Money market funds

By Daniel Bender
On 23 July 2014, the US Securities and Exchange Commission (SEC) adopted amendments to the rules that govern the approximately $2.6 trillion money market mutual funds industry, namely Rule 2a-7 under the Investment Company Act of 1940 (“Rule 2a-7” and the “1940 Act,” respectively), among others. These changes will fundamentally alter money market fund regulation and disclosure.

The amendments include provisions for the following defining types of money funds\(^1\) (i.e., government, non-government retail and institutional); requiring that certain money funds adopt market-based, floating net asset values (FNAV); and imposing liquidity fees and redemption gates, new and increased portfolio diversification requirements, increased stress-testing requirements, and new and increased regulatory reporting requirements.

In support of its adoption of the amendments, the SEC offered its primary objectives, noting that the amendments were “designed to address money market funds’ susceptibility to heavy redemptions in times of stress, improve their ability to manage and mitigate potential contagion from such redemptions, and increase the transparency of their risks, while preserving, as much as possible, their benefits.”\(^2\)

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1 Money market mutual funds are sometimes referred to as “money funds,” and throughout this discussion, money market mutual funds and non-money-market mutual funds will be referred to collectively as “money funds.”

2 Comments by Mary Jo White, Statement at SEC Open Meeting on Money Market Fund Reform, 23 July 2014.
Impacted products
Amended Rule 2a-7 impacts funds organized and structured as money market funds, including:

- Prime money market mutual funds
- Government and Treasury money market mutual funds (collectively called “government money funds”)
- Tax-exempt money market mutual funds
- Unregistered money funds operating under Rule 12d1-1 of the 1940 Act
- Master-feeder money funds

Definitions

The amendments changed several key definitions that impact the applicability of certain rules:

- “Retail” in the context of money funds now means money funds beneficially owned by “natural persons.”
- “Government money fund” means that funds must now have 99.5% of assets invested in government securities or repurchase agreements (REPOs) that are “collateralized fully” by government securities (rather than the current requirement of 80% in the “names rule,” Rule 35d-1 under the 1940 act).
- Control (which is applicable only for Rule 2a-7, as amended) means entities are “affiliated” with one another if one controls the other entity or is controlled by it or is under common control with it. “Control” means ownership of more than 50% of an entity’s voting securities.

Noteworthy: Under normal circumstances, an investment in a money fund that can impose a liquidity fee or redemption gate under Rule 2a-7(c)(2) still qualifies as a “cash equivalent” for purposes of US generally accepted accounting principles (GAAP).

Liquidity fees and redemption gates

- A board must make certain determinations regarding the imposition of liquidity fees and redemption gates to avoid a “run” on a money fund and the concomitant shareholder dilution that occurs (see the “Board guidance” on the next page).
- The decision on whether to impose liquidity fees or redemption gates must be in the fund’s best interest and recorded through meetings minutes or equivalent memoranda.
- Liquidity fees and redemption gates are not applicable to government money funds.

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3 For example, private funds are generally excluded from the definition of an “investment company” for purposes of the Investment Company Act. However, private funds that fall under Section 3(c)(1) or 3(c)(7) are deemed to be an investment company for purposes of the limitations set forth in Sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i) governing the purchase or other acquisition by such private fund of any security issued by any registered investment company and the sale of any securities issued by any registered investment company to any such private fund. Although a private fund is subject to the limitations set forth in Section 12(d) with respect to its investment in a registered investment company, a registered investment company is not subject to the limitations set forth in Section 12(d) with respect to its investment in any such private fund. See SEC Release No. 33-9616, IA-3879; IC-31165; at Note 812.
• The SEC prescribed certain thresholds that boards must consider when evaluating the imposition of liquidity fees or redemption gates, as described below:

• Under 30% weekly liquid assets: The board may impose a “discretionary” liquidity fee of up to 2% and/or impose a redemption gate for up to 10 business days in a 90-calendar-day period.

• Under 10%: The board must take action by imposing a “default” fee of at least 1% for up to 10 business days in a 90-calendar-day period (subject to the board’s determination).

• Lifting of the liquidity fees and redemption gates: When a money fund’s weekly liquid assets are greater than or equal to 30% of total assets, the fund must cease charging the liquidity fee or imposing the redemption gate, effective as of the beginning of the next business day.

Board guidance

The SEC offered some “guideposts” with respect to matters the board may wish to consider when deciding whether to impose liquidity fees or redemption gates:

• The 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?)

• For retail and government money funds, whether the fall in weekly liquid assets has been accompanied by a decline in the fund’s shadow price, the makeup of the fund’s shareholder base and previous shareholder redemption patterns, and/or the fund’s experience, if any, with the imposition of liquidity fees and redemption gates in the past.

Noteworthy: A board may choose not to impose any liquidity fees or redemption gates, provided it makes and documents a decision that not doing so is in the fund’s best interests.

Valuation

• The SEC rescinded the exemption that allows institutional prime money funds to maintain a stable net asset value (NAV) and is requiring those fund types to price and transact in their shares at market-based FNAV.

• Accordingly, institutional prime money funds, including unregistered money funds operating under Rule 12d1-1 of the 1940 act, must transition to an FNAV.

• For NAV transaction processing/reporting precision, the amendments change the rounding convention for money funds that are required to adopt an FNAV from penny rounding (i.e., to the nearest 1%) to “basis point” rounding (i.e., to the nearest 1/100th of 1%).

• For example: four decimal places for a $1,000.00 NAV, three decimal places for a $10,000 NAV and two decimal places for a $100.00 NAV.

• All stable NAV money funds must calculate the fund’s current NAV per share (based on current market factors before applying the amortized cost or penny-rounding method, if used, as of the end of each business day).

• FNAV money funds may rely on last-obtained market-based data for intraday comparisons of portfolio securities using amortized cost.

• Enhanced due diligence of third-party pricing service providers will be required of the board, management and compliance.

• Accounting Series Release (ASR) No. 219, the “60-day rule,” for valuing debt securities at amortized cost, remains available to all money funds (when it can reasonably conclude, at each time it makes a valuation determination, that the amortized cost value of the portfolio security is approximately the same as the fair value of the security as determined without the use of amortized cost valuation) and must be applied or validated at each valuation point (e.g., each business day).

Oversight of pricing vendors

Before deciding to use evaluated prices from third-party pricing service providers to help it determine the fair values of a fund’s portfolio securities, the board should assess:

• The adequacy of the inputs, methods, models and assumptions used by the third-party pricing service providers to determine its evaluated prices, and how those inputs, methods, models and assumptions are affected (if at all) as market conditions change.

• The quality of the evaluated prices provided by the third-party pricing service providers and the extent to which the pricing service determines its evaluated prices as close as possible to the time as of which the fund calculates its NAV.

Noteworthy: All money funds will be required to perform daily market-based valuations, including stable NAV money funds; accordingly, the SEC expects that the money fund investment 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, thus indicating that the use of amortized cost valuation for that security may no longer be appropriate.
Diversification requirements

The SEC adopted several important changes to the existing issuer diversification limits:

- Affiliates (under control or common control, with the parent owning more than 50% of the outstanding voting securities) must be treated as a single issuer for the 5% issuer diversification test.

- Non-asset-backed securities (ABS) that are subject to a guarantee by a non-controlled person would be subject to Rule 2a-7’s 10% diversification limit applicable to guarantees and demand features (but would continue to be able to take advantage of the exception to the 5% diversification limit).

- ABS would be subject to both a 5% issuer diversification limit on the Special Purpose Entity, and any ten-percent obligors and a 10% limit on the sponsor as the presumed guarantor.

- The 10% diversification limitation is now applied to 85% of a tax-exempt money fund’s total assets and to 100% of a fund’s total assets for money funds other than tax-exempt funds (rather than the current 75% of a money fund’s total assets).

- The 25% basket is eliminated for money funds other than tax-exempt funds and is reduced to 15% for tax-exempt money funds. Up to 15% of the value of securities held in a tax-exempt money fund’s portfolio may be subject to guarantees or demand features from a single guarantor.

Disclosures

The SEC adopted several amendments to existing disclosure and reporting requirements and added a new form (Form N-CR).

- General:
  - Categories of portfolio investments reported on Form N-MFP and fund websites have been revised.
  - For each portfolio security, money market funds must report the maturity date used to calculate the dollar-weighted average life maturity on Form N-MFP and its fund websites.

- Advertisements and prospectus (summary section):
  - For government, non-government retail and institutional funds, risk disclosures have been increased as prescribed in the adopting release (e.g., when a shareholder could lose money, the fund may impose fees or redemption gates – except for government money funds, where there is no Federal Deposit Insurance Corporation insurance, and sponsors have no legal obligation to provide support).

- Prospectus:
  - Money market funds will need to disclose the various situations in which the fund may impose a liquidity fee or redemption gate.
  - Retail money funds will need to disclose that beneficial ownership of the money fund is by “natural persons.”
  - Tax consequences for FNAV money funds should be detailed.
  - For money market funds transitioning to an FNAV, an update is required to the registration statement via a post-effective amendment or “sticker.”
• **Statement of additional information:**
  • There will need to be more detailed discussion of the operational implications of liquidity fees and redemption gates and their impact to shareholders.
  • Sponsor support, liquidity fees and redemption gates, and liquidity thresholds will include disclosure of occurrences where the money market fund's weekly liquidity passed the 10% and 30% thresholds, as well as occasions where the fund has considered or imposed liquidity fees or redemption gates and has received sponsor support and relevant durations.
  • The reporting period will cover any occasions in the last 10 years in which the fund's weekly liquid assets fell below 10% or 30% and whether the board imposed a liquidity fee and/or gate in either scenario.
  • The 10-year look-back period will begin after the compliance date for the amended rules.

• **Form N-MFP:**
  • The 60-day delay for public availability of portfolio holdings data has been eliminated.
  • Liquidity data will need to be reported weekly on Form N-MFP, with disclosure of weekly gross subscriptions (including dividend reinvestments) and weekly gross redemptions for each share class. Form N-MFP will continue to be required to be filed monthly within five business days.

**Noteworthy:** The complete Form N-MFP will still be filed monthly.

• **Other form requirements include:**
  • The market-based value of portfolio securities will need to be disclosed on the fund website at the same time that this information becomes public on Form N-MFP.
  • The number of shares outstanding, to the nearest hundredth, at both the series level and the class level will need to be disclosed.
  • The period remaining until the principal amount of a security may be recovered through a demand feature will need to be disclosed. Additionally, disclosure is required to identify whether a security demand feature is conditional, as well as to identify each demand feature issuer, guarantor or enhancement provider and the amount (i.e., percentage) of fractional support provided.
  • All three maturity calculations as required under Rule 2a-7 — weighted average maturity, weighted average life and the legal maturity date — will need to be disclosed.
  •Disclosure on new investment categories will be required.
  • REPO collateral investment categories that conform to those used by the NY Federal Reserve Bank will need to be disclosed.

• Disclosure will be required on whether the money market fund's adviser or a third party, has paid for or waived all or part of its operating expenses or management fees during a given reporting period.
  • The legal entity identifier that corresponds to the security, if available, and at least one other identifier, if available, will need to be disclosed.
  • Disclosure will be required on whether a security is categorized at fair value hierarchy Level 3 (not the fair value level of each security).
  • The money market fund daily and weekly liquid assets on both a dollar and percentage basis will need to be disclosed.
  • The cash position of the money market fund will need to be disclosed.

• **Website:**
  • **Liquid assets** — disclose prominently the percentage of daily/weekly liquid assets as of the end of each business day during the preceding six months
  • **Shareholder net inflows or outflows** — disclose prominently on its website, the fund's daily net inflows or outflows, as of the end of the previous business day, during the preceding six months
  • **NAV** — disclose prominently and daily on its website, the fund's current NAV per share (calculated based on current market factors), rounded to the fourth decimal place in the case of a fund with a $1.0000 share price or an equivalent level of accuracy for funds with a different share price as of the end of the previous business day during the preceding six months

• **Form PF:**
  • Question 63 is newly added to Section 3 (this will parallel the amended Form N-MFP, Part C).
  • The addition of question 63 will replace questions 56-57.

**Noteworthy:** Form PF remains a quarterly filing.

• **Form N-CR:**
  • A money market fund is required to file if a portfolio security defaults, an affiliate provides financial support, the money fund experiences a significant decline in its shadow price,4 or when liquidity fees or redemption gates are imposed and when they are lifted.
  • An initial report (within one business day of the event) replaces the current procedure for money funds to notify the SEC via email.

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4 Defined as when the fund's current NAV per share deviates downward from its intended stable price by more than a quarter of 1%; see Form N-CR, Part D.
A follow-up report should be filed within four business days of the event.

The report should be publicly available via EDGAR电子数据收集、分析和检索系统; www.sec.gov/edgar/aboutedgar.

Stress testing

To address disparities in the quality and comprehensiveness of stress tests, the types of hypothetical circumstances tested, and the effectiveness of materials produced by fund managers to explain the stress-testing results to boards, the SEC adopted increased stress-testing requirements:

- Investment advisers to money funds must test their ability to maintain weekly liquid assets of at least 10% and to minimize principal volatility in response to specified hypothetical events that include:
  - An increase in the general level of short-term interest rates
  - A downgrade or default of particular portfolio security positions, each representing various portions of the fund's portfolio (with varying assumptions about the resulting loss in the value of the security)
  - A correlated increase in the credit spreads for certain portfolio securities; advisers should group securities into logically related categories, or sectors, such as securities of a similar industry, similar geographic region or security type (such as asset-backed commercial paper or variable rate demand notes), and then test for the impact of yield spread changes on various sectors
  - An increase in shareholder redemptions – tested in combination with the other three events

Noteworthy: Advisers must evaluate a combination of events (as described above) and correlations among portfolio holdings (an important part of a fund’s stress testing).

Develop, enhance and adopt written procedures and maintain the written procedures and amendments for six years following the replacement of such procedures with new procedures, keeping the first two years in an easily accessible place, including:

- Written procedures must provide for a report of the stress-testing results to be presented to the board at its next regularly scheduled meeting (or sooner, if appropriate in light of the results)
- Document assumptions used in the stress-testing report
Response strategy
Firms will need to assess the impact of the amendments across several key dimensions consisting of product, vendor coordination and operational readiness.

**Product**

Fund sponsors and boards will need to evaluate their fund lineup in light of their current investor base and forward-looking distribution strategies:

- For fund scoping/triage, identify “retail only” funds and coordinate with distribution partners to assess omnibus accounts and underlying shareholders and determine ongoing transparency requirements.

- For fund lineup strategy, assess the level of “institutional” money fund assets and other key business considerations, i.e., historical level of institutional assets, if any institutional clients rely on the convenience of money funds within the fund family (e.g., would pull their assets if the fund family no longer offered institutional prime money funds).

- Consider fund mergers/splits to create “retail only” vs. “institutional only” prime money funds (assuming the fund family keeps offering institutional prime money funds).

- Discuss with institutional clients the possibility of shifting assets from institutional prime money funds to government money funds and/or the possibility of stratifying their cash management portfolio into “tactical” or stable NAV (lower yielding) and “strategic” or FNAV (higher yielding) investment options, including money market exchange-traded fund (ETF) options.

- Evaluate options for unregistered money fund products, managed accounts and ETFs.

**Vendor coordination**

Given the many dimensions of change driven by the final rule, funds and boards will need to assess their service provider’s (third-party or in-sourced business units or shared service organizations) capabilities and readiness to perform the necessary processing and reporting to comply with the requirements:

- Pricing services: re-evaluate third-party pricing service providers, including inputs, methods, models and assumptions used to determine its evaluated prices and how those inputs, methods, models and assumptions are affected (if at all) as market conditions change.

- Fund accounting: re-evaluate or confirm that a fund accounting agent’s systems and control environment are adequately designed and effectively implemented to produce NAVs and FNAVs with the appropriate precision and perform comparisons of amortized cost to market-based factors; process shareholder transactions with the appropriate precision; escalate any NAV/FNAV deviations; and efficiently provide accurate data sufficient for regulatory filings.

- Fund administration and regulatory administration: re-evaluate or confirm that enhanced regulatory reporting standards are addressed through systems, procedures and supervisory controls.

- Distribution partners, sub-transfer agent and omnibus accounts: implement enhanced due diligence procedures related to omnibus accounts so that only “natural persons” are beneficial owners of retail money funds (including requiring compliance certifications from distribution partners) and new contract provisions (i.e., where distribution partners agree to impose liquidity fees or redemption gates).
Operational readiness

Firms will need to assess the applicability of the SEC’s money fund amendments across the value chain to determine their own response activities and prioritization. Below is an example of some key changes and the primary stakeholders that need to conduct an impact assessment and develop a response plan:

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<th>Key responses</th>
<th>Primary response owner(s)</th>
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<tr>
<td>Enhancements to policies and procedures and supervisory framework</td>
<td>Board, investment adviser, fund accountant, fund administrator, custodian, transfer agent, sub-transfer agent, distributor, technology</td>
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<td>Weekly liquidity threshold monitoring processes and escalation</td>
<td>Investment adviser/front office, compliance, risk management</td>
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<td>Intraday pricing</td>
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<tr>
<td>NAV/FNAV reporting precision (enhance file formats/system functionality)</td>
<td>Fund accountant, transfer agent, sub-transfer agent, distributor, technology</td>
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<tr>
<td>Transaction pricing precision/10b–10 confirmations, “natural person” monitoring (SSNs, other representations from distribution partners) and omnibus transparency</td>
<td>Transfer agent, distributor</td>
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<tr>
<td>Investment guidelines updates</td>
<td>Compliance, technology</td>
</tr>
<tr>
<td>Reference data assessment – to address investment categories for portfolio holdings and REPO collateral (e.g., possibly through the use of user-defined data fields and translation tables)</td>
<td>Technology, compliance, fund administration, investment adviser</td>
</tr>
<tr>
<td>Technology – depending on the ultimate product strategy, firms must assess impact to internal systems (i.e., sweep systems), omnibus transparency capabilities, and file formats to address FNAV and shares precision</td>
<td>Technology, distributor, investment adviser, broker-dealer platform sponsors</td>
</tr>
<tr>
<td>Daily comparison of securities priced using amortized cost (under ASR No. 219) to market-based factors to monitor the ongoing appropriateness of using amortized cost</td>
<td>Fund accounting, fund administration, investment adviser/front office</td>
</tr>
<tr>
<td>Regulatory reporting</td>
<td>Fund administration/regulatory administration, fund accountant, technology</td>
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Key compliance dates

<table>
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<th>Change</th>
<th>Compliance date</th>
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<td>Form N-CR</td>
<td>9 months after the effective date*</td>
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<td>Diversification</td>
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<td>Stress testing</td>
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<td>Disclosure</td>
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<td>Form PF</td>
<td>18 months after the effective date*</td>
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<tr>
<td>Form N-MFP</td>
<td>18 months after the effective date*</td>
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<tr>
<td>Floating NAV</td>
<td>2 years after effective date*</td>
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<td>Liquidity fees</td>
<td>2 years after effective date*</td>
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<tr>
<td>Redemption gates</td>
<td>2 years after effective date*</td>
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</tbody>
</table>

* “Effective date” means 60 days after the final rule is published in the Federal Register, which was on 14 August 2014.
Looking forward
Although the SEC’s final rules closely tracked to the proposal, firms continue to assess the implications of the changes across several key dimensions:

1. Product strategy
2. Board governance
3. Organizational impact (including vendor oversight)
4. Distribution and investor transparency
5. Operational readiness (e.g., policies and procedures, reporting processes, data and technology)

The changes will drive institutional clients and money fund sponsors alike to focus on alternate solutions, such as separately managed accounts, ETFs, stratified cash management portfolios that allocate cash between stable NAV (lower-yielding government money funds) and FNAV (higher-yielding) investment options (including money market ETF options), and unregistered money funds (operated in all material respects as stable NAV, 2a-7 money funds).

The good news: Retail investors and investors in government money funds (together representing approximately two-thirds of the $2.6 trillion money market mutual fund industry) will likely see little to no impact to their money fund assets.

Operational future state

We continue to assess the impact of the final rules. Through conversations with industry participants, we believe the future state operational process will consist of three daily accounting periods providing shareholders with liquidity and requiring NAV calculations. Two estimated NAVs will be calculated at morning (9 a.m.) and afternoon (12 p.m.), and the final, official NAV being calculated at the end of day (between 3 p.m. and 5 p.m.). The components captured and used in the various NAV calculations will be different for intraday (9 a.m. and noon) versus end of day.

The morning and afternoon estimated NAV will most likely not include any income or expense accruals nor intraday millrate calculations. Net income, the daily millrate and yields will be calculated and reported once a day (at the end of day) when the final, official NAV is calculated, as is current practice.

The morning and afternoon estimated NAVs will include the effects of portfolio transactions (e.g., realized gains/losses) and market-based prices (unrealized gains/losses calculated based on “snap quotes” received from pricing services and fair valued assets). The millrate earned or paid to redeeming shareholders will be the prior day reported millrate.

Some pricing vendors are already working on their ability to deliver intraday prices. Investment managers and service providers will need to adjust systems and processes in order to capture the information and calculate the intraday NAV. In particular, service providers must be able to capture and retain multiple, point-in-time asset prices in their reference data files and process and record ledger/subledger entries and retain books and records adequate to evidence the calculation of each intraday NAV. New processes and controls will need to be established by the funds and adopted by fund boards of directors/trustees, including coordinating with their vendors (pricing services and service providers) in order to understand and effectively monitor what controls are being performed by the vendors. In addition, a firm’s ability to adequately evidence position-level credit risk/impairment monitoring, especially where a fund chooses to value positions with less than 60 days to maturity at amortized cost, will be front and center when the SEC examines policies, processes, controls, escalation and governance processes.

The industry is still reviewing the impact of the changes in applying liquidity fees and gates to the money market funds. Many industry participants believe that the application of a redemption gate and/or liquidity fee and the disclosure of the new Form N-CR will be viewed as the new “breaking the buck” threshold, and therefore portfolio management practices will be adjusted to avoid these scenarios. However, should a fund’s board choose to move forward with the imposition of a liquidity fee and/or redemption gate, either option is effective as of the next business day following the board’s determination. The fees/gates must be lifted on the business day following the curing of the liquidity threshold breech. Considering the duration and application of liquidity fees and redemption gates as described by the SEC, the final analysis and determinations would be made at the end of each day and effective as of the beginning of the next business day. Accordingly, new system reports will need to be generated, to ensure they are making decisions and new processes and controls will need to be established to ensure the boards can make timely and informed decisions for the benefit of the funds.

The changes required by the new rules will require greater communication among service providers, fund sponsors and boards. Policies and procedures across all of the service providers, funds and sponsors will need to be changed and coordinated for capturing the intraday NAV. Systems will need to adapt to capture the proper data from the service providers.

6 See ASR 219 and SEC Adopting Release No. 33-9616, IA-3879; IC-31166; FR-84; File No. S7-03-13, at note 871.

7 "... at the end of a business day, the money market fund has invested thirty percent or more of its total assets in weekly liquid assets, the fund must cease charging the liquidity fee, effective as of the beginning of the next business day." New Rule 2a-7(c)(ii)(A).
and provide the user with accurate and timely information. Fund sponsors should ensure vendor controls exist for areas where they intend to rely upon controls. Boards will have to change the types and timing of reporting and associated escalation protocols to be able to review the weekly liquid assets level information in order to make decisions in a timely manner.

The impact of the SEC’s amendments is widespread and implicates every step and stakeholder in the value chain. Fund advisers need to accelerate their processes to design and implement enhancements, including communicating/ coordinating with vendors and service providers to understand their response strategies and other improvements (i.e., technology, reporting, policies and procedures). Boards should start monitoring the response plans to ensure fund advisers and vendors and service providers are devoting adequate resources to develop, test, implement required people, process and technology enhancements and are on schedule to meet the fast-approaching regulatory deadlines.

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