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# Mutual Fund Directors and Investment Advisers Digest

**SEC staff issues FAQs related to valuation guidance contained in the money market fund rule: Key considerations for non-money market funds**

### Background

On July 23, 2014, the US Securities and Exchange Commission (SEC or "Commission") issued a final rule on money market fund reform. The money market fund rule[1] addressed many aspects affecting both money market funds and non-money market funds, including:

- A requirement that non-government institutional funds price holdings to current market (rather than use amortized cost)
- The ability to implement redemption fees and gates to directors of money market funds
- 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

In late April 2015, the staff of the SEC's Division of Investment Management issued two releases containing, in aggregate, 55 frequently asked questions (FAQs). The FAQs were designed to address questions that industry participants had asked regarding the topics listed above and other matters contained within the money market fund rule. For each question, the staff provided a detailed response. While such responses merely represent the views of the staff and do not necessarily reflect the views of the Commission, they still provide a beneficial interpretation of the money market fund rule. In addition, it is our belief and experience that the SEC's Office of Compliance Inspections and Examinations will refer to the FAQs as part of its inspection program.

This Digest focuses on the FAQs that specifically relate to the use of amortized cost by mutual funds that have a floating net asset value (NAV) per share, including money market funds and non-money market funds, as well as director responsibilities and oversight.

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### FAQs—Amortized cost

Although the use of amortized cost has been the main method for valuing holdings within a money market fund, many non-money market funds have been using amortized cost to value short-term debt securities with remaining maturities of 60 days or less, as permitted under Accounting Series Release No. 219 (ASR 219), as long as such securities approximated fair value. The money market fund rule detailed the Commission's view on when and how such mutual funds can use amortized cost to value short-term debt securities. In particular, the money market fund rule emphasized a fund should reconsider whether a security's amortized cost represents its fair value each time the fund makes a valuation determination (i.e., whenever the fund strikes its NAV) 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.

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

Many registrants questioned whether the SEC's intention was for mutual funds either to abandon the use of amortized cost in such permitted circumstances or to perform daily shadow pricing to validate that amortized cost approximates fair value. Based on our reading of the FAQs, the staff appears to hold the following views on this matter:

- A fund's policies and procedures should include the factors (such as existing credit, interest rate, liquidity, and issuer-specific conditions) that it considers every day relative to the use of amortized cost and how such factors are reviewed and monitored. These policies and procedures can help a fund conclude whether a portfolio security's amortized cost is approximately the same as its fair value.
- Shadow pricing is not required. If shadow pricing is used, it is not acceptable to default to the use of amortized cost as a good proxy for fair value if the fund is unable to obtain a price from a third-party vendor or broker.
- If a disparity exists between an individual portfolio security's amortized cost and its fair value that is large enough to affect the fund's NAV, amortized cost should not be used. The FAQs are silent as to whether a fund must use a security's fair value when a large disparity exists that does not have an effect on the NAV, but the presumption appears to be that a fund may elect to use amortized cost in such an instance. The FAQs are also silent as to whether the impact on the NAV is only meaningful if it constitutes the full penny or whether an impact that rounds the NAV up or down is sufficient to warrant the use of fair value pricing.

Although not required, many might use shadow pricing as a way to determine whether amortized cost approximates fair value. Regardless, it seems clear that the SEC expects funds to have written policies and procedures that explain how a fund determines whether to use amortized cost. Performing shadow price testing may constitute the main procedure, but putting some substance around why such a procedure is effective and how the fund monitors whether evaluated prices provided by others reflect the fair value of short-term debt securities (including during tumultuous market conditions) will likely demonstrate that a fund has been thoughtful about its valuation control environment and is not operating on "autopilot." In evaluating existing policies and procedures or developing new ones, we believe that fund groups might wish to consider the following:

- What factors/data points are most relevant? Should they vary based on security type?
- How much would certain inputs, such as interest rates, need to change in order to impact a fund's NAV per share? This is akin to the stress testing that many funds are already performing on their debt portfolios.
- Will the fund still use the amortized cost of a security if such is determined to not reflect fair value but there is no impact on the fund's NAV? How will the fund view a scenario where the difference for each fund's security is insignificant, but the impact of several securities in the aggregate would impact the NAV?
- Who will have the responsibility to performed the procedures, and who will evaluate the need to take action?
- How will the procedures/analysis performed and conclusions reached be documented and retained?
- What type of board reports are needed to help fund boards fulfill their oversight responsibilities?

Being proactive in considering these items may be smart, as it can save time if and when an issue occurs, especially when market conditions result in the lack of available third-party data. Of course, nothing precludes a fund group from obtaining evaluated prices from a pricing vendor or use broker quotes in lieu of using amortized cost. Still, even in that scenario, it is always possible that third-party prices may not be reliable or even available. Thus, it never hurts to be prepared by having a backup plan on what tools, models, and resources will be used and available in such circumstances.

### FAQs—Director oversight

The money market fund rule highlighted the role of the fund board in the valuation process and reiterated that, while directors can appoint others to assist in valuation, they cannot delegate the duty to determine whether prices used to value a fund reflect their fair values. The money market fund rule also discussed the use of third-party pricing services and suggested 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.

One of the FAQs clarified that, while directors cannot delegate their duty, they "may appoint others, such as the fund's investment adviser or a valuation committee, to assist the board in determining fair value and to make the actual calculations pursuant to the fair value methodologies previously approved by directors." For many directors, this clarification helps relieve a concern that has existed over the last year as to whether delegation was still permissible. The FAQs also explain that the appointee may assist the board in performing due diligence over the pricing services. This suggests that although directors are certainly free to meet with pricing vendors and perform onsite visits, this does not seem to be a required board oversight activity.

Still, it is clear that the SEC expects a fund to consider the inputs methods, models, and assumptions used by a third-party pricing service and to evaluate how they are affected by market conditions. While the directors do not have to directly evaluate these items, the SEC appears to expect them to oversee those who have considered them and evaluate the results of the work performed, including whether to continue using a pricing service or whether to use an alternative means for determining the fair value. It is also clear that the directors have the ultimate responsibility "to determine the method [used by the fund] for determining the fair value of each such security."

### Bottom line

Ultimately, directors have to be able to determine that the policies and procedures in place, whether they are for the short-term debt securities discussed above or for other investments without readily available market quotations, are appropriate to meet their objectives. Directors also must ensure that such policies and procedures are periodically reevaluated as necessary. Although the release focuses on short-term debt securities, directors should be cognizant that there are other thinly traded debt and equity securities that funds hold for which there might be little daily information available, creating a great challenge when striking a NAV. Understanding the policies and procedures for determining each day whether the price should change from the prior day's price and for ensuring that a process is carried out consistently and effectively for all such securities is paramount for an effective valuation control environment and board oversight model.

Perhaps, just as important is the valuation team carrying out such policies and procedures. The directors delegate to this team and, by doing so, place their trust in them. In order to consider such people to be reliable appointees, directors must evaluate not only their competency to carry out the tasks at hand, but also if they have adequate time and resources to be successful. If any of these do not exist, directors cannot be sure that the policies and procedures are operating as intended. Directors should continue to evaluate the competence, depth, and availability of their appointees throughout the year to be safe.

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