Governance of Money Funds to Face Greater Scrutiny

Reforms Emphasise 'Board' Role in Redemption Gate Decisions

Special Report

Methodology: We sampled 17 umbrella funds governing more than 50 sub-funds. We focused on Ireland- and Luxembourg-domiciled UCITS MMFs. We relied on the most recent published versions of the prospectus as of mid-2018. Our sample covered the vast majority of current European CNAV MMFs.

Our sample covered 88 fund directors, of which we consider 36 independent. We define an independent director as one with no direct or current link to the fund sponsor.

Gates and Fees More Prominent: The governance of European money market funds (MMFs) will be under greater investor focus as a result of coming reforms, given the prominence of liquidity fees and redemption gates in the new regulation. The reforms assign the 'board' additional responsibility for reform-specified fee and gate tests, on top of the existing discretion over applying a wide array of extraordinary liquidity management measures under UCITS.

Definitive Decision Points: If a post-reform European Low Volatility Net Asset Value (LVNAV) or Public Debt Constant Net Asset Value (CNAV) fund's weekly liquidity falls below 30% and the fund suffers a simultaneous net outflow of above 10%, the 'board' must consider applying a fee or gate. If weekly liquidity falls below 10% it must apply either a fee or gate, but retains discretion over which best serves investors.

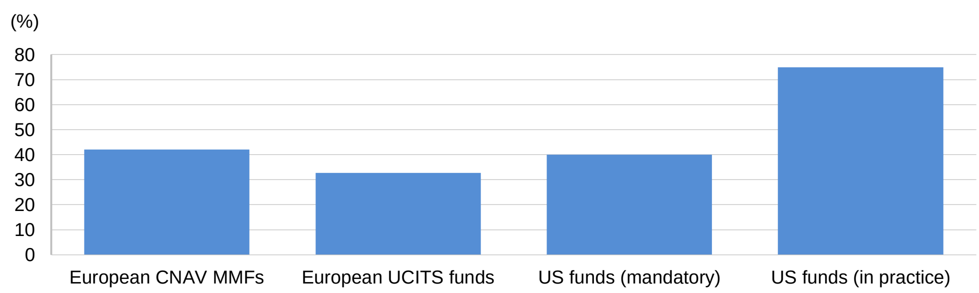
Adequate Board Independence: Of the Fitch Ratings-sampled CNAV MMFs boards, all had at least one independent director; however, only a few had boards in which more than half of the directors were independent. On average, funds had 2.1 independent directors (or 42%). While this level falls short of a majority, it is higher than the industry-wide average for European UCITS funds (33%) and is marginally higher than the regulatory minimum for US funds (40%).

Lack of Diversity: Women are significantly underrepresented on MMF boards: in more than half of our sample, there were no female directors on the board. This low level of diversity is not confined to MMFs, however. Only 11% of directors at European UCITS are women.

Board Addresses Principal-Agent Risk: The presence of independent directors, combined with effective policies and controls, can help to allay potential agency conflicts. The diversity of a fund's board can support effective and robust decision-making by adding varied backgrounds and perspectives, helping to ensure that investors' best interests are served.

'Board' Definition Potentially Unclear: The language in the reforms is potentially unclear as to whether the board of the fund or the board of the management company has ultimate responsibility for gate and fee decision-making. In any case, the 'board', be it fund or management company, will typically delegate significant responsibility for the management of the fund to the investment advisor.

European CNAV MMF Boards More Independent than European UCITS Funds



Source: Funds, Fitch, ICI

Related Research

European MMF Reform Dashboard (July 2018)

The Post-Reform European Money Fund Landscape (April 2018)

What Investors Need to Know: European Money Market Fund Reform (September 2017)

Reform Gate Risk Low for European Money Funds (October 2017)

European Mutual Fund Governance (April 2017)

Little Differentiation in Euro Bond Fund Liquidity Provision (May 2016)

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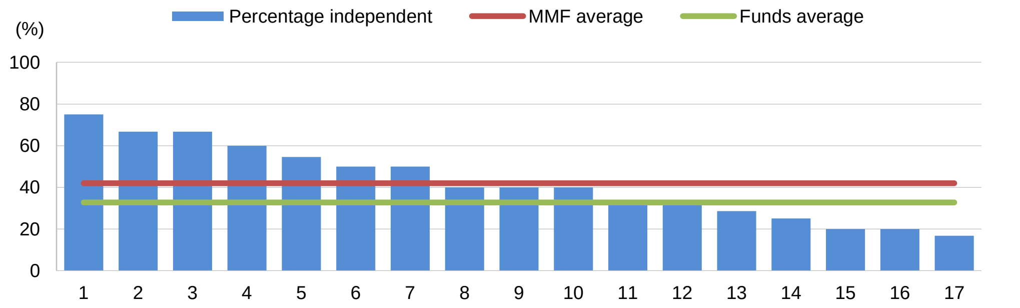
Boards to Play Increasingly Important Role

Few Funds Have a Majority of Independent Directors



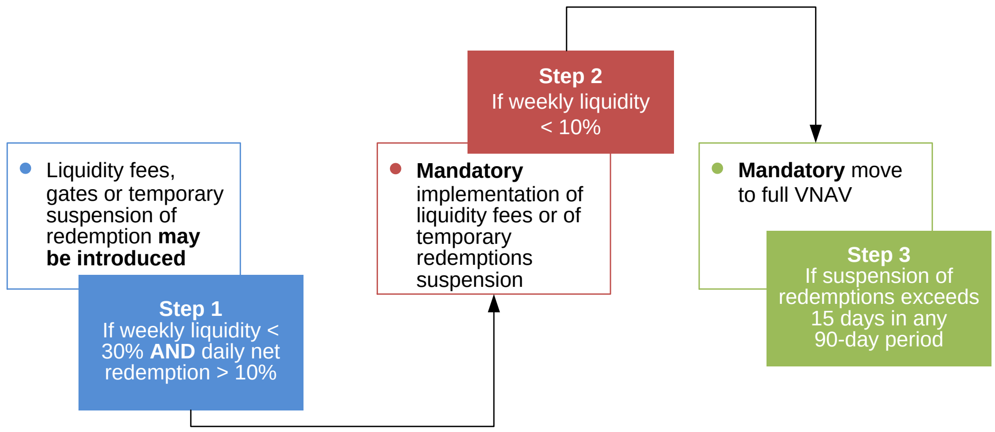
Source: Fund Prospectuses, Fitch; Fund Average refers to the average number of independent directors of UCITS funds identified in Fitch's 2017 research on European Mutual Fund Governance

The July 2017 European MMF reforms introduced additional responsibility for MMF boards, on top of their existing duties under UCITS and local regulatory requirements. For further information on the reforms, see our *Credit Hotspot: European Money Market Fund Reform*.

The reforms do not fundamentally change the role of a fund's – or MMFs – board of directors, which is to safeguard and act in the best interest of fund investors. The UCITS regulations already afford fund boards significant discretion over applying an array of extraordinary liquidity-management measures (which include fees and gates, see *Little Differentiation in Euro Bond Fund Liquidity Provision*, dated May 2016) and whose primary role is to protect investors. Boards should not have to use these measures.

In addition to the existing measures available to fund boards under UCITS, the coming MMF reforms codified how and when specific redemption gates and liquidity fees should be applied for Public Debt CNAV and LVNAV funds. If a LVNAV or Public Debt CNAV fund's weekly liquidity falls below 30% and the fund suffers a simultaneous net outflow of above 10%, the board must consider applying a fee or gate. If weekly liquidity falls below 10%, the board must apply either a fee or a gate, but it retains discretion over which best serves investors. These measures are not applicable to VNAV funds.

Phases of Applying Fees and Gates



Source: Fitch

Related Criteria

Global Money Market Fund Rating Criteria (November 2017)

Fitch believes the probability of a discretionary or mandatory liquidity fee or redemption gate being imposed is low, absent a systemic shock or idiosyncratic credit event (See *Reform Gate Risk Low for European Money Funds*, dated October 2017).

Independent Directors in Minority on European MMF Boards

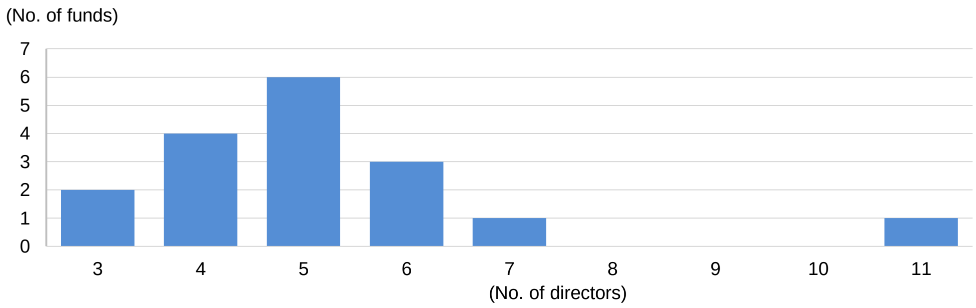
Fitch considers governance standards in European MMFs to be adequate. However, we believe that governance is likely to be more robust among those funds that have a majority of independent directors on their boards, which should still allow the benefit of having minority executive members who can provide fund-specific insight and investment management-specific expertise. The average representation of independent directors on fund boards is 42%, which in our view is a reasonable share. This level is also higher than the industry-wide average for European UCITS funds, at 33%. All of the MMFs sampled by Fitch had at least one independent director on the board. In the US, mutual fund regulation requires that at least 40% of mutual fund boards comprise independent directors. As of April 2017, the average was considerably higher at 75%. Outside of the mutual fund sector, high independent board representation is common: 61% in FTSE 250 boards and 84% in S&P500 boards (see *European Mutual Fund Governance,* dated April 2017).

European CNAV MMFs had an average of 2.1 independent directors in each Fitch-sampled board. All sampled funds had an independent presence, and around 30% of funds had a majority of independent directors.

Fitch adopts an asymmetric approach to assessing governance risk: very strong governance characteristics will not result in higher ratings, nor compensate for a fundamental weakness in any other part of Fitch's analysis. Conversely, and in extreme cases, poor governance – such as an ineffective board in action or construct – can result in the assignation of lower ratings than implied by Fitch's fundamental analysis.

The number of directors on fund boards varies. Sampled funds had 5.2 directors on average. The largest single segment had five (35%) board members. Majority decision-making was supported by the 59% of funds with an odd number of directors.

Majority of Funds Have Five Board Directors



Source: Funds, Fitch

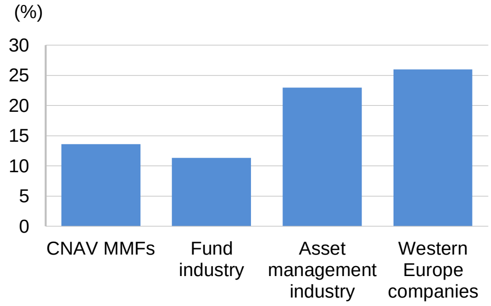
European MMF Boards Lack Diversity

The level of gender diversity in European CNAV MMF boards is low. In our sample funds, only 14% of board directors were women, although this level was marginally better than the 11% female representation we identified in (broad) European UCITS fund boards (see *European Mutual Fund Governance*). By comparison, the broader financial institutions/asset-management industry level was 23%.

More than half of the sampled funds had no women directors on their boards; 23% had one and 24% had two. None of the sampled funds had a majority of women board directors. On average, each fund board had 0.7 female directors, while the financial institutions/asset-management industry had 2.6 (as of April 2017).

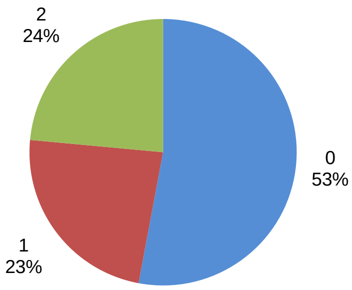
There is broad recognition that board diversity promotes robust decision-making and better challenges to management. Female representation on the board is considered as one measure of such diversity.

Under-Representation of Female Directors in Fund Industry



Source: Egon Zehnder, Funds, Fitch, Funds Europe

Half of the Funds Don't Have Female Directors



Source: Funds, Fitch

'Board' Definition Open to Interpretation

The language in the reforms is potentially unclear as to whether the board of the fund or the board of the management company has ultimate responsibility for gate and fee decision-making. SICAV (Luxembourg) and OEICs/ICVCs (Ireland) have boards responsible for the oversight of the fund itself. The fund's board will appoint a management company as a separate entity to manage the fund's affairs, which may include investment management, risk management and administration, or subcontract those roles to other entities. As such, the board of the fund of a SICAV or OEIC/ICVC is distinct form the board of the relevant management company.

The language in the reforms appears to use the fund and management company boards interchangeably[1]. For example, the reforms assign the board of the fund 'manager' responsibility for establishing, implementing and applying liquidity management procedures and refer to the fund manager in terms of assessing liquidity test breaches and deciding on what measure to apply. However, the reforms also refer to the board of directors of the 'fund' itself in the same section in terms of both decision-making and communication of decisions to relevant regulators.

A purposive reading of the European reforms would suggest the responsibility for reform-related fees and gates lies with the fund's board, concurrent with its existing responsibilities under UCITS; however, the language may also be interpreted as ascribing this responsibility to the board of the relevant management company. In any case, the 'board', be it fund or management company, will typically delegate significant responsibility for the management of the fund to the investment advisor.

European Reform Implementation Approaching

European MMF reforms became effective for all new funds in July, and all existing funds will need to submit applications to competent authorities by 21 January 2019. Non-government CNAV funds will cease to exist in their current form and will need to be converted to one of the new fund formats, most likely to LVNAVs.

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[1] FCPs - a structure prevalent in France but also common in Luxembourg - have no distinct legal entity (in contrast to SICAVs and OEICs/ICVCs); therefore the only relevant board in such cases is that of the management company, and this may be the source of this interchangeable use of language.