STRADLEY RONON

Fund Alert

A Publication of the Stradley Ronon
Investment Management Group

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JANUARY 2015

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BURIED TREASURES OR HIDDEN LANDMINES?
What You May Have Overlooked in the 893-Page Money Market Reform Adopting Release

By Joan Ohlbaum Swirsky and Amy G Smith

Since the SEC adopted money market fund reforms on July 23, 2014, practitioners have been digesting the 893-page adopting release (the Release). In this alert, we excerpt from the SEC's commentary in the Release and provide our observations to help guide funds' compliance efforts. The commentary does not carry the force of the text of the money market fund rule itself (the Rule), but it may inform the SEC's examination staff and conceivably could be raised as authority in enforcement proceedings. Accordingly, the Release is both a treasure trove and a minefield for the practitioner, providing practical guidance but also overlaying additional compliance advice around the 37-page Rule itself. Here (see http://www.stradley.com/~/media/Files/Publications/2015/Jan15FundAlertBuriedTreasureHiddenLandMines.pdf) we have included Release excerpts relating to some topics that have already been widely dissected by practitioners (such as the SEC's unexpectedly placed valuation commentary for all funds and its advice on identifying "retail" shareholders) and also excerpts on topics not yet widely addressed (such as some stress testing and disclosure guidance). Page references are to the SEC's version of the Release on its website.[1]

For a summary of the reforms, see our *Fund Alert*, "What You Need to Know About Money Market Fund Reform," available at http://www.stradley.com/insights/publications/2014/07/fund-alert. In summary, the SEC's rules will require institutional prime and institutional municipal money market funds to replace their current $1.00 stable share price with a floating net asset value (NAV). The reforms also will authorize fund boards to impose a liquidity fee of up to 2 percent and/or a redemption gate (for no more than 10 business days in any 90-day period) if weekly liquid assets[2] in the fund fall below 30 percent of assets. A liquidity fee of 1 percent would be imposed if weekly liquid assets fall below 10 percent of assets, unless the fund board takes action to eliminate, reduce or increase the fee (but not to more than 2 percent).

BOARD CONSIDERATIONS REGARDING LIQUIDITY FEES AND GATES

Board decision to impose fee/gate

Our observation: Each money market fund whose board will have authority to impose redemption fees or gates may have its board adopt related procedures. These procedures may list some of the factors that the SEC suggests in the Release as possibly relevant to the board's considerations in imposing the fee or gate. At the time the board implements a fee or gate, the factors the board considers will be reported publicly. New Form N-CR will require a public report by four business days after the event, "[b]rief[ly] discuss[ing] the primary considerations or factors taken in account by the board of directors in its decision

to impose (or not impose) a liquidity fee or to suspend the fund's redemptions." (There is no requirement to disclose the content of fund procedures that may recite the factors the board may consider.)

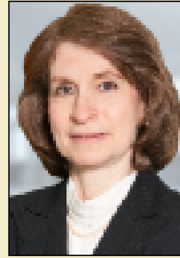
One commenter on the money market reforms was particularly concerned about the threat of litigation if boards were not protected by the business judgment rule, as it could "chill the board's ability to act in a manner that would be highly counterproductive in times of market stress." While sensitive to this commenter's concerns, the SEC said, "We do not believe it would be appropriate for us to address the application of the business judgment rule because the business judgment rule is a construct of state law and not the federal securities laws." (p. 91) Below is SEC commentary on the board's important, and very public, decision to impose fees or gates. (Note that the SEC says one factor the board may consider is the broader systemic effects of fees and gates.)

... [A]n exhaustive list of factors [for the board to consider] may not address each fund's particular circumstances and could quickly become outdated. Instead, we believe a fund board should consider any factors it deems appropriate when determining whether fees and/or gates are in the best interests of a fund. We note that <u>these factors may include the broader systemic effects of a board's decision, but point out that the applicable standard for a board's determination under the amended rule is whether a fee or gate is in the fund's best interests</u>. (p. 90, emphasis added)

... [W]e believe it is appropriate to provide certain guideposts that boards may want to keep in mind, as applicable and appropriate, when determining whether a fund should impose fees or gates and are providing such guidance in this Release. As recognized in the Proposing Release, there are a number of factors a board may want to consider. These may include, but are not limited to:

- *relevant indicators of liquidity stress in the markets and why the fund's weekly liquid assets have fallen (e.g., Have weekly liquid assets fallen because the fund is experiencing mounting redemptions during a time of market stress or because a few large shareholders unexpectedly redeemed shares for idiosyncratic reasons unrelated to current market conditions or the fund?);*

- *the liquidity profile of the fund and expectations as to how the profile might change in the immediate future, including any expectations as to how quickly a fund's liquidity may decline and whether the drop in weekly liquid assets is likely to be very short-term (e.g., Will the decline in weekly liquid assets be cured in the next day or two when securities currently held in the fund's portfolio qualify as weekly liquid assets?);*[264]



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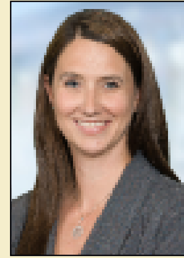

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- *for retail and government money market funds, whether the fall in weekly liquid assets has been accompanied by a decline in the fund's shadow price;*[265]

- *the make-up of the fund's shareholder base and previous shareholder redemption patterns; and/or*

- *the fund's experience, if any, with the imposition of fees and/or gates in the past*. (p. 90-91, footnotes omitted)

<u>Level of liquidity fee</u>

Our observation: Each money market fund whose board will have authority to impose redemption fees may have its board adopt related procedures. These procedures may list some of the factors that the SEC suggests in the Release as possibly relevant to the board's considerations in determining the fee level. One of the factors to consider, the SEC suggests, is the market cost of providing liquidity. Fund service providers may wish to consider how that data will be monitored in the event the board must consider the fee level.

As recognized in the Proposing Release, there are a number of factors a board may want to consider in determining the level of a liquidity fee. These may include, but are not limited to:

- *changes in spreads for portfolio securities (whether based on actual sales, dealer quotes, pricing vendor mark-to-model or matrix pricing, or otherwise);*

- *the maturity of the fund's portfolio securities;*

- *changes in the liquidity profile of the fund in response to redemptions and expectations regarding that profile in the immediate future;*

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- *whether the fund and its intermediaries are capable of rapidly putting in place a fee of a different amount from a previously set liquidity fee or the default liquidity fee;*

- *if the fund is a floating NAV fund, the extent to which liquidity costs are already built into the NAV of the fund; and*

- *the fund's experience, if any, with the imposition of fees in the past.*

We note that fund boards should not consider our 1 percent default liquidity fee as creating the presumption that a liquidity fee should be 1 percent. If a fund board believes based on market liquidity costs at the time or otherwise that a liquidity fee is more appropriately set at a lower or higher (up to 2 percent) level, it should consider doing so. (p. 100-101)

Board monitoring while fee or gate is in place

Our observation: When a fund operates with a fee or a gate in place, the board likely will need to meet frequently to monitor the continued need for the fee or gate and the fee level. Fund procedures may reflect this ongoing monitoring. The SEC says:

Once a liquidity fee has been imposed, the fund's board would likely need to monitor the imposition of such fee, including the size of the fee, and whether it continues to be in the best interests of the fund.[303] (p. 101, footnote omitted)

Similarly, once a gate is imposed, the fund's board would likely monitor the imposition of the gate and whether it remains in the best interests of the fund to continue imposing the gate. (p. 101, footnote 303)

STRESS TESTING

Reports to the board

Our observation: The amended Rule requires that a money market fund's adviser include in stress test reports a summary of the significant assumptions made when performing the stress tests. The SEC gives examples of assumptions. An adviser may wish to consider whether to include possible assumptions in its procedures.

Funds need to make some basic assumptions about how a fund obtains cash for redemptions to satisfy the new stress testing requirements relating to the fund's level of weekly liquid assets. In doing so, a fund could use a variety of assumptions. For example, some commenters suggested that funds assume that all redemptions are satisfied first using weekly liquid assets.[1827] *This assumption would provide conservative stress test results given that it would have the most dramatic effect on a fund's level of weekly liquid assets. On the other hand, some funds may prefer to assume in their stress tests other methods of meeting shareholder redemptions (or may prefer to show how the stress tests results would differ if this assumption were varied). For example, a fund might assume that redemptions are met with a combination of weekly liquid assets and sales of portfolio securities.*[1828] *The rule does not specify what assumptions the fund must make, leaving that to the discretion* of fund advisers *because we believe the determination of which assumptions are most appropriate will vary among funds, depending on, for example, how funds have satisfied redemptions historically, and the composition of the fund's portfolio. ... For example, such assumptions may include how redemptions are satisfied and the size of any "haircut" that the fund assumed in the sale of portfolio securities in order to meet redemptions* (p. 580-581, footnotes omitted, emphasis added)

Our observation: The amended Rule requires that a money market fund's adviser include in stress test reports such information as may reasonably be necessary for the fund board to evaluate the stress testing conducted by the adviser and the results of the testing. The SEC gives examples of information that may reasonably be necessary for the board's understanding. The fund may consider whether to include such information in reports to the board.

Some funds include information [in stress test reports] regarding, for example, the concentrations of several of the funds' largest portfolio holdings, both by individual issuer and by sector, and of historical redemptions rates, as points of reference. Several funds also include narratives to help explain the results. In some instances, for example, fund advisers used the narrative to compare results among funds or to explain results that they considered to be unusual. Some narratives also assessed the likelihood of the hypothetical events. We are not including requirements for any of these specific items in the rule because we recognize that there is no one set of factors that will be relevant for all funds, but we believe these are examples of items that we encourage fund advisers to consider when developing the required report assessing stress test results. ... (p. 584-585, emphasis added)

... [I]nformation about historical redemption activities, as mentioned above, and the fund's investor base could help boards evaluate the potential for shareholder redemptions at the levels that are being tested. Additionally, information regarding any contemporaneous market stresses to particular portfolio sectors could be helpful to a board's consideration of stress testing results. ... These assumptions would include, for example, how the fund would satisfy shareholder redemptions (e.g., through weekly liquid assets or by selling certain portfolio securities, including any assumption of haircuts such securities can be sold at) and the amount of loss in value of a downgraded or defaulted portfolio security. (p. 586)

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Even floating NAV money market funds will need to test whether they minimize principal volatility

Our observation: Funds will need to adopt stress tests for the ability of each floating and stable NAV money market fund to minimize principal volatility. The SEC makes clear that this test may be very similar to (perhaps even the same as) the tests currently used to determine the ability of a stable NAV money market fund to maintain a stable NAV (that is, to avoid breaking the dollar). Accordingly, a stable NAV money market fund may conduct two stress tests that are very similar to each other (or one test may serve double duty).

We have determined not to set specific limitations or thresholds against which funds should test principal volatility. Unlike stable NAV funds, which have a clear threshold [presumably this refers to breaking the dollar]*, we do not believe that there is [a] single measure of what level of volatility investors in floating NAV funds will tolerate. This measure might differ among floating NAV funds, depending on, for example, investor composition. Accordingly, we believe that funds and fund boards are best suited to determining the amount of principal volatility that investors in their floating NAV funds will likely tolerate and, accordingly, what volatility threshold or thresholds should be used in their stress testing. ... We believe, based on comments, that funds would generally approach this requirement* [to test ability to minimize principal volatility] *similar to how they today test the ability to maintain a stable share price although, as discussed above, funds will need to determine what volatility threshold or thresholds they believe are appropriate to test against.*[1783] *... We have chosen to use the metric of minimizing volatility, rather than avoiding losses because certain investors in floating NAV funds might demand overall price stability, and therefore some floating NAV funds might determine that it is appropriate to consider both upward and downward price pressures when developing stress tests.* (p. 563-564, footnotes omitted)

We have retained the requirement that stable NAV funds test their ability to maintain a stable share price. Although we do not anticipate that stable NAV funds would approach this additional requirement in a way that differs much, if at all, from a test to minimize principal volatility, it clarifies that stable NAV funds are required to test the ability of the fund to avoid breaking the buck. (p. 565, emphasis added)

Upward price movement not generally tested

Our observation: Money market funds are not generally required to test the ability to minimize upward principal volatility. Funds may wish to reflect this view in their stress test procedures. But the SEC leaves open the possibility that such testing may be appropriate under some circumstances.

Although we recognize that upward price pressures might be a relevant metric to stress test for some funds, we also recognize that funds will generally be more concerned with downward price pressures. Accordingly, we do not interpret the requirement to test the ability to minimize principal volatility to require funds, as a matter of course, to test against upward price movements. (p. 565, footnote 1784)

Combinations of stress events

Our observation: The SEC states that the Rule sets forth the minimum required stress tests (specifically, tests for interest rate increases, downgrades/defaults and widening spreads, each in combination with various levels of increase in shareholder redemptions). The SEC recognizes that some advisers may determine that the three combinations of events in the Rule are sufficient, but suggests that an adviser might determine additional stress tests are necessary. The Rule requires that the adviser test "any additional combinations of events that the adviser deems relevant."

The rule requires that fund advisers test for combinations of events that they deem relevant. Although a fund adviser might determine that the three combinations of events included in the rule are sufficient, there might be circumstances when a fund adviser believes it is necessary to incorporate additional scenarios. For example, a fund adviser might believe that it would be relevant for the board to understand the effect of a yield spread increase in a sector, in combination with a downgrade of a portfolio security in that sector, particularly if that sector, or an issuer within that sector, has historically experienced stress. (p. 582, emphasis added)

No need to develop a stress test for every risk a fund faces

Our observation: The SEC provides commentary on the potentially broad requirement in the amended Rule to test "any additional combinations of events that the adviser deems relevant." Advisers will need to focus on which, if any, additional stress combinations should be reported to the fund board.

One commenter also argued that the requirement [to test any additional combinations of events that the adviser deems relevant] *could be interpreted to mean that all special risk assessments take the form of stress tests.*[1831] *This is not a requirement of the rule. We agree with the commenters that stress tests are not the only method to communicate fund risks to the board and that not every risk can be incorporated into a stress test.*[1832] *The rule does not require the adviser to develop a stress test for every risk the fund faces, but requires the adviser to consider whether stress testing for combinations of events not explicitly listed in the rule might be relevant to the fund's board. We believe stress testing should be used to help the board understand the principal risks of the particular fund and the risks that reasonably foreseeable stress events may place on the fund.* (p. 582-583, emphasis added, footnotes omitted)

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DISCLOSURE AND NOTICE

Starting to operate with fees/gates

Our observation: The SEC expects money market funds to incorporate disclosure in the prospectus or statement of additional information discussing the operation of fees and gates in detail under the current requirements of Form N-1A, Item 11(c)(1) and Item 23. Funds will need to ready this disclosure by the time they operate under the fee and/or gate requirements. The SEC has indicated that the summary prospectus need not include disclosure of fees and gates and that there is no requirement that the fund's liquidation process be disclosed. However, the fund must make clear that it may suspend redemptions to liquidate.

... [W]e anticipate that funds generally would consider the following disclosure to be appropriate for the prospectus, as disclosure regarding redemption restrictions provided in response to Item 11(c)(1) of Form N-1A:

(i) means of notifying shareholders about the imposition and lifting of fees and/or gates (e.g., press release, website announcement);

(ii) timing of the imposition and lifting of fees and gates, including (a) an explanation that if a fund's weekly liquid assets fall below 10% of its total assets at the end of any business day, the next business day it must impose a 1% liquidity fee on shareholder redemptions unless the fund's board of directors determines that doing otherwise is in the best interests of the fund, (b) an explanation that if a fund's weekly liquid assets fall below 30% of its total assets, it may impose fees or gates as early as the same day, and (c) an explanation of the 10 business day limit for imposing gates;

(iii) use of fee proceeds by the fund, including any possible return to shareholders in the form of a distribution;

(iv) the tax consequences to the fund and its shareholders of the fund's receipt of liquidity fees; and

(v) general description of the process of fund liquidation[953] if the fund's weekly liquid assets fall below 10%, and the fund's board of directors determines that it would not be in the best interests of the fund to continue operating.[954] (p. 305-306, footnotes omitted)

The Proposing Release requested comment on the utility of including additional disclosure about the operations and effects of fees and redemption gates, including:

(i) requiring information about the basic operations of fees and gates to be disclosed in the summary section of the statutory prospectus (and any summary prospectus, if used) and

(ii) requiring details about the fund's liquidation process.

One commenter argued against the utility of such additional disclosure in helping investors to understand the effects of fees and gates on redemptions.[947] We agree and decided against making any changes to the rule text in this regard…. (p. 303, footnote omitted)

One commenter argued that it was unnecessary to describe the process of fund liquidation in either the prospectus or SAI. See Federated VIII Comment Letter. <u>We note that we are not mandating particular disclosures, but rather providing examples of the types of disclosures we believe that money market funds could provide in the prospectus or SAI.</u> We further note that it is <u>important for funds to ensure that investors are fully aware of the ability of the fund to permanently suspend redemptions and liquidate.</u> (p. 303, footnote 945, emphasis added)

Starting to operate as a retail money market fund

Our observation: A retail money market fund will need to include in its compliance timeline the addition of prospectus disclosure regarding its retail status and explaining that investors are limited to natural persons.

We also expect that a fund that intends to qualify as a retail money market fund would disclose in its prospectus that it limits investment to accounts beneficially owned by natural persons. (p. 301)

Starting to operate with a floating NAV

Our observation: A fund may update its registration statement "at the time" it transitions to a floating NAV, by either a post-effective amendment or a prospectus supplement.

Currently, a fund must update its registration statement to reflect any material changes by means of a post-effective amendment or a prospectus supplement (or "sticker") pursuant to rule 497 under the Securities Act.[941] As discussed in the Proposing Release, we would expect that, to meet this existing requirement, at the time that a stable NAV money market fund transitions to a floating NAV (or adopts a floating NAV in the course of a merger or other reorganization), it would update its registration statement to include relevant related disclosure, as discussed in sections III.E.1 and III.E.2 of this Release, by means of a post-effective amendment or a prospectus supplement. Two commenters explicitly supported that such disclosures be made when transitioning to a floating NAV.[942] <u>We continue to believe that a money market fund must update its registration statement by means of a post-effective amendment or "sticker" to reflect relevant disclosure related to a transition to a floating NAV.</u> (p. 302, footnotes omitted, emphasis added)

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Consider disclosing historical context of flows

Our observation: New disclosure requirements include disclosure of daily shareholder inflows on the fund website for a six-month rolling period. The SEC suggests that the historical context provided will assist shareholders in understanding normal asset volatility. Funds may consider whether any explanation of the data provided would be helpful.

We understand, as commenters pointed out, that many funds can experience periodic and expected large net inflows or outflows on a regular basis. We believe that disclosure of this information over a rolling six-month period, however, will mitigate the risk that investors will misinterpret this information. Information about the historical context of fund inflows and outflows, which funds can include on their websites, should help investors distinguish between periodic large outflows that can occur in the normal course from periods of increased volatility in shareholder flow. (p. 341, emphasis added)

Opt-in by U.S. government money market funds may require 60 days' notice

Our observation: If a government money market fund opts in to operating with fees and gates, the SEC suggests that the fund provide at least 60 days' notice to shareholders. The Release is silent on a notice period for funds that are required to operate with fees and gates (all money market funds other than government money market funds).

In addition, a government fund that later opts to rely on the ability to impose fees and gates provided in rule 2a-7(c)(2)(iii) should consider whether to provide any additional notice to its shareholders of that election.[955] (p. 306, footnote omitted) We note that 60-day notice is required by our rules for other significant changes by funds, for example, when a fund changes its name. See rules 35d-1(a)(2)(ii) and (a)(3)(iii). (p. 306, footnote 955)

Press release or social media update on negative events supplementing Form N-CR filing and fund website posting

Our observation: The money market fund reforms require that a money market fund disclose certain negative events on a new form, Form N-CR, which will be filed with the SEC and made public immediately and by simultaneous website filing. The negative events include defaults/events of insolvency, affiliated support, deviation from stable NAV when the fund is halfway to breaking the dollar, and imposition or elimination of fees/gates. The fund must post the negative information on its website on the date of each initial Form N-CR filing, other than a filing for deviation from stable NAV. The SEC states that the fund could consider additional complementary shareholder communications such as a press release or social media update. A money market fund which has "emergency" or "escalation" procedures for negative events may wish to revise the procedures to mention the new negative event reporting, and to consider mentioning the possibility of such additional disclosures. Alternatively, these requirements could be reflected in fund procedures under Rule 2a-7.

We understand that investors have become accustomed to obtaining money market fund information on funds' websites, and therefore we believe that website disclosure provides significant informational accessibility to shareholders, and the format and timing of this disclosure [regarding certain negative events] serves a different purpose than the Form N-CR filing requirement.[1123] While we believe that it is important to have a uniform, central place for investors to access the required disclosure, we note that nothing in these amendments would prevent a fund from supplementing its Form N-CR filing and website posting with complementary shareholder communications, such as a press release or social media update disclosing a fee or gate imposed by the fund. (p. 354-355, footnote omitted)

Prospectus disclosure when fee or gate is imposed

Our observation: Each money market fund is expected to file a post-effective amendment or prospectus supplement when a fee or gate is imposed. A fund may refer to such capacity in its money market fund procedures. (See above regarding additional negative event disclosures on Form N-CR and possibly via press release and social media update.)

We also expect that, promptly after a money market fund imposes a redemption fee or gate, it will inform investors of any fees or gates currently in place by means of a post-effective amendment or prospectus supplement.[2463] (p. 784, footnote omitted)

If a fund imposes a liquidity fee, shareholders will also be informed about the imposition of this fee on the fund's website[986] and possibly by means of a prospectus supplement.[987] (p. 315, footnote omitted)

Form N-CR

Our observation: New Form N-CR for public filing with the SEC regarding specified negative events includes an optional section that funds may use to update prior filings. Funds may wish to address the permitted optional filings in fund procedures. Such updated filings may be useful if facts change rapidly in the fluid circumstances of a troubled fund.

For example, one commenter cautioned "in a rapidly changing environment, the reasons for which the board acted [to impose a fee or gate, both of which are required to be reported on Form N-CR,] *may well change within a period of four days, or significant amounts of additional information may be available*

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to the fund and its board. In this context, a filing requirement focused on a prior decision risks inadvertently misleading fund investors and others about the state of the fund's operations." (p. 407, footnote 1317)

This optional disclosure [under section H of Form N-CR, of "any other events or information not otherwise required by this form"] *is intended to provide money market funds with additional flexibility to discuss any other information not required by Form N-CR, or to supplement and clarify other required disclosures.*[1318] *This optional disclosure does not impose on money market funds any affirmative obligation. Rather, this is solely intended as a discretionary forum where funds, if they so choose, can disclose any other information they deem helpful or relevant.* (p. 407-408, footnote omitted)

60 days' notice required for involuntary redemption to separate retail and institutional shareholders

Our observation: The SEC provides exemptive relief to involuntarily redeem shareholders in connection with separating retail and institutional classes into new funds under money market fund reforms. The SEC says that shareholders must receive 60 days' notice of the involuntary redemption. This notice requirement may mean the fund board must approve the restructuring earlier than it otherwise would, to ensure the board has approved the class separation by the time the fund notifies shareholders.

Notwithstanding the prohibitions in section 22(e) of the Act, in the context of a one-time reorganization to distinguish between retail and institutional money market funds (either in separating classes into new funds or in ensuring that an existing fund only has retail or institutional investors), the Commission's position is that a fund may involuntarily redeem investors who no longer meet the eligibility requirements in a fund's retail and/or institutional money market funds without separate exemptive relief, provided that the fund notifies in writing such investors who become ineligible to invest in a particular fund at least 60 days before the redemption occurs. (p. 231-232)

Transition to a floating NAV: Attempting to ensure NAV at the time of conversion

Our observation: The SEC has suggested that a fund could take steps to ensure that its market-based NAV is $1.00 or higher at the time of transition to a floating NAV fund, to help stave off pre-emptive runs on the fund by shareholders who fear the NAV will be less than $1.00 upon conversion. We are not aware of commentary on this suggestion. The SEC has said it will monitor redemption activity during the transition period and will consider actions such as the potential need for any exemptive or other relief.

We recognize that, although money market funds may comply with the rule amendments at any time between the effective date and the compliance date, in practice, money market funds may implement amendments relating to floating NAV near the end of the transition period, which may further cause the potential for widespread redemptions prior to the transition. Although a few commenters suggested as much,[624] *we did not receive any survey data and we are not able to reasonably estimate the extent to which money market funds may or may not stagger their transition to a floating NAV. We note, however, that in order to mitigate this risk, money market fund managers could take steps to ensure that the fund's market-based NAV is $1.00 or higher at the time of conversion and communicate to shareholders the steps that the fund plans to take ahead of time in order to mitigate the risk of heavy pre-emptive redemptions, though funds would be under no obligation to do so. Even if funds took such steps, investors may pre-emptively withdraw their assets from money market funds that will transact at a floating NAV to avoid this risk. We note, however, that while a two-year compliance period does not eliminate such concerns, we expect, as discussed above, that providing a two-year compliance period will allow money market funds time to prepare and address investor concerns relating to the transition to a floating NAV, and therefore possibly mitigate the risk that the transition to a floating NAV, itself, could prompt significant redemptions. In addition, the liquidity fees and gates reforms will be effective and therefore available to fund boards as a tool to address any heightened redemptions that may result from the transition to a floating NAV.*[625] (p. 201, footnotes omitted, emphasis added)

We will monitor fund redemption activity during the transition period and consider appropriate action if it appears necessary. For example, such action could include SEC Staff contacting fund groups to determine the nature of any stress from redemption activity and the potential need for any exemptive or other relief. (p. 202, footnote 625)

Same-day settlement

Our observation: The move to a floating NAV will complicate a money market fund's ability to provide same-day redemption proceeds. The fund will need to obtain market values for its holdings to calculate NAV, a process that may take several hours. Funds will need to determine how many times per day they will calculate market-based NAV and whether the fund must close early to enable the last pricing of the day to provide same-day proceeds. The SEC provided some commentary on the number of daily pricings in a floating NAV money market fund.

We estimate that money market funds will likely establish twice per day pricing as the appropriate balance between current money market fund practice to provide multiple settlements per business day and the additional costs and complexities involved in pricing money market fund shares using market-based values. (p. 199, footnote 619, emphasis added)

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VALUATION

Evaluated prices

Our observation: The SEC recognizes that the vast majority of money market fund portfolio securities do not have readily available market quotations because most portfolio securities such as commercial paper, repos, and certificates of deposit are not actively traded in the secondary markets. Therefore, the asset prices used to calculate the floating NAV would largely be accounting- or model-based estimates by pricing services, rather than prices based on secondary market transactions. Based on the SEC commentary below, both money market funds and non-money market funds will need to consider whether to enhance reporting to the fund board about evaluated prices provided by pricing services. Note the SEC's use of the words "may want" and "should generally" in this discussion, so that this advice falls short of a mandate.

Before deciding to use evaluated prices 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 service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change. In choosing a particular pricing service, a fund's board may want to assess, among other things, the quality of the evaluated prices provided by the service and the extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its net asset value. In addition, the fund's board should generally consider the appropriateness of using evaluated prices provided by pricing services as the fair values of the fund's portfolio securities where, for example, the fund's board of directors does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions.[899] (p. 287-288, footnote omitted, emphasis added)

Fair valuation of securities maturing within 60 days at amortized cost value

Our observation: Under a long-standing SEC position applicable to floating NAV funds, a fund may value securities that mature within 60 days at amortized cost unless particular circumstances, such as impairment of creditworthiness of the issuer, indicate that amortized cost is not appropriate. In the Release, the SEC provides guidance to floating NAV funds (money market funds and non-money market funds alike) as to when they can use the amortized cost of securities maturing within 60 days as the fair value of those securities. A fund cannot simply recite in its valuation procedures that these securities are valued at amortized cost and leave it at that, but rather must evaluate this valuation each time it is used.

Note that this advice will have no application to stable NAV money market funds. That is because Rule 2a-7 provides the exemptive relief to use amortized cost for retail and government money market funds (that can have a stable NAV), so the guidance regarding use of amortized cost for securities maturing within 60 days or less is not applicable to a retail or government money market fund. Also, when a retail or a government money market fund shadow prices, it uses market value as the shadow price even for the securities maturing within 60 days. So there too the guidance is not applicable. (The SEC staff allowed an exception to the requirement to shadow price using market values for those very short-term securities in stable NAV money market funds in a special temporary no-action letter, which has since expired, issued to the Investment Company Institute on Oct. 10, 2008, during the financial crisis. In that unusual circumstance, the SEC staff concluded that the market prices for very short-term securities were not reflecting their fair value, and permitted money market funds to use amortized cost values as fair values.)

... [I]t would not be appropriate for a fund to use amortized cost to value a debt security with a remaining maturity of 60 days or less and thereafter not continue to review whether amortized cost continues to be approximately fair value until, for example, there is a significant change in interest rates or credit deterioration. We generally believe that a fund should, at each time it makes a valuation determination, evaluate the use of amortized cost for portfolio securities, not only quarterly or each time the fund produces financial statements. We note that, under the final rules, each money market fund will be required to value, on a daily basis, the fund's portfolio securities using market-based factors and disclose the fund's share price (or shadow price) rounded to four decimal places on the fund's website. As a result, we believe that each money market fund should have readily available market-based data to assist it in monitoring any potential deviation between a security's amortized cost and fair value determined using market-based factors. We believe that, in certain circumstances, such as intraday, a fund may rely on the last obtained market-based data to assist it when valuing its portfolio securities using amortized cost. To address this, a fund's policies and procedures could be designed to ensure that the fund's adviser is actively monitoring both market and issuer-specific developments that may indicate that the market-based fair value of a portfolio security has changed during the day, and therefore indicate that the use of amortized cost valuation for that security may no longer be appropriate. (pp. 280-281, emphasis added)

Thinly traded securities

Our observation: Funds may wish to confirm that their valuation procedures reflect the SEC's view that thinly traded securities must be valued based on current market conditions, not based on an assumption that they will be held to maturity.

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Because most money market fund portfolio securities are not frequently traded and thus are not securities for which market quotations are readily available, we understand that they are typically fair valued in good faith by the fund's board.[890] As a general principle, the fair value of a security is the amount that a fund might reasonably expect to receive for the security upon its current sale.[891] Determining fair value requires taking into account market conditions existing at that time. Accordingly, funds holding debt securities generally should not fair value these securities at par or amortized cost based on the expectation that the funds will hold those securities until maturity, if the funds could not reasonably expect to receive approximately that value upon the current sale of those securities under current market conditions.[892] (p. 284-285, footnotes omitted, emphasis added)

NATURAL PERSONS

Retail and institutional examples

Our observation: A retail money market fund which is exempt from the floating NAV is one with procedures reasonably designed to limit all beneficial owners of the fund's shares to natural persons. Many difficult questions will arise as to whether particular shareholders are natural persons. The SEC provides a few examples of accounts utilized by natural persons.

Natural persons often invest in money market funds through a variety of tax-advantaged accounts and trusts, including, for example:

(i) participant-directed defined contribution plans (section 3(34) of the Employee Retirement Income Security Act ("ERISA"));

(ii) individual retirement accounts (section 408 or 408A of the Internal Revenue Code ("IRC"));

(iii) simplified employee pension arrangements (section 408(k) of the IRC);

(iv) simple retirement accounts (section 408(p) of the IRC);

(v) custodial accounts (section 403(b)(7) of the IRC);

(vi) deferred compensation plans for government or tax-exempt organization employees (section 457 of the IRC);

(vii) Keogh plans (section 401(a) of the IRC);

(viii) Archer medical savings accounts (section 220(d) of the IRC);

(ix) college savings plans (section 529 of the IRC);

(x) health savings account plans (section 223 of the IRC); and

(xi) ordinary trusts (section 7701 of the IRC).

Accounts that are not beneficially owned by natural persons (for example, accounts not associated with social security numbers), such as those opened by businesses, including small businesses, defined benefit plans, or endowments, would not qualify as retail money market funds. (p. 225-226, footnote 697)

Plan decision-maker

Our observation: The fact that there is a plan sponsor (a non-natural person) as a decision-maker for a retirement plan does not preclude the plan from being considered a natural person (or the fund in which it invests from being a retail money market fund exempt from the floating NAV).

A number of commenters noted, for example, that under section 3(34) of ERISA, the plan sponsor of a defined contribution plan can eliminate or change an investment option without providing notice of the change, but stated that the plan sponsor would likely provide 30 days' notice of any change in order to obtain the benefit of the fiduciary safe harbor in section 404(c) of ERISA.[698] To the extent that there remains a risk that an institutional decision maker associated with a qualifying retail fund makes decisions inconsistent with how we understand retail funds generally behave, we believe that our approach appropriately balances this potential risk against the substantial benefits of providing a simple and cost-effective way to distinguish retail funds and provide a targeted floating NAV requirement. (p. 226-227, footnote omitted)

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We look forward to continuing to keep you informed as the compliance dates approach.

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

[2] Weekly liquid assets include cash, direct obligations of the U.S. government, certain U.S. government discount notes with maturities within 60 days, and accounts receivable on securities sales unconditionally due within five business days.

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