While not every fund board will deal with all of these issues, most will deal with at least some, and they are expected to be topics of conversation among directors, regulators and industry professionals throughout the coming year. "SEC regulation is always a big component of this," Amy Lancellotta, managing director of Independent Directors Council, said of boards’ process of devising to-do lists.

**MONEY MARKET FUNDS**

"Implementation of money market fund reform will be a big deal," Lancellotta predicted. "Even though it’s a two-year compliance program, obviously funds and boards will be starting to talk more specifically about the steps that are necessary to implement the reforms." She cautioned, however, that the number of boards dealing with this particular issue – which, no doubt, is a big one that gets a lot of industry and media attention – is relatively small.

Susan Wyderko, president and CEO of Mutual Fund Directors Forum, pointed out that the valuation guidance embedded in the reforms has revived a topic that has long been on boards’ agendas. "Valuation issues continue to be..."
important for boards, and the issuance of SEC guidance on board oversight of pricing vendors that was included in the SEC’s final rule on money market funds has thrown new light on the topic,” she told FD. Related to valuation is the issue of third-party pricing vendor oversight. Boards are permitted to delegate fair value pricing but the overriding responsibility for the task remains in the boardroom. Directors are expected to continue probing vendors’ methodologies, processes and procedures. “Vendors say board visits have increased exponentially,” Lancellotta said. “And it’s less marketing fluff and a lot more of the business aspects, more discussions about inputs and assumptions and methodologies being used; that will only increase.”

‘DISTRIBUTION-IN-GUISE’
The SEC’s so-called distribution-in-guise sweep is expected to be a headline issue in 2015, though it is unclear what the agency’s next move will be. Lancellotta offered a number of possible outcomes: a risk alert the Office of Compliance, Inspections and Examinations; staff guidance from the Department of Investment Management; future rule-making; and Division of Enforcement referrals. “This issue will percolate and come to the top in 2015 one way or another,” she said. “Boards will continue to focus on this issue.”

Wyderko agreed, maintaining there is a renewed focus on analyzing the payments made to distributors and intermediaries — including revenue-sharing, sub-transfer agent fees, and shareholder servicing fees — the services shareholders receive for those fees, and how the payments are made. “The move to omnibus accounting has made such analysis opaque for both fund managers and boards,” she added.

ALTS FUNDS & FIXED-INCOME FUNDS
“Liquid alternatives continue to be a key area of growth in the fund industry,” Wyderko said. “Not surprisingly, the SEC staff also has taken an interest in this area with a sweep exam of these funds.” Lancellotta, citing remarks made by Division of Investment Management (DIM) head Norm Champ, noted the SEC is focused on liquidity, valuation, and disclosure. “It’ll be interesting to see what comes out of the sweep exam,” she said.

Meyrick Payne, managing partner at Management Practice Inc., listed “governing numerous ‘alternative’ or ‘liquid alternative’ funds” as the No. 1 issue for boards in 2015. He predicted many such funds will underperform the market, which would likely intensify the attention they receive.

On a related issue, Lancellotta said she wouldn’t be surprised if DIM were to issue another concept release or staff guidance on the use of derivatives by funds before the end of the year.

The increased focus on fixed-income funds follows guidance issued last January by DIM on handling volatility in the bond markets (FD, 1/24) and is in the midst of an SEC sweep. “The SEC staff is conducting a sweep exam of fixed-income funds to determine whether funds will be able to sell securities if liquidity declines, urging advisers to stress test their portfolios and reviewing fund disclosure regarding potential effects of an increase in interest rates,” Wyderko said. Lancellotta added: “It’s a matter of when, not if, interest rates go up. There already has been a lot done in the area of stress testing and liquidity issues; that will continue in 2015, and it will be interesting to see what comes out of it.”

MEYRICK PAYNE, MANAGING PARTNER AT MANAGEMENT PRACTICE INC., LISTED “GOVERNING NUMEROUS ‘ALTERNATIVE’ OR ‘LIQUID ALTERNATIVE’ FUNDS” AS THE NO. 1 ISSUE FOR BOARDS IN 2015.

BEST EXECUTION
Directors are beginning to pay more attention to trade execution practices (see related story, page 4) and Payne predicted that so-called dark pools will receive a lot of attention in 2015. Wyderko pointed specifically to the fixed-income markets as a focal point. “While a variety of factors may impact the ability of funds to get best execution in the equity markets, fixed-income issues are in many ways more challenging,” she explained. “The opaque nature of the fixed-income markets in general coupled with reduced inventories as a result of Dodd-Frank make measuring whether shareholders receive best execution especially difficult.”

CYBERSECURITY
Cybersecurity is an issue that is “front and center for directors,” according to Lancellotta. “They continue to ask for presentations from the adviser on their initiatives.” That said, she doesn’t believe the SEC will take specific action following its sweep in 2014. Wyderko added that the issue is complicated for the fund industry because of the amount of sensitive information that is in the hands of third parties. “As a result, boards and advisers alike are focusing on a risk-centered evaluation of potential areas of concern,” she said.

In addition to these issues, Payne has a keen eye on the industry’s interaction with an “aggressive SEC” that he says is determined to target directors, as well as the governing of multi-manager funds, where multiple sub-advisers need to be “harmonized”—perhaps even using a sort of “overlay” to modify or even out the risk profile of multiple managers.

IDC, MFDF and MPI all have educational sessions and publishing projects on tap for 2015 to shepherd directors through many of these issues.
ICI praises, offers suggestions on money market fund tax rules

Rules proposed by the Internal Revenue Service and Treasury Department on the tax treatment of money market funds have garnered praise from the fund industry. The Investment Company Institute said in a comment letter that the IRS/Treasury guidance generally “provides a workable tax accounting method for shareholders in floating [net asset value] money market funds.” However, the ICI also included recommendations to further improve the tax treatment for floating NAV money market funds.

The IRS/Treasury proposals accompanied the Securities and Exchange Commission’s money fund reforms passed over the summer (FD, August) and would allow investors in floating NAV money market funds to use a simplified tax accounting method to track gains and losses and provide a wash sale exemption for any losses on shares of a floating NAV money market fund. Investors – particularly institutional investors that frequently move money in and out of money market funds – would have faced a heavy reporting burden related to small gains and losses if Treasury and the IRS had not stepped in with a way to simplify.

In its nine-page October 23 letter, the ICI recommends three changes to the NAV method in the proposed regulations:

- Shareholders should be permitted to use the NAV method on an account-by-account basis.
- The NAV method should be available for shareholders in stable NAV money market funds that charge a liquidity fee.
- The IRS and Treasury should confirm that a regulated investment company, or RIC, is permitted to use the one-year period from November 1 to October 31 as its “computation period” for the purposes of the excise tax.

Further, the ICI asked the IRS to extend the wash sale exemption in the proposed regulations to stable NAV funds that impose a liquidity fee, requests guidance regarding the tax implications to funds and shareholders if a stable NAV fund imposes a liquidity fee, and asks for guidance permitting a money market fund that separates existing institutional and retail classes into standalone funds – in order to comply with the SEC rule – to treat such transaction as a tax-free reorganization.

MFDF preps case study for January director gathering

Mutual Fund Directors Forum members will tackle an array of current issues when they head to Florida in January for the 2015 Directors’ Institute, including sub-advisers and sub-adviser fees, overseeing alternative investment funds, distribution, the use of peer groups and benchmarks, the quest-for-yield environment, and understanding the competitive positioning of funds.

The format of the event revolves around a case study that is presented to groups of attendees formed into “boards.” The issues are “baked into the case study”, and each group deals with them differently, MFDF President Susan Wyderko told FD. The directors are assigned ahead of time to the groups with the goal of creating diverse boards, she added.

David Smith, executive vice president and general counsel, said the event involves “free-ranging discussion that is centered on the case study” and that it’s fascinating to see the direction each group takes that discussion. “Attendees emphasize and prioritize what they want to talk about,” Smith told FD. The exercises are meant to teach participants how to collaborate and think as a group, lessons they can take back to their own boardrooms, he said.

The “faculty” for the event includes legal and accounting experts, as well as fund management representation and consultants. Lipper provides the board book for the meeting, and PwC contributes accounting issues taken from real cases, Wyderko said. At press time, MFDF hadn’t yet announced the faculty for the January meeting.

This annual event is hugely popular and sold out this year in October, Wyderko said. While MFDF wants to meet demand, it also has a strong desire to keep the groups small enough that they’re manageable and the overall event is productive, she explained. The event will be moved to San Diego in 2016 to meet West Coast demand, she noted.
One year ago

Securities and Exchange Commission officials Doug Scheidt and Jaime Eichen made comments during a Mutual Fund Directors Forum webinar that spooked independent fund directors and industry lawyers, who said they feared the agency was maintaining a regulate-through-enforcement mindset. The two made it clear that various factions within the SEC were focused on fund governance and that promised guidance had been sidelined by higher-priority initiatives. Specifically, the two honed in on intermediary payments and valuation. [The SEC surprised the market in July by issuing broad valuation guidance within its long-awaited money market fund reforms (FD, September), and the agency is in the process of examining distribution payments (FD, March). The industry remains wary of the SEC’s intentions.]

Five years ago

Fund boards were looking at new ways to set compensation in the face of declining assets and the introduction of more complex funds. The traditional way of setting director pay – by basing it on assets under management and number of funds overseen – was being evaluated to determine if it was the best way forward. [Compensation for mutual fund directors has doubled in the past decade, according to Management Practice Inc. The upward trend indicates a continued reliance on AUM, but MPI maintains that boards increasingly are looking at other factors when setting compensation (FD, March).]