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CESR Issues Guidelines for Two-Tier Classification of European Money Market Funds

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TO: INTERNATIONAL COMMITTEE No. 9-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 27-10
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 26-10
SEC RULES MEMBERS No. 60-10 RE: CESR ISSUES GUIDELINES FOR TWO-TIER CLASSIFICATION OF EUROPEAN MONEY MARKET FUNDS

On May 19, 2010, the Committee of European Securities Regulators (CESR) issued guidelines for a common definition of European money market funds (the "Guidelines") setting forth two classifications: (1) short-term money market funds and (2) money market funds. [1] The classifications are intended to distinguish short-term money market funds from money market funds that operate with a longer weighted average maturity and weighted average life. Only funds that comply with the Guidelines may have in their name any reference to "money market." The Guidance applies to both UCITS money market funds and national-level non-UCITS money market funds. We have attached a chart of the criteria for the two categories of money market funds. CESR believes that the two classifications will improve investor understanding of money market funds.

The Guidelines will enter into force on July 1, 2011; however, money market funds that existed before this date have an additional six month period, until December 31, 2011, to comply. Beginning July 1, 2011, all funds operating as money market funds under the Guidelines must state this in their offering documents. Similarly, any fund that does not intend to comply (i.e., those that will cease to call themselves money market funds) should make this clear in their documentation beginning on the same date, July 1, 2011.

I. General Guidelines for Disclosure

Under the Guidance, a European money market fund will be required to indicate in its prospectus and, in the case of a UCITS, in its Key Investor Information Document, whether the fund is a short-term money market fund or a money market fund. In addition, money market funds will be required provide information to investors on the risks and rewards of the fund so investors can assess the risks linked to the investment strategy of the fund. The disclosure must clearly explain the implications of investing in the type of money market fund, taking into account, if relevant, any investment in new asset classes, financial instruments or investment strategies with unusual risks and rewards.

II. Investment Limits and Other Restrictions

Generally, many of the investment restrictions that are applicable to short-term money market funds are also applicable to money market funds. For example, both short-term money market funds and money market funds must take into account the impact of financial derivative instruments, deposits and efficient portfolio management techniques. Both types of funds must invest in high quality money market instruments or deposits with credit institutions and the credit quality must be monitored on a continuing basis, not only at the time of purchase. For both fund types, if the rating of a money market instrument held in the fund's portfolio no longer complies with the Guidelines, the management company must take corrective action. In addition, both short-term money market funds and money market funds have the same primary investment objective of maintaining the principal of the fund and seeking to provide a return in line with money market rates. Both types of funds are permitted to invest in non-base currency securities, provided that the currency exposure is fully hedged and that all risks incurred by these investments are appropriately disclosed in the prospectus.

There are, however, several distinctions between short-term money market funds and money market funds. While short-term money market funds may have constant net asset value ("NAV") or fluctuating NAV, money market funds must have a fluctuating NAV. [2] The key criteria for distinguishing between short-term money market funds and money market funds generally are based on differences related to some criteria for high quality money market instruments and the proposed limits for the maturity of securities and the restrictions on weighted average maturity ("WAM") and weighted average life ("WAL"). [3], [4] For short-term money market funds, such funds must have a WAM of no more than 60 days and a WAL of no more than 120 days (not a WAL of 90 days as CESR originally proposed). For money market funds, the WAM can be no longer than 6 months and the WAL can be no more than 12 months (rather than a WAL of 6 months as CESR originally proposed). For both short-term money market funds and money market funds, when calculating the WAL for securities, the maturity calculation must be based on the residual maturity until the legal redemption of the instrument. Short-term money market funds must limit investment in securities to those with a legal maturity of less than or equal to 397 days. In contrast, for money market funds, the legal maturity or residual maturity must be less than or equal to 2 years, provided that the time until the next interest rate reset date is less than 397 days. [5] Although CESR originally considered restricting investments in structured financial instruments for short-term money market funds, both short-term money market funds and money market funds are permitted to invest in structured financial instruments or asset-backed commercial paper.

In connection with the requirement to invest in high quality money market instruments, neither short-term money market funds nor money market funds may take direct or indirect exposure to equity or commodities, including via derivatives. Both funds may only invest in other funds which, in the case of a short-term money market fund, meet the definition of short-term money market fund, or in the case of a money market fund, comply with the definition of either type of European money market fund. Both types of funds must only use derivatives in line with the money market investment strategy of the particular fund. With respect to "high quality," a money market instrument is not of high quality unless it has been awarded one of the two highest available short-term credit ratings by each recognized credit rating agency that has rated the instrument (i.e., the two highest ratings of the specific ratings scale). If not rated, the instrument must be of equivalent quality as determined by management's internal rating system. Responsibility for the assessment of quality lies with the management company and management companies must not place undue weight on credit ratings. As an exception to the general principles regarding credit quality, money market funds may hold sovereign issuance of at least investment grade quality as awarded by one or more recognized credit rating agencies. [6]

On valuation, CESR recognizes two approaches: (1) amortized cost for constant NAV short-term money market funds with requirements under CESR's guidance for eligible assets for UCITS relating to areas such as credit quality and diversification and also marking to market the portfolio on a regular basis; and (2) market value for variable NAV money market funds, although instruments with a residual maturity of less than three months may be valued at amortized cost. [7]   CESR expects that the use of constant NAV should only be allowed with amortization method requirements which are similar to CESR's guidance relating to eligible assets for UCITS and imposed under local law. CESR does not address any issues associated with a variable NAV money market fund that may have limited variability in its NAV (given the ability to value instruments with a residual maturity of three months or less at amortized cost).

On settlement, CESR notes that settlement requirements should be addressed at a national level; however, for UCITS money market funds, settlement should not exceed T+3. On the basis that employee savings schemes typically invest on a long-term basis, weekly subscriptions and redemptions, rather than daily, are permitted for non-UCITS money market funds marketed through employee savings schemes. Similarly, money market funds offered to a specific category of investor with divestment restrictions also may provide weekly subscriptions and redemptions as permitted under home state rules.

If you have any questions regarding these new guidelines, please feel free to contact me at solson@ici.org or 202-326-5813.

Susan Olson
Senior Counsel - International Affairs

Attachment

endnotes

[1] Committee of European Securities Regulators, CESR's Guidelines on a Common Definition of European Money Market Funds (CESR/10-049), May 19, 2010, available at http://www.cesr.eu/popup2.php?id=6638 ("Final Guidance"). See also Committee of European Securities Regulators, A Consultation Paper: A Common Definition of European

Money Market Funds (CESR/09-850), Oct. 20, 2009, available at http://www.cesr-eu.org/data/document/09_850.pdf ("Original Consultation Paper").

[2] A constant NAV money market fund seeks to maintain an unchanging face value NAV. UCITS must ensure that such a method will not result in a material discrepancy between the market value of the instruments held by the fund and the value calculated according to the amortization method. The fund must periodically calculate both the market value of its portfolio and the amortized cost valuation as well as take action if any discrepancy between them becomes material.

[3] CESR defines WAL as the weighted average of the remaining life (maturity) of each security held in a fund, meaning the average time until the principal is repaid in full (disregarding interest and not discounting). Contrary to the calculation of WAM, the calculation of WAL for floating rate securities and structured financial instruments does not permit the use of interest rate reset dates and instead only uses a security's stated (legal) final maturity. WAL is used to measure the credit risk, as the longer the reimbursement of principal is postponed, the higher the credit risk. The limit on WAL also helps mitigate the effect of changes in interest rate spreads.

[4] CESR defines WAM as a measure of the length of time to maturity of all of the underlying securities in the fund weighted to reflect the relative holdings in each instrument, assuming that the maturity of a floating rate instrument is the time remaining until the next interest rate reset, rather than the time remaining before the principal value of the security must be repaid. WAM used to measure the sensitivity of a money market fund to changing interest rates. The sensitivity to changes in interest rates is also commonly known as modified duration.

[5] For additional discussion of "residual maturity" for both types of money market funds, see Final Guidance paragraphs 13, 16, 17 and 26.

[6] "Sovereign Issuance" should be understood as money market instruments issued or guaranteed by a central, regional or local authority or central bank of a Member State, the European Central Bank, the European Union or the European Investment Bank. This flexibility for money market funds accounts for the need for financing of short-term sovereign debt across the EU and the possible difficulties that would arise for funds based in certain Member States if they were no longer able to invest in the sovereign debt of that jurisdiction.

[7] See Original Consultation Paper at paragraph 8 and Final Guidance at paragraph 21.
