

## COMMENT LETTER

December 3, 2015

# Letter to IRS on Money Market Funds and Variable Insurance Products (pdf)

By Electronic Delivery December 3, 2015 Helen Hubbard Associate Chief Counsel (Financial Institutions and Products) Internal Revenue Service 1111 Constitution Avenue, NW Washington, DC 20225 RE: Money Market Fund Reform – Diversification under Section 817(h) Dear Ms. Hubbard: The Investment Company Institute<sup>1</sup> appreciates the opportunity to have spoken with you and your colleagues on November 5, 2015, regarding the effect of the recently adopted money market fund rules on variable annuity and life insurance products (collectively, “variable insurance products”). As we discussed in our meeting, money market funds that serve as investment vehicles underlying variable insurance products are concerned that the evolving market for U.S. government securities, in light of the new money market fund rules promulgated by the Securities and Exchange Commission (“SEC”), will make it increasingly difficult or impossible for the insurance company segregated asset accounts investing in those funds to satisfy the diversification requirements under section 817(h). As you know, the consequences of failing section 817(h) can be quite dire for the contract holders, insurance companies, and the underlying funds. Given the changing money market fund industry and the expected increased demand for government securities (as defined under the Investment Company Act of 1940, or “the ‘40 Act”), we ask the Internal Revenue Service (“IRS”) to provide a safe harbor under section 817(h) for segregated asset accounts that qualify as, or invest in, “government money market funds,” as defined under Rule 2a-7 under the ‘40 Act.<sup>2</sup> As explained in greater detail below, pursuant to this safe harbor, the IRS

<sup>1</sup> The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s U.S. fund members manage total assets of \$17.9 trillion and serve more than 90 million U.S. shareholders.

<sup>2</sup> We ask that this guidance apply to all ‘40 Act-registered investment companies that qualify as government money market funds under SEC Rule 2a-7, including regulated investment companies (“RICs”) under Subchapter M, partnerships, and trusts, any of which may be used as investment vehicles underlying segregated asset accounts, and segregated asset accounts

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would view a segregated asset account investing in a ‘40 Act-registered fund as adequately diversified under section 817(h)(1) if, among other things: (1) the fund intends to qualify as a government money market fund under SEC Rule 2a-7; (2) the fund manager is authorized to invest in any and all money market fund-eligible government securities, as defined in section 2(a)(16) of the ‘40 Act; and (3) the fund

manager uses its sole discretion to determine in which government securities it will invest.<sup>3</sup> SEC Rule Changes and Internal Revenue Code Requirements In July 2014, the SEC adopted new rules for money market funds.<sup>4</sup> Under these new rules, beginning on October 14, 2016, prime institutional money market funds (including institutional municipal money market funds) must maintain a floating net asset value ("NAV") for sales and redemptions, based on the current market value of the securities in their portfolio and rounded to the fourth decimal place. These funds also must have mechanisms in place to impose liquidity fees and gates if their weekly liquid assets fall below a designated threshold. "Retail" money market funds may maintain a stable NAV but also are subject to the fees and gates requirement. The only money market funds that may continue to use a stable NAV and will not be subject to fees and gates will be government money market funds. Rule 2a-7 defines a "government money market fund" as any money market fund that invests 99.5% or more of its total assets in cash, government securities, and/or repurchase agreements ("repos") that are collateralized solely by government securities or cash.<sup>5</sup> The '40 Act does not require any diversification within the category of "government securities." that themselves are registered under the '40 Act and qualify as government money market funds under Rule 2a-7 (collectively, "funds").

3 This letter and our requested relief focus on scenarios in which a segregated asset account invests directly in one insurance- dedicated fund that intends to qualify as a government money market fund under Rule 2a-7, or in which the segregated asset account itself operates as a government money market fund. We note, however, that insurance-dedicated government money market funds also may be held in insurance-dedicated fund-of-funds structures. The concerns raised in this letter also may apply to those scenarios. We are considering whether relief is necessary with respect to insurance-dedicated government money market funds held in insurance-dedicated fund-of-funds structures and, if so, what type of relief would be most beneficial. One possibility would be to ignore the insurance-dedicated government money market fund in the fund of funds (if the money market fund otherwise satisfies the criteria set forth in this letter) when determining whether the segregated asset account satisfies the section 817(h) diversification test. As a result, the assets of the government money market fund would not be aggregated with the other assets in the fund of funds for diversification purposes. A second possibility would be to permit the segregated asset account the flexibility, on a quarterly basis, to choose whether to apply look-through treatment under Treas. Reg. § 1.817-5(f) to the insurance-dedicated government money market fund within the fund-of-funds, or whether to treat the holding in such money market fund as a single investment.

4 Money Market Fund Reform; Amendments to Form PF, SEC Release No. IC-31166 (July 23, 2014).

5 "Government security" is defined in section 2(a)(16) of the '40 Act and means "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing." ICI Letter re Money Market Funds and Section 817(h) December 3, 2015 Page 3 of 8

For purposes of RIC qualification under Subchapter M, a fund may satisfy the asset test under section 851(b)(3) if, among other things, at least 50 percent of the total value of its assets is invested in cash and cash items, government securities, and securities of other RICs.<sup>6</sup> Like Rule 2a-7, section 851(b)(3) does not require any diversification within the category of "government securities." Section 817(h), however, contains an additional diversification test for segregated asset accounts with respect to variable insurance contracts. Section 817(h)(1) provides the Secretary of the Treasury regulatory authority to determine when a segregated asset account is "adequately diversified." Treas. Reg. 1.817-5(b)(1) thus provides that the investments of a segregated asset account shall be considered adequately diversified under section 817(h) if: (A) No more than 55% of the value of the total assets of the account is represented by

any one investment; (B) No more than 70% of the value of the total assets of the account is represented by any two investments; (C) No more than 80% of the value of the total assets of the account is represented by any three investments; and (D) No more than 90% of the value of the total assets of the account is represented by any four investments. For purposes of this test, all securities of the same issuer are treated as a single investment; in the case of government securities, each government agency or instrumentality is treated as a separate issuer.<sup>7</sup> In determining whether a segregated asset account meets the section 817(h) diversification test, that account typically looks to the assets held by the “investment company, partnership, or trust” in which the account invests.<sup>8</sup> Unlike the SEC and Subchapter M diversification requirements, section 817(h)(6) and Treas. Reg. § 1.817-5(b)(1)(ii) as noted above require a segregated asset account to treat each U.S. government agency or instrumentality as a separate issuer.<sup>9</sup> Thus, a fund that qualifies as a government money market fund under Rule 2a-7 and also satisfies the diversification test under section 817(h) must have investments (in the right proportions) in at least five issuers. <sup>6</sup> “Government security” is not defined in section 851, but section 851(c)(5) provides that any terms not specifically defined in section 851(b)(3) have the same meaning as when used in the ‘40 Act. <sup>7</sup> Treas. Reg. § 1.817-5(b)(1)(ii). <sup>8</sup> See Treas. Reg. § 1.817-5(f). <sup>9</sup> Treas. Reg. § 1.817-5(h)(1) defines “government security” to mean “any security issued, guaranteed, or insured by the United States or an instrumentality of the United States; or any certificate of deposit for any of the foregoing.” ICI Letter re Money Market Funds and Section 817(h) December 3, 2015 Page 4 of 8 Some variable insurance product funds also use repos collateralized by government securities to satisfy the section 817(h) diversification tests. Many in the industry believe that funds may look to the counterparty of these instruments, rather than the issuer of the collateral, as the issuer of these instruments for purposes of section 817(h).<sup>10</sup> We understand that the IRS generally agrees with this view.<sup>11</sup> Use of Money Market Funds by Variable Insurance Products Money market funds are a typical investment option in variable insurance products and play a unique role in the functioning and operation of those products. In particular, in addition to serving as a stable very low risk option to which contract owners can allocate a portion of their contract value, they are utilized to process transactions and act as a temporary holding or “parking” place within variable insurance products. The uniquely important role that money market funds play in variable insurance products is illustrated by the features and programs noted below, which generally require or rely on the money market funds that offer a stable NAV without fees or gates. Under the amendments to SEC Rule 2a-7, a government money market fund will be the only type of money market fund meeting those criteria and therefore now will be extremely important for variable insurance products. First, state insurance laws generally require that individual annuity and life insurance products, including variable insurance products, provide the purchaser with a “right to refund,” or “free look” right, which is a specified period (usually 10 to 30 days) during which the purchaser can return the insurance contract for a full refund. Some states require that the full premium amount be refunded. In these states, many insurers automatically allocate the premium to a money market fund during the free look period (rather than bear the investment risk) and then, at the end of that period, automatically re-allocate that amount to the investment options chosen by the contract owner. Also, most variable insurance products offer a dollar cost averaging program. Dollar cost averaging is a widely recommended and utilized investment program in which all or a portion of the contract value initially may be allocated to a money market fund, and then a specified dollar amount or percentage of that contract value is automatically re-allocated periodically (e.g., 1/12th on the first business day of each month) from the money market fund to the investment options chosen by the contract owner. <sup>10</sup> See PLR 9125038. We note that Rev. Proc. 2004-28 provides that a RIC may look to the collateral of a repo to determine whether it is a

government security for purposes of section 851(b)(3). Notably, the revenue procedure does not address section 817(h) and thus should be read as limited in scope to section 851. Further, the revenue procedure was intended to make it easier for RICs to satisfy the asset test under Subchapter M; applying the same rule to section 817(h) actually would make it more difficult for funds to satisfy that diversification test. Therefore, many in the industry have concluded that funds may still look to the repo counterparty as the issuer for purposes of section 817(h). 11 At the 2015 May Meeting of the American Bar Association Tax Section, an attorney in Financial Institutions and Products, speaking on her own behalf, indicated that this was the IRS's prevailing view. ICI Letter re Money Market Funds and Section 817(h) December 3, 2015 Page 5 of 8 Periodic charges also are deducted from most variable insurance products on specified dates (i.e., annual administrative charges, monthly insurance charges, and quarterly or other periodic rider charges for optional benefits). These charges can be deducted pro rata from the contract value allocated to all investment options, but a significant number of contracts deduct these charges entirely from the money market fund option so as not to impair contract owners' long term investment strategies and goals. Death benefits, systematic withdrawals, and variable annuity payouts also are basic features of variable insurance products that generally must be processed in accordance with the '40 Act requirements for withdrawals and that therefore depend on funds without fees or gates.<sup>12</sup> Finally, there are many other types of features and transactions in variable insurance products that also may require or utilize a money market fund with a stable NAV and no fees or gates. These include processing of periodic policy loans and loan repayments; temporary holding of premiums received under group annuities without allocation instructions; payouts of required minimum distributions; and temporary holding of premiums received from an underlying fund liquidation. As noted above, these features and programs are inherent to the operation of variable insurance products and generally require money market funds that offer a stable NAV without fees and gates. Accordingly, as discussed below, many prime institutional or retail money market funds in variable insurance products are converting or will convert to government money market funds.

**Increased Demand for Government Securities** The prospect of floating NAVs and liquidity fees and gates provides a number of operational and customer service concerns for money market funds, including those sold to the public and those limited to variable insurance products, and their intermediaries. A significant concern, for example, is the imposition of a liquidity fee or gate midday. As money market fund redemptions (including exchanges) for variable insurance products generally are processed after markets close, it will be difficult to track which transactions occurred before the fee or gate is imposed and which occurred after that event (and thus are subject to the fee or gate). It also is unclear how the imposition of fees and gates will impact prescheduled transactions, including those described above (e.g., death benefits, dollar cost averaging programs, systematic withdrawals, and periodic charges), in particular when a fee or gate is imposed intraday. Further, we understand that many institutions that previously have invested in prime money market funds with stable NAVs will be either unable or unwilling to hold floating NAV money market funds with fees and gates, and thus will shift to government money market funds. 12 Death benefit proceeds, systematic withdrawals and variable annuity payouts from the separate (i.e., segregated) account must be processed as redemptions in accordance with Section 22(e) and Rule 22c-1 under the '40 Act (subject to applicable exemptions or modifications, such as those provided by Rules 2a-7(c)(2)(iv) and 6e-3(T) under the '40 Act). Accordingly, all of these types of transactions generally are subject to the same-day transaction date valuation and pricing requirements of Rule 22c-1, and to the seven day payment requirement of Section 22(e). ICI Letter re Money Market Funds and Section 817(h) December 3, 2015 Page 6 of 8 As a result, a substantial number of existing money market funds plan to convert to government money market funds.<sup>13</sup> Indeed, a

number of large institutional money market funds already have announced plans to become government money market funds.<sup>14</sup> This substantial increase in demand may place considerable strain on the market for U.S. government securities that qualify to be held in a government money market fund. There currently are five primary types of U.S. government securities in which money market funds invest: (i) U.S. Treasuries; (ii) Federal Home Loan Bank (“FHLB”) securities; (iii) Federal National Mortgage Association (“Fannie Mae”) securities; (iv) Federal Home Loan Mortgage Corporation (“Freddie Mac”) securities; and (v) Federal Farm Credit Bank System (“Farmer Mac”) securities.<sup>15</sup> The FHLB currently is by far the largest issuer of money market fund-eligible securities. This limited number of government issuers may make it difficult for government money market funds to satisfy the requirements of section 817(h). Although variable insurance product money market funds may engage in repo transactions, thus providing exposure to issuers other than the five government agencies listed above, the potential use of repos does not eliminate the difficulties for government money market funds attempting to satisfy the requirements of section 817(h). The number of dealers in these government repos fluctuates from year to year. <sup>16</sup> We understand that larger funds currently have more than ten counterparties that they use. Smaller funds, however, may have access to fewer, or in some cases, none. We expect the demand for government securities to increase substantially over the next year, as many money market funds convert to government money market funds. Variable insurance product funds that seek to qualify as government money market funds under Rule 2a-7 while satisfying the diversification test of section 817(h) are concerned that the supply for such securities will not meet the demand. As discussed above, these funds must have access to at least five U.S. government issuers in the right proportions; it is unclear whether they will be able to do so once the demand increases. The consequences for failing to be adequately diversified under section 817(h) can be dire. For example, a variable insurance contract holder in some cases could be subject to immediate tax on the contract’s entire appreciation, even though only a small portion of the contract’s premiums might have been

<sup>13</sup> See [https://www.ici.org/viewpoints/view\\_15\\_mmf\\_changes](https://www.ici.org/viewpoints/view_15_mmf_changes); see also, “The Great Money Fund Migration Kicks Off,” *Ignites*, Nov. 11, 2015.

<sup>14</sup> For example, Fidelity (<https://www.fidelity.com/mutual-funds/fidelity-funds/money-market-funds-statement>), Blackrock (<https://www.blackrock.com/investing/literature/shareholder-letters/blackrock-product-plans-mmfr-reform-april-twenty-fifteen-letter-web.pdf>), and Invesco (<https://www.invesco.com/static/us/investors/contentdetail?contentId=57b7303b5d7c0510VgnVCM100000c2f1bf0a&CRD>) all have announced plans to convert many of their prime money market funds into government money market funds.

<sup>15</sup> The Government National Mortgage Association (“Ginnie Mae”) and the Tennessee Valley Authority (“TVA”) also issue securities, but we understand these issuances are quite small and not often utilized by money market funds.

<sup>16</sup> See [http://www.newyorkfed.org/markets/pridealers\\_current.html](http://www.newyorkfed.org/markets/pridealers_current.html) for a list of primary dealers. A list of historical primary dealers can be found at [http://www.newyorkfed.org/markets/Dealer\\_Lists\\_1960\\_to\\_2014.xls](http://www.newyorkfed.org/markets/Dealer_Lists_1960_to_2014.xls). ICI Letter re Money Market Funds and Section 817(h) December 3, 2015 Page 7 of 8 allocated to a segregated asset account that failed to meet the section 817(h) diversification requirement. Finally, as we discussed at our meeting, the Federal Reserve has encouraged the creation of a central clearing for repo transactions, including government repos. This may greatly reduce the potential number of repo counterparties for purposes of meeting the section 817(h) diversification requirements. If repos are centrally cleared, it is unclear to what extent variable insurance product funds could use repos to help diversify their portfolios.

**Request for Relief** It is imperative that variable insurance products be able to continue offering as an investment option stable NAV money market funds with no fees or gates, for the reasons

discussed above. The only way to continue doing so will be to offer government money market funds, under the recently adopted SEC rules. Given the anticipated increased demand for U.S. government securities, however, it likely will become increasingly difficult or impossible for variable insurance products that seek to qualify as government money market funds to obtain the variety of government securities necessary to satisfy any of the existing diversification tests under section 817(h) and Treas. Reg. § 1.817-5(b). This will have significant impact on the ability of firms to continue to offer these products. It also is likely to have a greater impact on smaller funds than large funds, creating inequities in the industry. We thus ask the IRS to issue guidance that would allow variable insurance products to continue to include government money market funds as underlying investment options. Specifically, we urge the IRS to issue a revenue procedure indicating that it will treat a segregated asset account as adequately diversified for purposes of section 817(h) if:

- (i) The segregated asset account invests all of its assets in one entity<sup>17</sup> (a “fund”) that qualifies for look-through treatment under Treas. Reg. § 1.817-5(f) and that is registered with the SEC under the ’40 Act (or the segregated asset account is itself a “fund” that is registered with the SEC under the ’40 Act);
- (ii) The prospectus or other offering document of that fund (as any such document is in effect on the diversification testing date specified in Treas. Reg. § 1.817-5(c)(1) or within 30 days after such date) states that the fund intends to qualify as a government money market fund under SEC Rule 2a-7;
- (iii) The fund is authorized to invest in any and all securities that are government securities under section 2(a)(16) of the ’40 Act and are eligible money market fund securities for purposes of Rule 2a-7; and
- (iv) The fund’s investment adviser or manager will determine, in its sole discretion but consistent with the fund’s prospectus or other offering document, those government securities and other positions (such as repurchase agreements) in which the fund will invest.

This revenue procedure would apply only to those variable insurance product funds that are intended to qualify as government money market funds under the SEC rules and would not alter the diversification test under Treas. Reg. § 1.817-5(b) for other types of funds. \* \* \*

We greatly appreciate your consideration of this very important issue. If you have any additional questions or would like to discuss it further, please do not hesitate to contact me.

Sincerely,  
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