regulatory reforms aimed at protecting the safety of money market mutual funds go into effect, it is critical that financial intermediaries and investors be aware of the impact of these changes and alternative ways to safeguard and maximize future cash investments.

Reform's Effect On Money Market Mutual Funds

Stability, *liquidity* and *yield* have been the foundation and competitive advantage of money market mutual funds for decades. In our opinion, the regulatory reform, which was intended to stabilize money market mutual funds in times of stress, has actually affected those three features for investors and financial intermediaries in the following ways:

- A floating net asset value (NAV) for institutional prime and tax exempt funds affects share-price stability because it is no longer a stable dollar per share;
- The ability of a fund's board to implement gates and fees for redemptions from retail prime and institutional prime and tax exempt funds affects liquidity; and
- Going forward, the many changes impacting liquidity requirements, issuer eligibility and diversification for money market mutual funds, and the market adjustment to these changes in funding options, will likely hinder yields and their spread relative to alternative investment options, such as bank deposits when compared to prior periods.

Financial intermediaries, such as trust organizations, have recognized that imposing fees and gates on money market mutual funds and an additional floating NAV requirement on institutional prime and tax exempt funds will likely affect the willingness of many customers to invest in these types of money market mutual funds. As a result, customer interest will likely increase their investments in treasury and government money market funds and alternatives to money market mutual funds.

In attempting to quantify the changes in how cash will be invested going forward, the SEC stated the following:[1]

"Institutions invested approximately $1.27 trillion in non-government money market funds as of February 28, 2014. Of this $1.27 trillion, institutional prime funds, other than tax-exempt funds, managed approximately $1.19 trillion in assets and institutional tax-exempt funds managed $82 billion. Under the reforms, these funds will be subject not only to fees and gates, but also to an additional floating NAV requirement. As such, we believe as much as $1.269 trillion in assets could be at risk for being reallocated to government funds and other investment alternatives."

Investors Seek Out Competitive Alternatives

There are numerous investment alternatives that currently compete with money market mutual funds. Each alternative involves different trade-offs, and money market mutual fund investors that are unwilling or unable to continue to invest in their current money market mutual funds after implementation of the reforms will need to analyze the various trade-offs associated with each alternative. Additionally, many current money market mutual fund investors will be precluded from investing in certain alternatives due to restrictions on participation.

For example, short-term investment funds (STIFs) managed by banks are available to certain fiduciary accounts, such as personal trusts and estates, as well as employee benefit plans that are exempt from taxation under the U.S. Internal Revenue Code.[2] Offshore money market mutual funds, which are investment pools domiciled and authorized outside the United States, cannot be promoted within the United States.

Investors that shift their assets from prime funds to government money market funds will likely see the yield on government funds lag even further below prime funds. An increase in demand for government funds, which must invest almost exclusively in eligible U.S. Treasury and agency securities, will increase demand for U.S. government securities, resulting in further downward pressure on yields for eligible government securities.

Therefore, given the possible alternatives available to meet cash investment needs and the related pros and cons, it is likely bank deposits – when facilitated by an effective sweep program – will continue to experience increased demand.

Money in Motion

The shift in market preference from prime to government funds is very real and is already starting as evidenced by Fidelity's decision[3] to convert some of its prime funds into government funds, including the $114 billion Fidelity Cash Reserves, which is the world's largest money market mutual fund. A similar move has been taken by Federated Investors, Inc., one of the nation's largest investment managers, which announced on Feb. 19, 2015[4] its plan to restructure its line of money market mutual funds.

Federated will continue to offer government money market mutual funds but will change existing prime and municipal money market mutual funds to either institutional or retail funds. Additional changes are planned for money market mutual funds offered in both the retail and institution fund categories.

Since October 2015, roughly $1.1 trillion has moved out of Prime MMFs, while Government MMFs have increased by $1.04 trillion during that period.

MMFs SHIFT FROM PRIME TO GOVT ($B)

While insured deposit sweep programs are still early in gaining traction with trust organizations, they have been in existence since the early 1980s and have, over that time, become the default sweep option for most broker-dealers today because of their stability, yield and same-day liquidity. It is estimated from various sources that brokerage sweep programs likely maintain more than $800 billion today.

How Do Insured Deposit Sweep Programs Work?

A sweep program is made up of relationships between the administrator of the sweep program and multiple depository banks that provide investors the opportunity to qualify for extended FDIC insurance and to generate a competitive yield on cash deposited into bank money market deposit accounts. Insured deposit sweep programs require specific technology and processes to manage the balances at each depository bank so that a single customer's deposits do not exceed the maximum limit for FDIC insurance coverage at a single bank. The same technology and processes also maintain detailed subaccounting records and monitor the number of transactions in the deposit account, which is important to ensure that the account is categorized as a money market deposit account (MMDA).

Insured deposit sweep programs provide daily liquidity, and because they are bank deposits and not securities, they have a higher level of flexibility in terms of the type of accounts and customers to whom they can be offered and the attributes of the program itself.

Insured deposit sweep programs typically place funds in Money Market Deposit Accounts (MMDAs) and/or transaction accounts, often referred to as demand deposit accounts (DDAs). MMDAs have long been used by sweep programs in a "single account" structure or in combination with DDAs in a "dual account" program. Sweep programs are designed to specifically address the definition of and limits associated with MMDAs under Regulation D.[5]

Regulation D subjects an MMDA to three requirements: First, the depositor is not required by the deposit contract, but may at any time be required by the depository bank, to give written notice of the intent to withdraw funds not less than seven days before the withdrawal is made. Second, the deposit account may not be made payable on a specific date or after a predetermined period of time. Last, the account does not allow the depositor to make more than six transfers and withdrawals, or a combination of transfers and withdrawals per calendar month or statement cycle of at least four weeks to another account of the depositor at the same institution or to a third party by means of a preauthorized or automatic transfer or telephonic (including electronic) agreement, order or instruction, or by check, draft, debit card, or similar order made by the depositor and payable to third parties.[6]

The first and second required elements of an MMDA are easily met by the terms of the depository bank's account agreement. The third element, which limits the number of certain types of deposits and withdrawals, has historically been a significant limitation. However, over the last 15 years, sweep programs have developed specialized technology to track all transactions for each depositor in each depository bank so that withdrawal limitations are addressed by either limiting withdrawals from MMDAs and/or managing withdrawals in combination with transaction accounts. This monitoring and adjustment ensures that no single customer in an MMDA exceeds the withdrawal limitation.

FDIC Insurance "Pass Through"

FDIC insurance regulations provide that deposit insurance coverage is based upon ownership rights and capacities in which deposit accounts are maintained at insured depository institutions. The FDIC recognizes that in the case of custodial deposits, such as those maintained under a sweep program, the interest of each beneficial owner may be determined on a fractional or percentage basis.[7] The FDIC also will recognize a claim for insurance coverage based upon a fiduciary relationship if the relationship is expressly disclosed by way of specific references in the deposit account records of the institution.[8]

Sweep programs typically are structured so that the deposit account records of the participating banks contain specific references that the MMDAs are being maintained by the custodian "as agent and custodian for the exclusive benefit of its customers." As a result, the insured institution's deposit account records will expressly disclose that there exist multiple relationships in the form of an agency and custodial relationship. Records will be maintained indicating the names and interests of each customer on whose behalf the organizer is acting as agent and custodian with respect to each MMDA as well as other necessary information. This procedure addresses the requirements set forth in the FDIC's regulations regarding the "pass through" of deposit insurance.

How Do Insured Deposit Sweep Programs Benefit the Customer?

An FDIC insured deposit sweep program can provide not only a competitive rate,[9] but also the benefit of pass-through FDIC insurance coverage. For example, a sweep program with 10 participating banks would be able to make FDIC coverage available from all of the 10 participating banks for a potential total of $2.5M in FDIC insurance coverage. The administrative simplicity of an insured deposit sweep program allows customer and financial intermediaries such as trust organizations, regardless of the amount of cash invested, to monitor balances at individual institutions. Should an investor's sweep balance exceed the program's maximum insurance level, most insured deposit sweep programs are flexible to include additional investment options for uninsured balances.

Benefits of Insured Deposit Sweep Programs for Trust Organizations

Now that money market fund reforms have gone into effect, trust organizations must re-evaluate the range of sweep options that best meet the needs of their clients. One approach to cash investment – that being bank MMDAs facilitated by an insured deposit sweep program – can provide the safety and *stability* of FDIC insurance coverage, daily *liquidity*, and a rate which has historically exceeded that of U.S. government and prime money market mutual funds, while at the same time presenting the trust organization with a product that supports the fulfillment of its fiduciary duty. It is clear that since the final reforms that govern money market mutual funds are now in effect, intermediaries will be faced with a critical decision that will impact their organizations and customers for years to come. Trust organizations, acting in a fiduciary capacity, may increasingly recognize the benefits of insured deposit sweep programs for their clients, resulting in increased adoption of insured deposit sweep programs across the industry.

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End Notes

[1] SEC Release No. 33-9616, at page 600 (July 23,2014).

[2] See Office of the Comptroller of Currency, Treasury, Short-Term Investment Funds, at n.6 and accompanying text (77 FR 61229 (Oct. 9, 2012).

[3] https://www.fidelity.com/viewpoints/investing-ideas/money-market-update

[4] http://www.federatedinvestors.com/FII/daf/pdf/about_federated/press_releases/2015/021914_Money_Fund_Product_ Line.pdf

[5] 12 CFR §204.2(d).

[6] Exceeding the limit would change the nature of the account to a demand deposit and as a result change the applicable reserve requirement from zero (0) percent to ten (10) percent. Regulation D, however, permits depositors to make an unlimited number of withdrawals from an MMDA when the withdrawals are made by mail, messenger, ATM or in person.

[7] 12 C.F.R. § 330.5(a)(2).

[8] 12 C.F.R. § 330.5(b)(1).

[9] Currently, the rate is higher than U.S. government money market mutual funds.

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