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Mutual Fund Directors Digest

Broad discretion and additional responsibilities in final money fund rule: Challenges for directors

Background

On July 23, 2014, the U.S. Securities and Exchange Commission (SEC or Commission) issued its final rule on money market fund reform. The rule[1] is intended to prevent heavy redemptions on money funds in times of crisis by, among other changes, giving directors tools to react to heavy redemptions, and by increasing transparency into money funds.

The Commission took a multifaceted approach to achieving its goal of stabilizing money funds in times of crisis. The final rule and accompanying release touched on a number of issues including:

- a requirement that non-government institutional funds price holdings to current market (rather than use amortized cost)
- giving directors of money market funds the ability to implement redemption fees and gates
- new valuation guidance for short term securities, i.e., use of amortized cost valuation
- reminders on how to calculate fair value for thinly traded securities and the use of pricing services
- a requirement for enhanced stress testing
- a requirement for additional reporting in order to increase transparency, including Form N-CR and amendments to Form N-MFP

This Digest focuses on the responsibilities of directors related to fees and gates for retail money funds; and it provides an overview of the new valuation guidance on determining the fair value of short-term and thinly traded securities, as well as the use of pricing services. It is clear from the final rule and release that the SEC has emphasized the importance of the role of directors in money market reform. For example, the final rule gives directors new tools, in the forms of fees and gates that they may use, at their discretion. This development brings directors increased flexibility to respond to a potential crisis rather than mandating a "one size fits all" approach. However, the approach also brings increased responsibility to money fund directors. The new valuation guidance also heavily emphasizes the role of the directors and a reminder they have a "non-delegable" responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes fair value for a security in the fund's portfolio.

Fees and gates

The SEC stated that it believes liquidity fees would have helped money market funds manage redemptions during the financial crisis. The Commission stated its belief that the cost of the fees would cause shareholders to reevaluate their decision to redeem by reducing the first mover advantage and causing early redeemers to bear some of the economic cost of their redemptions.

The SEC also stated in the release that it believes redemption gates would have helped during the financial crisis by temporarily stopping redemptions, allowing funds to build internal liquidity and provide them time to communicate the nature of any stresses to shareholders.

[1] http://www.sec.gov/rules/final/2014/33-9616.pdf

In light of this, the SEC determined that these tools should be used to prevent future instability in the money markets and, accordingly, established general rules for the application of liquidity fees and gates. The chart below gives an overview of the fees and gates outlined in the new rule as it relates to retail money funds:

Triggering event	Board action
Weekly liquid assets* fall below 30% of total assets	***Allowed*** to establish a liquidity fee of up to 2% and/or ***Allowed*** to suspend redemptions (i.e., establish a "gate") for up to 10 business days within a 90 day period
Weekly liquid assets* fall below 10% of total assets	***Required*** to establish a liquidity fee of 1%, unless the board determines it is not in the best interest of the Fund to do so
Weekly liquid assets* rise to 30% or greater of total assets	***Required*** to lift fees and gates

* "Weekly liquid assets" generally include cash, direct obligations of the U.S. government, securities that will mature or are subject to a demand feature that is exercisable and payable within five business days; see the rule for a full definition including the new clarifying amendments.

Considerations for directors: The proposed rule would have set the default liquidity threshold at 15 percent and would have required a fund to wait until the next business day to impose a fee or gate. By allowing fees and gates at the 30 percent threshold, the final rule gives directors the ability to impose fees and gates well before the default liquidity threshold of 10 percent is reached. The rule also allows directors to impose fees and gates on the same day that heavy redemptions occur. This discretion is intended to allow directors the flexibility to prevent or stem redemptions before they occur and allow them to react very quickly if heavy redemptions begin.

In many ways, increased flexibility is a positive development in that it allows each board of directors to respond to a potential crisis in the manner that it believes is best for a particular fund and its shareholders. However, the increased flexibility also imposes increased responsibility on directors. Rather than imposing "bright line" rule that they must follow, the SEC established a 30 percent threshold (the point at which the SEC believes that directors should consider taking action) and a 10 percent default threshold (the point at which the directors are required to make an active choice whether or not to impose a liquidity fee). This brings substantial accountability in times of crisis and is likely to require significant time and effort from money fund boards. Also, this opens the board up to "Monday morning quarterbacking" and potential criticism in the aftermath of a crisis.

Policies and procedures: Knowing this, it is imperative that Boards establish clear policies and procedures dealing with how they will design and implement controls and discharge their duties under the rule. For example, while the release identified several factors that a board could consider before imposing fees and gates, except as required, the SEC also indicated that the board should consider any factors it deems relevant. As a result, policies and procedures will also need to clearly document when and how directors should be notified about an impending liquidity crisis. We suggest that directors will need to decide whether fees and gates will go into effect automatically or trigger a special meeting of the board and its delegates.

Valuation

The SEC also quietly expanded its guidance on the use of amortized cost to value short-term securities and other valuation matters. The final rule release details the Commission's view on whether and how amortized cost can be used to value short-term securities.

The expanded valuation guidance:

- Focuses on the use of the amortized cost method (ACM) for securities having maturities of less than 60 days (longer-term securities are barred from ACM for valuation)
- Applies to registered investment companies and business development companies that invest in short-term securities and value them using ACM
- Emphasizes that the determination as to whether amortized cost represents fair value should be reconsidered each time the fund makes a valuation determination, and must be based on real data about actual market conditions such as credit, liquidity, or interest rate conditions in the relevant markets, as well as issuer-specific circumstances

- Clarifies that amortized cost and the penny rounding method (i.e., pricing to the nearest one percent), are appropriate when such measurement is approximately the same as fair value

- Highlights the role of the fund board and reiterates that while directors can appoint others to assist in valuation, they cannot delegate the duty to determine fair valuation

- Discusses the use of third-party pricing services and suggests that boards may want to consider the inputs, methods, models, and assumptions used by the third party, and evaluate how they evolve as market conditions change

Considerations for directors: As the SEC had included in the rule several reminders for the role of directors, directors will need to work with management to understand how management will comply with the rule. A key takeaway is that the valuation guidance in the rule applies to short-term securities in all funds, not just money market funds. Thus, directors will need to consider whether valuation policies and procedures should be updated as the rule emphasizes that amortized cost can only be used when the Board determines such value for the security represents fair value.

The SEC continues to place importance on the role of directors. For example, with regards to use of pricing services the rule states that before deciding to use an evaluated price from a pricing service to assist it in determining the fair values of a fund's portfolio securities, "the fund's board of directors may want to consider the inputs, methods, models, and assumptions used by the pricing services to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change."

We believe that the SEC will want to see policies and procedure in order to understand how boards comply with this statement and what sort of tools, reports and protocols are in place to assist them and facilitate the need for action should market conditions change. We also anticipate that as part of the Commission's filing comment and inspection processes that management and boards may be required to affirm that they have evaluated the inputs, methods, and assumptions of third-party vendors.

Next steps

Money funds and their directors have many decisions to make in light of the rule and several new responsibilities to evaluate. They need to consider how to implement the rule, if they plan to perform test scenarios and what they will communicate to their distributors and shareholders. Fund boards need to act and work effectively to ensure that they meet the compliance date set by the rule, which is October 14, 2016 for amendments related to liquidity fees and gates. Paul Kraft, a Deloitte partner and U.S. mutual fund and investment adviser practice leader said, "Management and the directors will need to work together to operationalize the rule to make sure policies and procedures properly reflect the changes and focus on the controls that will ensure they operate as expected. Also, directors should continue to focus on the valuation process in time when market conditions change and price uncertainty exists."

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