SEC Staff Responds to Frequently Asked Questions on 2014 Money Market Reform Release, Including Valuation Guidance

On April 22, 2015, the Securities and Exchange Commission ("SEC") staff released guidance (available here), titled "2014 Money Market Fund Reform Frequently Asked Questions," that discusses various interpretive issues arising from the SEC's 2014 Money Market Fund Reform release (the "2014 Reform Release"). On April 23, 2015, the SEC staff released additional guidance (available here), titled "Valuation Guidance Frequently Asked Questions," that discusses the valuation guidance applicable to *all* mutual funds that was included within the 2014 Reform Release. Both the April 22 release and the April 23 release (together, the "Guidance") were in a question-and-answer format and represent the views of the SEC's Division of Investment Management's staff (the "IM Staff"). This Alert discusses the highlights of the Guidance.

For a detailed discussion of the 2014 Reform Release's effects on money market funds, please refer to our August 2014 Alert, which can be accessed here.

Valuation Guidance

In the Guidance, the IM Staff sought to clarify the scope of the responsibilities of a mutual fund's board of directors ("Board") when determining whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security. In the 2014 Reform Release, the SEC made these three points:

- A Board has a non-delegable responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security.
- It is incumbent upon a Board to satisfy itself that all appropriate factors relevant to the fair value of securities have been considered, and that the Board must continuously review the appropriateness of the method used in fair valuing each security owned by the fund.
- Although a fund's Board cannot delegate their statutory duty to determine the fair value of fund portfolio securities, a Board may appoint others, such as the fund's investment adviser or a valuation committee, to assist them in determining fair value, and to make the actual calculations pursuant to the fair valuation methodologies previously approved by the Board.

Arguably, these three points in the 2014 Reform Release suggested that a Board must be more intimately involved in the fair value process, perhaps even in real-time determinations of the appropriate methodology to fair value individual securities, than many practitioners had previously thought to be the case. In the Guidance, the IM Staff reiterated these three points. However, in the Guidance, at the outset of its response, the IM Staff stated:

> The staff believes that the guidance provided in the [2014 Reform Release] was not intended to change the general nature of the board's responsibility to oversee the process of determining whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security or limit a board's ability to appropriately appoint others to assist in its duties.

Therefore, it would appear that the IM Staff believes the 2014 Reform Release's valuation guidance does not expand a Board's responsibilities with respect to the fair value process. Instead, the Guidance indicates that a

Board may wish to consider various factors in its oversight of evaluated prices that are supplied by third-party pricing services:

> 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 [Board] 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 [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 [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. (Emphasis added).

Seeding New Retail Money Market Funds

As revised, Rule 2a-7 restricts beneficial ownership in a retail money market fund to natural persons. This restriction could present a problem for a new retail money market fund because, typically, the fund's affiliated sponsor provides seed capital to launch the fund. However, the Guidance states that the IM Staff would not object if a "non-natural person affiliate beneficially owns shares of a retail money market fund to provide initial seed capital or financial support, so long as these investments solely are intended to facilitate fund administration and operations."

Cash Items for Purposes of § 3(a)(1)(C) Investment Company Definition

Section 3(a)(1)(C) of the 1940 Act deems an "investment company" to be any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire "investment securities" having a value exceeding 40% of the value of the issuer's total assets, excluding government securities and "cash items."

In the Guidance, the IM Staff confirmed that shares of a floating NAV money market fund qualify as "cash items" for purposes of the definition of "investment company" under § 3(a)(1)(C).

U.S. Treasury-Only Money Market Funds Remain Exempt from Stress Testing

In an August 2012 release, titled "Staff Responses to Questions About Money Market Fund Reform," the IM Staff stated it would not object if an investment adviser to a U.S. Treasury money market fund (*i.e.*, a fund that invests solely in direct obligations of the U.S. government) refrained from stress testing the fund for downgrades and defaults, provided the Board made a determination that these types of stress events are not relevant for the particular fund. In the Guidance, the IM Staff stated that this 2012 guidance was unaffected by the 2014 Reform Release.

Involuntary Exchanges, Involuntary Redemptions Outside of a Reorganization

In the 2014 Reform Release, the SEC exempted money market funds from §§ 17, 18, and 22 of the 1940 Act to permit involuntary redemptions of certain shareholders in a one-time reorganization transaction intended to permit a money market fund to comply with the Rule 2a-7 amendments.

In the Guidance, the IM Staff stated that, in the case of an involuntary redemption in a one-time reorganization, a money market fund may not exchange the redeemed shares for shares of another money market fund that does not maintain a stable NAV. Instead, the redemptions must be paid in cash. The IM Staff reasoned that the investment and risk preferences of involuntarily redeemed shareholders, who would be the recipients of the new shares, would not necessarily coincide with the investment and risk characteristics of a floating NAV fund.

Separately, the IM Staff recognized that there may be instances not involving a fund reorganization in which a fund would be required to redeem involuntarily certain shareholders in order to comply with the Rule 2a-7 amendments. The IM Staff cited as an example a fund with few institutional shareholders that desires to qualify as a retail money market fund. In such circumstances, the IM Staff stated that it would not object if a money market fund determines that the most efficient way to comply with Rule 2a-7 was through the involuntarily redemption of certain shareholders. However, the Guidance stated, all of the other requirements within the 2014 Reform Release's exemptive relief must be followed (*i.e.,* 60 days' prior written notice of redemption).

Government Money Market Fund Receivables

As revised, Rule 2a-7 defines a government money market fund as "a money market fund that invests 99.5 percent or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized fully." In the Guidance, the IM Staff stated that, given the small 0.5% *de minimis* basket for non-conforming securities permitted to be held by government money market funds, treating the value of the fund's receivables arising from the sale of government securities as non-confirming securities could result in a government money market fund no longer qualifying as such. Accordingly, the IM Staff stated that it would not object if a government money market fund treated such receivables as government securities. Moreover, the IM Staff noted, such treatment of the receivables arising from pending securities sales would be consistent with the definitions of daily liquid assets and weekly liquid assets in Rule 2a-7.

Additional Guidance?

The Guidance stated that the IM Staff expects to update the Guidance from time to time to include responses to additional questions. Most notably, in early 2015, the Investment Company Institute (the "ICI") and the Securities Industry and Financial Markets Association submitted to the SEC a draft Q&A regarding the 2014 Reform Release. However, only two of the answers in the Guidance were expressly identified as corresponding to questions submitted by the ICI. Therefore, it should not be surprising if the IM Staff issues additional guidance in the near future, as the compliance dates for additional provisions of Rule 2a-7 approach.