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A Director's Guide to Understanding Liquidity Fee and Redemption Gate Responsibilities

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With new regulations going into effect soon, boards of money market funds should be readying themselves for the new fee and gating responsibilities imposed on them by the SEC.

New regulations governing money market mutual funds (Funds) will be phased into effectiveness as soon as July 2015 – just a few weeks from now. Because of their daily management and oversight of Funds' portfolios, most Fund sponsors have been strategically planning their implementation of the new regulations since they were passed last summer. But the new regulations also provide Fund boards with a new set of responsibilities. Because boards typically meet on a quarterly basis, they may not be as far along as fund managers preparing to exercise these new responsibilities. In this article, we will briefly outline the new board responsibilities with respect to the establishment of liquidity fees (which charge shareholders a percentage-based fee to redeem shares based on the amount redeemed) and redemption gates (which suspend a shareholder's right to redeem shares) and suggest some ways that boards may prepare themselves so that they are in a position to protect their Funds (and themselves) when challenging market conditions arise again.[1]

Background

When the US Securities and Exchange Commission (SEC) significantly amended the money market fund regulatory framework on July 23, 2014, it emphasized that the reforms include "new tools" for Fund boards to employ when their Funds face heavy redemptions during volatile market conditions. Specifically, under certain conditions, boards will be able to impose on Fund shareholders a liquidity fee and will also be able to "shut the gate" on shareholder redemptions for a period of time. These new tools are as-yet untested, however,[2] and prior to using these tools, boards should (a) understand the circumstances under which liquidity fees and redemption gates may be imposed; and (b) develop a framework for evaluating the types of market conditions and other factors that would support a board finding that implementing either a liquidity fee or redemption gate is in the best interests of their Funds and shareholders.

By now, most people reading this article probably know that substantial changes for Funds lie on the horizon, so we will only provide a very brief overview of those changes here. A variety of new requirements will be applied to Funds from July 2015 through

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October 2016.[3] The reforms can be grouped into four general categories: (i) shares of certain Funds will have to trade at a floating net asset value (NAV), (ii) boards of certain Funds will have to implement liquidity fees and redemption gates (which is the main focus of this article), (iii) Funds will face new disclosure and reporting obligations, and (iv) Fund managers will face new operational requirements, in particular with respect to diversification and stress testing mandates. As discussed below, the application of these reforms depends, in part, on the type of Fund.

The compliance dates for these various reforms are staggered. Beginning in July 2015, Funds will be required to promptly report significant events (for example, financial support from an affiliate or default of a portfolio security) to the SEC on a new form, Form N-CR. (When implemented, the imposition of liquidity fees or redemption gates will also have to be reported on Form N-CR). In April 2016, enhanced stress testing, new disclosure requirements (including web-based disclosures), amended portfolio diversification requirements and changes to SEC Form N-MFP all take effect. Finally, in October 2016, the liquidity fees and redemption gates and, with respect to "institutional prime" Funds, floating net asset value (NAV) requirements go effective. The following chart may provide a helpful summary of the timing of these various new requirements.

Requirement	Compliance Date
Form N-CR reporting	July 14, 2015
Diversification and stress testing	April 14, 2016
Modifications to Form N-MFP and other disclosures	April 14, 2016
Floating NAV	October 14, 2016
Liquidity fees and redemption gates	October 14, 2016

The October 2016 requirements will not apply to all Funds. For example, Funds that meet the definition of "government money market fund" or "retail money market fund" will not need to maintain a floating NAV.[4] In addition, Funds that meet the definition of "government money market fund" are not required to impose liquidity fees and redemption gates. For that reason, many Fund complexes are already in the process of restructuring their Fund lineup to divide their investor base along retail and institutional lines. Some Fund complexes are also separating their existing portfolios or creating new portfolios that can be categorized as government Funds under the new rules. Other Fund sponsors may elect to get out of the money market fund business altogether or move to product structures that are not subject to the Investment Company Act of 1940 (Investment Company Act) and Rule 2a-7 thereunder.[5] Under the new rules, Government Funds will have the easiest pathway to compliance because they are not subject to the mandatory liquidity fee and redemption gate requirements and will not be required to trade at a floating NAV. Institutional prime Funds, which have a non-retail investor base and will invest in a range of portfolio investments broader than government securities, will have the most complicated path to compliance because they are subject to the liquidity fees, redemption gates and floating NAV requirements. The following chart provides a summary of the application of these new requirements across the three different types of Funds.

	Government Funds	Retail Funds	Institutional Prime Funds
*New Structural Limitations Unique to Fund Type**	Must invest 99.5% or more of total assets in cash, government securities, shares of other Government Funds, and/or repurchase agreements that are collateralized fully by government securities.	Must have policies and procedures reasonably designed to limit all beneficial owners to natural persons.	None

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NAV	Stable	Stable	Floating
Liquidity Fees and Redemption Gates	Optional	Required	Required

*We note that the amendments to Rule 2a-7 impose certain structural limitations on all Fund portfolios.

Liquidity Fees and Redemption Gates

As revised, Rule 2a-7 will require both institutional prime Funds and retail Funds to impose liquidity fees and/or redemption gates on shareholders under certain circumstances. Government Funds may voluntarily impose liquidity fees and redemption gates in accordance with the new rules, provided their ability to do so is disclosed in their prospectuses. Liquidity fees are structured to reduce the frequency of redemptions, but still allow shareholders to access their investments, by requiring redeeming shareholders to bear some of the liquidity costs caused by their redemptions. Redemption gates are structured to provide Fund boards with a tool to stop heavy redemptions in times of Fund stress. According to the SEC, redemption gates give boards the opportunity to assess the condition of their Funds to determine the proper strategy to meet redemptions and create liquidity buffers, as well as to provide time for market stress to subside and investors to reevaluate their investments.

Liquidity Fees. Under the revisions to Rule 2a-7, a Fund's board *will have the discretion to impose* liquidity fees of up to two percent on all redemptions if a Fund's weekly liquid assets drop to less than 30 percent of its total assets and the board (including a majority of its independent directors) determines that doing so is in the Fund's best interests. Additionally, a Fund *will be required to impose* a liquidity fee of one percent on all redemptions if its level of weekly liquid assets falls below 10 percent of its total assets. However, a liquidity fee would not be required under these circumstances if the Fund's board (including a majority of its independent directors) determines that imposing such fee is not in the best interests of the Fund. The board also could impose a different fee if it determined that a higher or a lower fee is in the best interests of the Fund, but in no case can the liquidity fee exceed two percent.

Redemption Gates. A Fund's board will also have the authority to impose a redemption gate if a Fund's weekly liquid assets drop to less than 30 percent of its total assets and the board (including a majority of its independent directors) determines that doing so is in the Fund's best interests. A Fund that imposes a gate would be required to lift that gate within 10 business days and could not impose gates for more than 10 business days within any 90-day period, which is measured on a rolling basis.

In the Proposing and Adopting Releases, the SEC listed the following non-exclusive factors that a Fund board may want to consider, in consultation with the Fund's adviser, when determining whether a liquidity fee or redemption gate is in a Fund's best interests:

- Relevant indicators of liquidity stress in the markets and why the Fund's weekly liquid assets have fallen (for example, 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 (for example, 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?);

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- For retail Funds and government Funds that maintain a stable NAV, whether the fall in weekly liquid assets has been accompanied by a decline in the Fund's market-based value (or shadow price);
- The makeup of the Fund's shareholder base and previous shareholder redemption patterns;
- The Fund's past experience, if any, with the imposition of fees and/or gates; and
- Any other factor that the board considers appropriate.

In addition, the SEC listed the following non-exclusive factors that a Fund board may want to consider, in consultation with the Fund's adviser, when determining what level of liquidity fee would be appropriate:

- 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;
- Whether the Fund and financial intermediaries that sell shares of the Fund are capable of rapidly putting in place a liquidity 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.

A Fund's board may impose a liquidity fee or redemption gate the same day that the Fund's level of weekly liquid assets drops below 30 percent of its total assets. In other words, a board does not have to wait until the next business day to take action. Any fee or gate imposed must be lifted once the Fund's level of weekly liquid assets rises to or above 30 percent of its total assets. Any fee or gate can be voluntarily lifted (or varied) at any time if the board determines that an early lifting (or a variation) is in the best interests of the Fund. However, a board is prohibited from adopting in advance a policy not to allow a Fund ever to impose a liquidity fee or redemption gate. In that regard, the SEC stated that such a "blanket decision" by a board not to impose fees or gates without any knowledge or consideration of the Fund's particular circumstances at the time "would be flatly inconsistent" with the amendments to Rule 2a-7, given that the SEC regards liquidity fees and redemption gates as "additional tools for boards to employ when necessary and appropriate to protect the fund and its shareholders."[6] In addition, the need for active engagement of the board does not subside while a liquidity fee or redemption gate is in place. The SEC stated that boards would likely need to monitor the Fund during this time to ensure that the continued imposition of the fee or gate remains in the best interest of the Fund and its shareholders, including whether the amount of any fee is appropriate.

An Evolving Role for the Board?

It has long been the duty of an investment company board to perform vigilant oversight and to be alert to situations that may involve actual or potential conflicts of interest between the fund and its service providers, particularly when those service providers are affiliates of the Fund. In this respect, the term "watchdog" has frequently been used by the courts and regulators to describe the board's responsibility and particularly the role played by the board's independent directors.[7] In this regard, boards historically have acted as a check on the inherent conflicts of interest within an investment company structure.

In contrast to exercising oversight responsibilities, boards traditionally have not been called on to play an active role in the day-to-day operations of investment companies. This traditional balance of

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oversight and day-to-day responsibility is illustrated by Rule 38a-1 under the Investment Company Act. Under Rule 38a-1, funds must adopt a written compliance program and boards must approve the written compliance policies and procedures of each fund and each of its service providers based upon a finding that the policies and procedures are reasonably designed to prevent violation of federal securities laws. However, to facilitate such compliance with federal securities laws on a daily basis, Rule 38a-1 requires the board to appoint a chief compliance officer to oversee the fund's compliance program and administer the policies and procedures of the fund. After a chief compliance officer has been appointed, the board is regularly updated regarding the fund's compliance with those policies and procedures and what, if any, changes need to be made to those policies and procedures.

In contrast to the traditional division of responsibilities, under the amended Fund regulations, Fund boards may be called on to make proactive determinations quickly about whether to take action to protect the Fund and its shareholders. This is a more hands-on role than some boards may be accustomed to providing their fund complexes. Accordingly, boards will have to be increasingly nimble during times of market stress, particularly if Fund liquidity levels are approaching the 30 percent threshold. In response to commentators, the SEC did clarify that board determinations with respect to liquidity fees and redemption gates do not need to be made at in-person meetings and can be done telephonically or through other technological means that permit all directors to be heard.[8]

Many of a board's new duties also will be non-delegable and will have to be based on a substantial body of information made available to the board by the Fund and its adviser so that the board can have a robust record on which to base its determinations. This information likely would include the results of any recent stress testing performed on the Fund in accordance with the amended requirements under Rule 2a-7 along with any information reasonably necessary for the board to understand the results of that testing. In this regard, boards likely will rely heavily on the recommendations and information provided by representatives of the Fund and the adviser, but determinations of whether to impose, when to impose, and when to lift liquidity fees and redemption gates, as well as the amount of any liquidity fees, will ultimately fall to the board. Accordingly, boards and their counsel should be prepared to review information provided by Funds and their advisers with a critical eye so that they are able to question assumptions made and drill down on the data provided to ensure it provides a sufficient basis for the board's determinations. All of this likely will have to be done on an accelerated timeframe given the likelihood of challenging market circumstances that Funds and their boards will be facing when these determinations must be made.

Given the likelihood that these determinations will be made on tight deadlines and under difficult conditions, boards, their counsel and Fund advisers may be well served by beginning the process of identifying the various types of information they believe are most relevant to their determination of whether the imposition of a liquidity fee or redemption gate is in the Fund's best interests. In doing so, Fund boards and advisers should review the list of factors included in the Proposing and Adopting Releases and supplement such list with any other information that the Board and adviser considers appropriate based on the particular characteristics of the Fund, its shareholders, and certain assumptions about market conditions. As more fully discussed below, if a Fund board has not already done so, the board may also wish to consider implementing a formal "emergency" contact list and procedures to seek to ensure that a considered process is in place to alert board members of important issues and to facilitate the calling of special meetings in connection with these new responsibilities.

In addition, a board's deliberative processes and the considerations made by a board in determining whether to impose a liquidity fee or redemption gate

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will now be subject to disclosure (to an extent) on Form N-CR. Other than with respect to a board's advisory contract approval process under Section 15(c) of the Investment Company Act, board deliberations and findings generally need not be publicly disclosed. Starting this July, Funds will have to file a report with the SEC when certain significant events occur. Usually, within one business day of a significant event, a Fund must file a brief summary report on new Form N-CR and then file a follow-up Form N-CR report within four business days that includes more detail about the event. Significant events that trigger the filing of a Form N-CR include, among other items, the imposition of liquidity fees or redemption gates, the lifting of liquidity fees or redemption gates, or the decision not to impose liquidity fees or redemption gates when a Fund passes the relevant liquidity thresholds.

Notably, Form N-CR will require a description of the primary considerations or factors that the board took into account when deciding whether to impose a fee or gate. On this point, the SEC cautioned that Funds should avoid using "boilerplate" disclosures and instead should provide information tailored to a Fund's particular situation and the context in which the decision was made, including considering both present circumstances and potential future risks and contingencies. Form N-CR also will require the disclosure of information about when the fee or gate was imposed, a Fund's liquidity levels at the time, and the amount of the liquidity fee. These new disclosure requirements emphasize the importance of establishing (ideally in advance of the actual event) a robust review process that will provide a solid foundation for the board's deliberations and ultimate disclosures to Fund shareholders.

These new disclosure requirements are, for better or worse, consistent with recent emphasis placed on disclosure of board considerations in other contexts.[9] The fact that these items will have to be reported could have the unintended effect of chilling the board's deliberative process and providing a new data source to the plaintiff's bar from which opportunistic litigation could derive.[10] In response to commentators concerns in this area, the SEC adopted the reporting requirement so that only *primary* considerations or factors taken into account by the Board need to be disclosed. In adding this flexibility, the SEC noted that Form N-CR would need to include only the most important factors that shape a board's determination to take action (and a brief discussion of each) and would not need to include every factor the board considered. The report would not need to "dissect a board's internal deliberations."[11] Although this requirement is generally consistent with the SEC rules requiring fund shareholder reports and proxy statements to include a reasonably detailed discussion of the *material* factors and the conclusions with respect thereto that formed the basis for the board's approval of any advisory contract, SEC Staff reviewing advisory contract approval disclosure frequently request that funds provide a more granular level of detail of the board's considerations and findings than a plain reading of the SEC rules seems to require. It remains to be seen whether the SEC Staff will take a similar approach to reviewing and commenting on board deliberations regarding liquidity fees and redemption gates included in Form N-CR notwithstanding that the determinations will involve complex issues and exercise of business judgment. Unfortunately, the SEC was hesitant to address commentators' concerns regarding the application of the business judgment rule as a protection for board determinations, noting that it would be inappropriate for the SEC to address the application of the rule because it is a construct of state law.[12] Nonetheless, we would expect that a Fund board's determinations with respect to liquidity fees and redemptions gates when taken in good faith and on the basis of appropriate diligence and inquiry would be entitled to substantial deference.

Importantly, disclosure obligations with respect to liquidity fees and redemption gates do not end with Form N-CR. Any Fund that may be required to impose a liquidity fee or redemption gate, or any

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government Fund that may voluntarily impose a fee or gate, must disclose in its prospectus that the Fund may impose a fee upon the sale of shares or may temporarily suspend a shareholder's ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. Because Fund directors, as signers of the Fund's registration statement, have strict liability for the registration statement's disclosure under Section 11 of the Securities Act of 1933 (subject to certain defenses), they should ensure that any Funds they oversee have also implemented appropriate disclosure in the prospectus, as required by the amendments to Rule 2a-7 and guidance provided by the SEC in the Adopting Release or otherwise. Disclosure of a board's authority and responsibilities with respect to liquidity fees and redemption gates should not be a simple restatement of the rule and should accurately reflect the actual process expected to be taken by the board as well as the historical use by the board of fee and gating mechanisms, if any. This disclosure should change over time to the extent that board processes are modified or refined or to the extent that liquidity fees and/or redemption gates are actually employed.

As a result of the amendments to Rule 2a-7, boards may have to be more proactive and responsive during periods of market volatility and asset illiquidity, particularly as Fund portfolios approach the 30 percent liquidity mark. It is important to remember that when a board will be facing these issues, it is very possible that the board will simultaneously face challenges with respect to many other Funds that it oversees. The board's attention will not be solely focused on Fund liquidity fees and gates. In such a challenging environment, Fund boards will have to be on high alert and be available to meet – telephonically or otherwise – on short notice. Boards should be prepared to critically review information provided to it by the Fund and the adviser to ensure that such information provides a sound basis on which the board can make appropriate determinations. As liquidity continues to decrease and the Fund's portfolio approaches 10 percent weekly liquid assets, the board will have to consider adjusting the existing liquidity fee or, if no fee has yet been imposed, will have to determine that it is in the best interests of the Fund *not to impose* a liquidity fee. Once fees and gates have been imposed, the board must continue to monitor the Fund and will have to determine whether to modify or remove these restrictions. While considering all of these determinations and the particular factors and circumstances surrounding each, boards will also have to be aware of their reporting and disclosure obligations and be careful to fully document their deliberative processes in board minutes, but also meaningfully summarize in Form N-CR the primary considerations or factors taken into account by the Board when making these determinations while seeking to avoid boilerplate disclosure. It is not yet clear what level of detail the SEC expects to be provided in Form N-CR, but as a practical matter it may be useful to consider the level of discussion currently included by a board in Fund annual reports in the context of its 15(c) process.

Tips for Boards Exercising These New Responsibilities

If the first time a Fund board is discussing liquidity fees and redemption gates is when market liquidity has dried up and shareholders are lining up to redeem their shares, there is a risk that the board's review and analysis of the relevant factors necessary to make an informed determination regarding the implementation of liquidity fees or redemption gates may be compromised. Like any tool, liquidity fees and redemption gates will be much more effective if, in collaboration with a Fund's adviser, boards become familiar (to the extent possible) with the pros and cons of implementing such tools. This process might include gaining an understanding of how the tool would be implemented, projected shareholder and market reaction to the tool's implementation and seeking to understand the market conditions in which each tool would work best (that is, picking the "right tool for the job").

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To this end, boards and investment advisers may consider the following items at meetings between now and October 2016 so that, if a need to take action arises, they are in the best possible position to act in the Fund's best interests.

- Consider identifying factors that the board might consider when determining whether to impose a fee or gate and identify the types of information the board will want to review in connection with its decision making process. It may also be advisable for a board (or the Fund adviser on behalf of the board) to identify which persons in Fund management and at the Fund's service providers are responsible for tracking and providing the various data the Board has identified as important. Boards with numerous Funds also may want to consider establishing a new Board committee (either full time or on an ad hoc basis) that is tasked with the ongoing review of the operations of the Funds, evaluating the Funds' stress testing procedures, keeping abreast of current market conditions and how they are impacting the Funds and identifying the types of information that the Board will ultimately review when making determinations with respect to liquidity fees and redemption gates. Such a committee may be able to provide the full Board with invaluable assistance if the Board is asked to make quick decisions during times of market stress.
- If not already in place, establish a communication policy so that the board can be quickly notified of the need for a special meeting. Ideally, this communication policy would contemplate preferred methods of being contacted for each board member and key persons of Fund management, the adviser, counsel, and other fund service providers. It may also be advisable to have multiple means of contacting each person. The policy should also consider possible back-up persons if the primary person tasked with sending out a communication is not available. Many boards will already have some process in place to regularly communicate, but the amendments to Rule 2a-7 may provide an opportune time to test and make necessary enhancements to that process.
- Determine a threshold at which point the board will be put on notice of potential liquidity events on the horizon (for example, when the percentage of a Fund's weekly liquid assets falls below 35 percent of its total assets). When establishing such thresholds, Boards should consider the particular facts and circumstances with respect to each Fund and, therefore, may find it appropriate to establish different thresholds for different types of their Funds. Establishing a clear framework for putting the Board on advance notice of the potential upcoming need to act likely will increase responsiveness if and when the 30 percent or 10 percent weekly liquid asset thresholds are hit.
- Consistent with the consideration of reports or information that the board may expect to receive, a complimentary template for the drafting of the Form N-CR disclosure to ensure that all disclosures are accurate reflections of the actual process employed and the primary considerations that the board took into account when deciding whether or not to impose a fee or gate may be useful. Boards and counsel that choose to use template language as a starting point for Form N-CR disclosures should develop processes to appropriately tailor that language to the particular Board deliberations at issue.
- Funds and advisers should consider developing new procedures (or revising existing procedures) to specifically address the confidentiality of the information relating to the Board's and adviser's discussions regarding the potential imposition of a liquidity fee or redemption gate. It is critical for Fund complexes to safeguard the confidentiality of this information in order to avoid a situation where certain Fund shareholders receive this information prior to its public dissemination

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and redeem from the Fund based on such information, which may have a negative effect on the Fund's remaining shareholders. This will be particularly important given that multiple lines of disclosure (likely involving representatives of multiple service providers) – web-based, prospectus and Form N-CR – are now required under the amendments to Rule 2a-7.

- After a fee or gate has been imposed, the board should discuss how often and in what format it wants to meet so that it can continue to monitor and assess the Fund. When and if the board determines to raise the gate or remove or modify the fee, the same above considerations regarding the deliberative process, available information and public disclosure will apply.
- Consistent with the objectives of "stress testing" the Fund's portfolio, boards, Funds and advisers may undertake a testing drill to assess the adequacy of their procedures and lines of communications. Any testing should closely simulate expected real conditions, such as by relying on historical data from prior instances of market stress (such as September 2008) to run any such testing drills.
- Funds should consider reviewing their governing documents to ensure that they permit (and do not prohibit) the board to take any actions necessary to impose, monitor, adjust, and remove liquidity fees and redemption gates. If a Fund's governing documents are unclear, the board may want to consider amending the documents, which, in limited cases, may require shareholder consent.
- Funds should identify the various operational challenges they will face if they seek to implement liquidity fees and redemption gates. For example, Funds should begin the process of developing a communication protocol that they will use to inform service providers and financial intermediaries (possibly on a real-time basis) of the Board's decision to impose a liquidity fee or redemption gate. Funds also may want to review their financial intermediary agreements to determine whether such agreements need to be revised to address the implementation of fees and gates or to incorporate periodic certification requirements regarding the implementation of such fees and gates.
- Funds should also begin to develop protocols governing various types of situations regarding the receipt of orders (including orders by check) during or around the time of the Board's imposition or lifting of liquidity fees or redemption gates, including protocols that address what happens when an order is submitted to the Fund (a) immediately prior to the Board's decision to impose, lift or revise a liquidity fee or redemption gate; or (b) during the period when a redemption gate is in place (that is, must the order be resubmitted to the Fund). Funds should consider disclosing these protocols in their Funds' prospectuses.
- The board process should fully consider the various new amendments applicable to Funds. Although this article focuses on liquidity fees and redemption gates, other elements will have to be considered by the board in parallel, such as stress testing and valuation issues and floating NAV (for institutional prime Funds). These other issues will also face heightened sensitivity during an illiquid, volatile market.

With these amended requirements under Rule 2a-7, boards will play an enhanced role in the oversight and protection of Funds and their shareholders. With advanced planning and development of appropriate procedures (and the testing of such procedures), boards will be able to efficiently and effectively exercise their new responsibilities for the imposition of liquidity fees and redemption gates during market times that will likely be stressful and intense. A comprehensive, well-designed set of procedures should also improve the board's ability to make determinations that are in the Fund's best interests, which could help the Fund's overall

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operations by maintaining shareholder confidence while simultaneously lowering the risk of second-guessing by regulators or opportunistic litigation. For these reasons it will be very important for boards and Fund sponsors to work together in the lead up to October 2016 to ensure that everyone is fully prepared to understand and use the new tools that the SEC has placed in the trusted hands of the board.

Sean Graber is a partner, and **John (Jack) O'Brien** is an associate, in the Investment Management practice group of Morgan, Lewis & Bockius LLP. Copyright © 2015 Morgan, Lewis & Bockius LLP. All rights reserved. This article provides general information on the subject discussed and should not be relied on for legal advice of any matter. The authors would like to thank Barry N. Hurwitz, a partner in the Boston office of Morgan, Lewis & Bockius LLP, and Timothy W. Levin, a partner in the Philadelphia office, for their thoughtful contributions to this article.

NOTES

1 This article focuses on liquidity fees and redemption gates. Importantly, this article does not discuss in detail the various other board responsibilities imposed under the recent amendments, such as obligations with respect to the oversight of floating net asset value, oversight of new operational limitations of portfolios (*e.g.*, diversification and liquidity requirements), oversight of stress testing and valuation issues.

2 Not only are liquidity fees and redemption gates untested, there is a body of thought that suggests these tools could have the opposite of the intended effect. Comments on the Proposing Release (defined below) expressed concern that mandatory fees and gates could start preemptive runs and that lengthy gating periods could be problematic due to the effect of an extended loss of access to cash on investors with liquidity needs. In response, the SEC made modifications in the final rule amendments that allow the imposition of fees and gates to be more discretionary, based on board decisions, which the SEC believes makes it less likely that investors will be able to front run the imposition of a fee or gate.

3 *See Money Market Fund Reform; Amendments to Form PF*, Investment Company Act Rel. No. 31,166 (July 23, 2014) [hereinafter Adopting Release]. *See also Money Market Fund Reform; Amendments to Form PF*, Investment Company Act Rel No. 30,551 (June 5, 2013) [hereinafter Proposing Release]. A useful, detailed discussion of the various Fund reforms is available in the October volume of *The Investment Lawyer*. *See* Michael Caccase, et al., "SEC Adopts Final Rules Governing the Structure and Operation of Money Market Funds," *The Investment Lawyer* (Oct. 2014). Morgan Lewis also published a white paper in September 2014 on this topic, "The New Era of Money Market Fund Regulation," which can be found online by searching for the title in the search engine field on the firm's website, *www.morganlewis.com*.

4 Government Funds are defined in the amendments as Funds that invest 99.5 percent or more of their total assets in cash, government securities, and/or repurchase agreements that are collateralized fully by government securities. A government Fund's investment in another government Fund falls into this qualifying asset category. Retail Funds are defined in the amendments as Funds with policies and procedures reasonably designed to limit all beneficial owners of the Fund to natural persons, although it is not entirely clear whether this term will be defined to include more than the plain meaning of "natural person." "Beneficial ownership" typically means having voting and/or investment power.

5 Rule 2a-7 does not directly apply to many types of retirement products, including, but not limited to, bank collective trust funds, US private funds, offshore money market funds, and separately managed accounts. Many such products are either unregulated or primarily regulated outside the purview of the SEC, and it is not yet clear whether such other regulators (*e.g.*, the Office of the Comptroller of

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the Currency) will impose new requirements on these products similar to the revisions to Rule 2a-7 adopted by the SEC.

[6] Adopting Release, *supra* n.3, at 92.

[7] *See* Chairman Mary Schapiro, Address to Mutual Fund Directors Forum Ninth Annual Policy Conference: Critical Issues for Investment Company Directors (May 5, 2009) ("As fund directors, you play a critical role as the watchdogs of fund management and the champions of fund investors. I urge you to approach that role with a strong spine and an overarching commitment to serving fund investors."); Eileen P. Rominger, Keynote Address at the Insured Retirement Institute 2011 Government, Legal & Regulatory Conference (June 28, 2011) ("I think it is important that the board of directors of any fund that may be subject to conflicting interests on the part of its adviser be vigilant watchdogs for the fund's investors, ensuring that arrangements entered into are for the benefit of those investors. To accomplish that goal, I believe board deliberations should squarely address any potential conflict on the part of the fund's adviser and other service providers.").

[8] *See* Adopting Release, *supra* n.3 at 93.

[9] *See Northern Lights Compliance Services, LLC, Gemini Fund Services, LLC, Michael Miola, Lester M. Bryan, Anthony J. Hertl, Gary W. Lanzen, and Mark H. Taylor*, Investment Company Act of 1940 Release No. 30502 (May 2, 2013) (settled order found that directors made inaccurate statements to trustees with regard to their approval of advisory contracts); *In the Matter of J. Kenneth Alderman, CPA; Jack R. Blair; Albert C. Johnson, CPA; James Stillman; R. McFadden; Allen B. Morgan Jr.; W. Randall Pittman, CPA; Mary S. Stone, CPA; and Archie W. Willis III*, Investment Company Act Release No. 30557 (June 13, 2013) (settled order found that directors bore responsibility for determining securities' fair value but entrusted duties to valuation committee without providing "meaningful substantive guidance" on calculating valuations or making any significant effort to understand valuation methods).

[10] *See* Adopting Release, *supra* n.3 at 400.

[11] *Id.* at 403.

[12] *See id.* at 91. In deciding cases brought under Section 36(b) of the Investment Company Act, courts have stated that boards are entitled to the benefit of the business judgment rule, which is a precept of state law that states that courts will not substitute their judgment for, and will accept as proper, the business judgment of a board who in good faith acted independently and exercised due care in making its decision. For business judgment rule protection to be applicable, the board may not have a material personal interest in the decision, and may not engage in self-dealing. Common law variations on the business judgment rule vary state by state.

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