

MEMO# 27549

September 9, 2013

European Commission Publishes Proposal for Money Market Fund Regulation

[27549]

September 9, 2013

TO: ICI GLOBAL SHADOW BANKING TASK FORCE
INTERNATIONAL MEMBERS No. 40-13
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 19-13 RE: EUROPEAN COMMISSION
PUBLISHES PROPOSAL FOR MONEY MARKET FUND REGULATION

On September 4, 2013, the European Commission (“EC”) published a proposal for the regulation of money market funds (“EU proposal”). [\[1\]](#) While the proposal incorporates some regulatory recommendations from other policymakers, the proposed regulation includes provisions that are quite different or, in some cases, are not provisions that have been proposed by others for the regulation of money market funds (“MMFs”). A version of this regulation was leaked in April and this September 4 regulation reflects a few changes. Most notably, there are positive changes related to the eligibility of certain collateral for reverse repurchase agreements. It is also important to note that in June, the U.S. Securities and Exchange Commission (“SEC”) issued their proposal for changes to the regulation of U.S. money market funds (“SEC’s June proposal”). Despite the close timing of the two proposals, the reforms proposed by the EC and the SEC are fundamentally very different.

The EU proposal must now go through the European Union’s ordinary legislative process for approval and then implementation. The focus therefore turns to the European Parliament and the Council of the European Union. The timeline for this process is uncertain due to several factors, including the priority of other legislative matters and the influence of upcoming Parliament elections in May 2014. There is no formal public comment process similar to the process that is being followed for the SEC’s June proposal.

EU Proposal

The EU proposal follows from exceptionally limited public dialogue on reforms for MMFs. In April and May 2012, there was a shadow banking conference and a green paper on shadow banking. In July 2012, the European Commission issued a consultation paper on UCITS that included approximately 4 pages dedicated to MMFs. [\[2\]](#) The European Systemic Risk Board (“ESRB”) made public its recommendations on MMFs in January; however these

recommendations were not subject to any public discussion or comment. [\[3\]](#)

While the EU proposal has many well recognized and industry supported provisions, including many that are already followed by MMFs or that are in the MMF guidelines issued by the Committee of European Securities Regulators (CESR/ESMA 2010 guidelines"), [\[4\]](#) such as average weighted maximum maturity ("WAM") and weighted average life ("WAL") limits, minimum liquidity holdings, limits related to diversification and concentration as well as stress testing and "know your investor" policies, a number of the provisions in the EU proposal are new and, in some cases, may have no corollary to the recommendations of other policymakers.

The EU proposal is just under 50 pages and contains provisions that will result in dramatic changes for both constant net asset value ("CNAV") and variable NAV ("VNAV") MMFs. While many anticipated that any reforms would impact CNAV MMFs, the proposal includes significant provisions that will materially impact the management of VNAV MMFs. The EU proposal also maintains the two types of funds permitted under the CESR/ESMA 2010 guidelines but with different labels: (1) "short-term money market funds" which may be CNAV or VNAV and (2) "standard money market funds" which, along with some other differences, hold longer maturity instruments and must be VNAV. [\[5\]](#)

For CNAV funds, the EU proposal sets forth a requirement for a 3 percent capital buffer that is in operation at all times and designed to absorb any fluctuations between a mark-to-market NAV and a CNAV. The buffer must be held in cash in a protected reserve account with a bank, in the name, and on behalf of, the MMF. Whenever the amount of the buffer falls below 3 percent it must be replenished. If the buffer is not replenished within one month and is below 3 percent by 10 basis points, the MMF must cease being a CNAV MMF. Existing MMFs have a 3 year phase-in for establishing the buffer. Only CNAV funds may use amortized cost valuation and all other MMFs must use mark-to-market valuation as defined in the EU proposal.

The EU proposal includes requirements on diversification, concentration, liquidity (the same for both types of MMFs), eligibility of assets including limitations on collateral for reverse repurchase agreements and limitations on the eligibility of securitizations. The proposal only permits investment in a narrowly defined type of securitization related to high-quality, short-term corporate debt. With respect to reverse repurchase agreement collateral, the proposal permits the receipt of certain high quality government issued or guaranteed debt. There also are detailed provisions on portfolio credit quality assessments with an internal rating system. The EC has been given the authority to adopt delegated acts further specifying the definitions and details of the rating grades. Money market funds and their managers are prohibited from obtaining a rating for the MMF itself. Stress testing, "know your customer" provisions and requirements for reporting portfolio and other information to authorities are included. While there are provisions related to improving transparency to investors, such as clearer disclosure in fund documents, details on MMF portfolios are required only to be reported to competent authorities (at least quarterly), not the public. Sponsor support is prohibited except competent authorities, for VNAV MMFs, may permit support in exceptional circumstances justified by systemic implications or adverse market conditions.

Within 6 months following enactment, existing MMFs must submit an application to their competent authority to demonstrate compliance with the regulation. Competent authorities have no more than two months to assess a MMF's application and issue their decision.

Some of the most notable provisions of the EU proposal that were not included in the SEC's June proposal include:

- a 3 percent NAV buffer in effect at all times to operate a CNAV MMF;
- no distinction between government and prime MMFs (although the buffer for Member State government CNAV MMFs will be reviewed in 3 years by the EC) or between retail and institutional funds;
- a prohibition on obtaining a rating for the MMF;
- an internal assessment and rating system proposal for the MMF portfolio assets;
- a prohibition on investing in securitizations other than the corporate debt type specified by the EC;
- a complete ban on the use of amortized cost except for CNAV MMFs that maintain a 3 percent NAV buffer;
- a ban on sponsor support (except as noted above for VNAV MMFs)
- valuation provisions for mark-to-market that appear to require bid pricing or swing pricing unless the fund "can close out at mid-market" and other mark-to-market valuation provisions do not conform to IFRS or GAAP;
- narrow definitions of daily and weekly liquid assets;
- no portfolio reporting to the public; and
- a compliance period of only 6 months. [\[6\]](#)

More Details of the EU Proposal

Chapter I, General Provisions: Articles 1-6 (Scope, Definitions and Authorization)

The EU proposal is intended to apply to all MMFs established, managed, or marketed in the European Union, [\[7\]](#) such as funds authorized under the UCITS Directive (funds referred to as UCITS) or those managed under the Alternative Investment Fund Managers Directive ("AIFMD") (funds referred to as "AIFs"). Member States are prohibited from adding requirements. ESMA will maintain a central public register of each MMF authorized under the regulation.

A fund may not use the designation "money market fund" unless it has been authorized under the regulation and funds cannot use a designation suggesting a MMF, such as through the use of a designation like "cash" or "liquid," unless authorized under the regulation (Article 5).

Chapter II, Obligations Concerning the Investment Policies of MMFs: Section I General Rules and Eligible Assets (Articles 7-13)

Each investment compartment is a separate MMF and MMFs authorized as UCITS would not comply with the investment policies in the UCITS Directive's Articles 49, 50, 50a, 51(2) and 52-57 unless otherwise specified in the regulation.

Eligible assets for money market funds include:

- certain money market instruments (Article 9) which, as drafted, does not appear to permit investments in other MMFs; [\[8\]](#)
- securitizations for which the underlying exposure consists exclusively of certain high-quality short-term corporate debt (Article 10);
- deposits that fulfill specified conditions (Article 11);
- derivatives dealt on a regulated market or are OTC subject to specific conditions related to types, purpose, counterparties, and valuation (Article 12); and

- reverse repurchase agreements where the collateral is eligible for investment by the MMF or, in the case of government collateral, high quality and issued or guaranteed by certain governmental entities (Article 13).

Chapter II, Obligations Concerning the Investment Policies of MMFs: Section II Provisions on Investment Policies (Articles 14 -15)

The EU proposal sets forth specific diversification and concentration limits for MMFs, which in some cases are more restrictive than current UCITS requirements. For example, under the regulation, a MMF can invest no more than 5 percent of its assets in money market instruments issued by the same body (10 percent for UCITS) and no more than 5 percent in deposits with the same credit institution (20 percent for UCITS). Money market funds also may have no more than 20 percent of its assets in reverse repurchase agreements with the same counterparty. Further, assets received as part of a reverse repurchase agreement are subject to the diversification requirements (Article 13(4) and (5)). Different diversification limits apply to government MMFs, which may present different challenges depending on the underlying currency of the MMF. For non-government MMFs, the concentration limit is no more than 10 percent of the money market instruments issued by a single body (same as UCITS).

Chapter II, Obligations Concerning the Investment Policies of MMFs: Section III Credit Quality of Money Market Instruments (Articles 16-20)

Articles 16-20 set forth detailed standards and procedures for the credit assessment of a MMF's portfolio. These are novel provisions when considered against the current CESR/ESMA 2010 guidelines, UCITS requirements, U.S. MMF requirements and the recommendations of other policymakers for MMFs. The Preamble (paragraphs 29-31) to the EU proposal explains that, to avoid any mechanistic reliance on ratings of rating agencies, MMFs should have an internal rating system and an assessment procedure. To avoid managers using different criteria and thus attributing different risk to the same instrument, the EC wishes managers to rely on the same criteria.

Under the Articles, a MMF must implement a credit analysis process that includes the use of an internal rating system that will be specified by the EC. The process must be documented and detailed in a fund's organizational documents. Senior management and other governing entities also must approve the procedures and remain responsible for oversight and reviewing reports related to the process. Part of the reporting to authorities (Article 38) includes reporting the assigned internal ratings.

Chapter III, Obligations Concerning the Risk Management of MMFs (Articles 21-25)

The regulation generally includes the following portfolio rules for short-term MMFs and standard MMFs.

Short-Term MMFs

Standard MMFs

WAM

No more than 60 days

No more than 6 months

WAL

No more than 120 days

No more than 12 months

Liquidity [\[9\]](#)

At least 10 percent in “daily maturing assets” and at least 20 percent in “weekly maturing assets.”

The manager must ensure that the value of shares held by a single investor cannot exceed the value of daily maturing assets (Article 24).

At least 10 percent in “daily maturing assets” and at least 20 percent in “weekly maturing assets.”

The manager must ensure that the value of shares held by a single investor cannot exceed the value of daily maturing assets (Article 24).

Diversification (Articles 14 and 22)

No more than 5 percent of its assets in (1) money market instruments issued by the same body or (2) deposits with the same credit institution. The aggregate risk exposure to the same counterparty of the MMF from OTC derivatives cannot exceed 5 percent of its assets.

Up to 10 percent in money market instruments issued by a single body; however, standard MMFs may combine, where this would lead to an investment of up to 15 percent of its assets in a single issuer, any of the following: (1) investments in money market instruments issued by that body, (2) deposits made with that body and (3) OTC derivatives giving counterparty exposure to that body.

Use of Amortized Cost (or CNAV structure)

Prohibited from using a CNAV structure.

No MMF or a manager may solicit or finance a credit rating for the MMF and if one is awarded to a MMF, the manager must refrain from relying on any criteria attached to the external rating. [\[10\]](#)

Managers to MMFs must establish “know your customer” policies that incorporate the following factors: (1) identifiable investor patterns in cash needs; (2) sophistication of investors; (3) risk aversion of investors; and (4) degree of correlation or links among investors. The manager must ensure that any investor redemption does not materially impact the liquidity profile of the fund.

Stress testing also is required (at least yearly) and must take into account certain scenarios and parameters, including if applicable scenarios for CNAV MMFs. Managers also must

develop action plans for different scenarios. Reports to the board are required and the results of stress testing also must be submitted to competent authorities. The board must amend any proposed action plans as needed and approve the final action plan. ESMA will issue guidelines to establish common reference parameters for the stress tests that will be annually updated.

Chapter IV, Valuation Rules (Articles 26-28)

Assets must be valued at least on a daily basis. The assets of a CNAV MMF may be valued by amortized cost. For mark-to-market, assets must be valued at the prudent side of bid and offer unless the fund can close out at mid-market. Market data shall be assessed on all of the following factors: (1) number and quality of counterparties; (2) volume and turnover in market; (3) issue size and portion that MMF intends to buy or sell. When market data is not sufficient or mark-to-market is not possible, a model may be used but it cannot be based on amortized cost.

The NAV per share must be rounded to the nearest basis point when published in a currency (e.g., 1.0000). [\[11\]](#) The NAV for a CNAV MMF must be rounded to the nearest percentage point when it is published in a currency unit (e.g., 1.00). MMF shares must be issued or redeemed at a price equal to the MMF's NAV per share, except CNAV MMF shares must be issued or redeemed at the CNAV MMF's constant NAV.

Chapter V, Specific Requirements for CNAV MMFs (Articles 29-34)

A MMF may only use amortized cost valuation if it is specifically authorized as a CNAV MMF. Among the requirements to operate as a CNAV MMF are the establishment of a constant NAV buffer of 3 percent of the total value of the MMF's assets. The buffer must be exclusively used to cover differences between the CNAV and the mark-to-market NAV per share. In some cases there may be an amount that will be credited to the reserve account and in other circumstances an amount may be debited from the account. The buffer must be composed of cash, held in a protected or reserve account with a credit institution in the name of the fund. The depositary must verify that transfers from the reserve account to the MMF are in compliance with the regulation. The buffer must be replenished when it falls below 3 percent and, if not replenished in a timely manner, the MMF must cease operating as a CNAV MMF.

Article 43 provides a three year phase-in for establishment of the buffer for existing MMFs. Article 45 also provides that in three years the EC will review the buffer and the applicability of NAV buffers to Member State government CNAV MMFs. Article 45 is silent on CNAV MMFs that concentrate their portfolios on debt issued or guaranteed by third-country governments.

Chapter VI, External Support (Articles 35-36)

A CNAV MMF may only use the NAV buffer as "support" in compliance with the regulation. In exceptional circumstances justified by systemic implications or adverse market conditions, a VNAV MMF's competent authority may permit it to receive external support with certain conditions (e.g., the support is justified, limited in amount and time, the provider is financially sound). External support is broadly defined to include activities such as cash injections from third parties, purchases by third parties to provide liquidity, guarantees or letters of support or any action by a third party the direct or indirect objective of which is to maintain the liquidity and NAV of the MMF.

Chapter VII, Transparency (Articles 37-38)

Money market fund documents must clearly indicate the type of MMF and the methods used to value assets and calculate the NAV. Any documents used for marketing must include statements indicating that a MMF is not a guaranteed investment, that it does not rely on external support for guaranteeing the liquidity of the fund or the stability of the NAV, and the risk of principal loss is borne by the investor. CNAV MMFs also must provide specific disclosure about the buffer.

The regulation also includes quarterly reporting of portfolio and other information to competent authorities. Information to be reported includes, type and characteristics of the MMF, total value of assets, NAV, WAM, WAL, maturity breakdown, liquidity, stress test results, asset information (e.g., name, county, issuer category, internal ratings assigned), and information on “liabilities” of the MMF such as country of investor, category of investor and subscription and redemption activity. ESMA will develop technical standards for reporting. Competent authorities also must transmit the information to ESMA and ESMA will create a central database of all MMFs established, managed, or marketed in the EU.

Chapter VIII, Supervision (Articles 39-42)

Competent authorities must supervise the fund and the manager. Competent authorities also must monitor the marketing of MMFs established or marketed in their territories.

Chapter IX, Final Provisions (Articles 43-46)

The regulation will “enter into force” twenty days after publication in the Official Journal of the European Union. Within six months of “entry into force,” existing MMFs must submit applications to their competent authorities demonstrating compliance with the regulation. No later than two months after receiving the application, the competent authority must assess compliance and issue a decision.

The NAV buffer can be established over a three year period: 1 percent within one year, 2 percent within two years, and 3 percent at the end of 3 years. Three years after entry into force, the EC will review the adequacy of the regulation from a prudential and economic point of view. In addition, the review must consider the operation of the CNAV buffer and the operation of the buffer to CNAV MMFs concentrating their portfolios in debt issued or guaranteed by Member States.

Susan Olson
Senior Counsel - International Affairs

Jane G. Heinrichs
Senior Associate Counsel

endnotes

[1] The EU proposal and other associated documents are available at http://ec.europa.eu/internal_market/investment/money-market-funds/index_en.htm.

[2] European Commission, Consultation Document, UCITS, Product Rules, Liquidity Management, Depositary, MMFs, Long-Term Investments (July 26, 2102) available at

http://ec.europa.eu/internal_market/consultations/docs/2012/ucits/ucits_consultation_en.pdf

[3] The ESRB MMF recommendations and an accompanying annex with additional detail are available at

http://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_1.en.pdf?5871e2e02e683aa3508027f7e095670a

[4] See CESR, Guidelines on a Common Definition of European Money Market Funds, CESR/10-049, May 19, 2010, available at

http://www.esma.europa.eu/system/files/10_049.pdf.

[5] The leaked April version of the EU proposal had referred to the second type as “extended maturity money market funds” but that term has been replaced in the September EU proposal.

[6] On the temporary suspension of redemptions, paragraph 38 of the Preamble to the EU proposal notes that UCITS have this ability under the UCITS Directive and managers of AIFs also have the ability to use special arrangements to handle “supervening illiquidity” of a fund’s assets.

[7] Explanatory Memorandum to the EU Proposal, paragraph 3.4.1.

[8] Article 9 requires that in order for a money market instrument to be eligible for investment it must, among other conditions, fall within Article 50(1)(a), (b) or (h) of the UCITS Directive (but this list omits Article 50 (1)(e) which specifies units of UCITS or other collective investment undertakings).

[9] The definition of “legal maturity” is the date when the principal is to be repaid in full and is not subject to any optionality. See Article 2 of the EU proposal. There is no unique or different status afforded government securities for purposes of the liquidity requirements in the EU proposal.

[10] See Preamble, paragraph 39.

[11] The Preamble (paragraph 44) states that in the case of a NAV at €100, the incremental value should be done at every €0.01.