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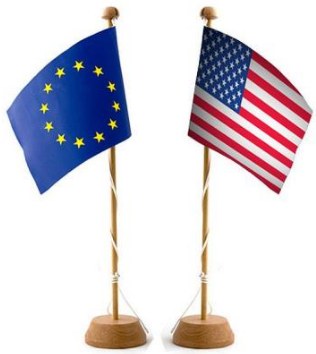
Money Market Funds

European regulation – compromise on the horizon?



After two years of negotiations, the European Parliament is due to meet in March to discuss the regulation on Money Market funds (the Regulation). Originally proposed as part of a set of reforms to the UCITS regime, the Regulation will affect all European domiciled money market funds (MMFs), including UCITS and AIFs. It has changed significantly since its original draft: some recent compromises espouse the approach adopted by the Securities and Exchange Commission (SEC) in 2014, particularly the replacement of the European '3% buffer' for MMFs with a constant net asset value, with a system of redemption gates and liquidity fees.

In this article, we consider the current status of the Regulation and how it compares to some of the key rules adopted by the SEC last year: particularly the calculation of the NAV; the introduction of liquidity fees and redemption gates; increased disclosure; diversification; and stress testing. We also explore some of the proposals for compromise suggested during negotiations which may be discussed at the upcoming Parliament debates.

European Regulation timeline

Feb '12	Jul '12	Sep '13	Feb '15	Mar '15
ESMA updates its Q&A on common definition of EU MMF	European Commission consults on potential UCITS measures as part of 'UCITS VI'	European Commission proposes Regulation on MMF	ECON to consider proposed MMF Regulation in a Committee meeting	European Parliament to consider proposed MMF Regulation in plenary session

Background

Following the financial crisis, Regulators were concerned about the systemic risks of 'shadow-banking', including MMFs. When the European Commission issued the Regulation on 4 September 2013, its stated aim was to ensure "that MMFs can better withstand redemption pressure in stressed market conditions by enhancing their liquidity profile and stability." Internal Market and Services Commissioner Michel Barnier commented:

> We have regulated banks and markets comprehensively. We now need to address the risks posed by the shadow banking system. It plays an important role in financing the real economy and we need to ensure that it is transparent and that the benefits achieved by strengthening certain financial entities and markets are not diminished by the risks moving to less highly regulated sectors.

MMF were one of the topics originally included in the European Commission's proposed improvements to the UCITS regime in July 2012, dubbed 'UCITS VI'. However, rather than just regulating UCITS MMFs, the Regulation instead applies to all European domiciled MMFs (including AIFs) by imposing an extra layer of regulation over and above UCITS and AIFMD.

In the US, the Securities and Exchange Commission (SEC) on 23 July 2014 published their revised rules on MMFs. They stated that the "amendments are designed to address MMF' 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."

MMFs provide short-term finance to financial institutions, corporates or governments, and thereby contribute to the financing of the real economy in Europe. MMFs provide short-term cash management solutions that provide a high degree of liquidity, diversification, and certainty, combined with a market-based yield. As MMFs are mainly used by corporations seeking to invest their excess cash for a short time frame, they represent a crucial link bringing together demand and supply of short-term money.

However, large redemption requests could prompt MMFs to realise investments assets in a declining market, potentially jeopardising the viability of the constant NAV which is fundamental to many MMFs. Any contagion to the short term funding market could then potentially create difficulties for the financing of the financial institutions, corporations and governments, thus the economy.

Because of this systemic interconnectedness with the banking sector and with corporate and government finance, MMFs have been central to the US and EU revisions to shadow banking regulation.

The Commission described shadow banking as:

> "the system of credit intermediation that involves entities and activities that are outside the regular banking system. Shadow banks are not regulated like banks yet engage in bank-like activities. The Financial Stability Board (FSB) has roughly estimated the size of the global shadow banking system at around €51 trillion in 2011. This represents 25-30% of the total financial system and half the size of bank assets. Shadow banking is therefore of systemic importance for Europe's financial system."

Key Facts

MMFs can be ‘short-term’ or ‘standard’. The former have a residual maturity of less than 397 days while standard MMFs have a residual maturity of up to two years. They can be denominated in any particular currency - MMFs mostly invest in debt denominated in euro, pound sterling or US dollar.

Some MMFs seek to maintain a stable price per share when investors redeem or purchase shares, known as ‘constant net asset value’ or CNAV MMFs. The value of the underlying assets held by an MMF can, however, fluctuate. To avoid these fluctuations, a CNAV MMF uses amortised costs to calculate the NAV per share. MMFs which do not stabilise their share value (like most other mutual funds) are known as variable net asset value MMFs and are said to have ‘floating NAVs’ (VNAV).

Some sponsors to MMF’s provide additional capital to the MMF when its asset values are declining to maintain its NAV to prevent a potential investor run which could spread into the sponsor's other businesses or affect its reputation. The support that the sponsor provides to the MMF could reduce its own liquidity, putting the sponsor itself at risk.

Key Comparison between the US and proposed EU money market fund reforms

The key revisions to the MMF rules on both continents affect the calculation of the NAV; the introduction of liquidity fees and redemption gates; increased disclosure; diversification; and stress testing.

a) NAV calculation - floating or constant?

In the US, the SEC’s revised rules restrict the use of amortised cost or ‘penny rounding’ to government and retail funds, and to funds holding debt securities with 60 days or less to maturity. They may also continue to use a constant NAV (usually $1). Retail MMFs are in turn restricted to subscription by natural persons only.

Institutional MMFs will be required to use market based values to price their shares and to have a floating NAV (or current net asset value) like those of other mutual funds. They may however ‘continue to use amortized cost to value debt securities with remaining maturities of 60 days or less if the fund directors, in good faith, determine that the fair value of the debt securities is their amortized cost value, unless the particular circumstances warrant otherwise’.

The SEC’s rationale for introducing the floating NAV was twofold – they wanted to mitigate the ‘first mover advantage’ and to reduce unfair dilution which could occur during periods of market stress when ‘first mover’ investors redeem shares at a constant NAV and remaining shareholders receive less.

Similarly, in the EU, the current draft of the Regulation proposes a new definition with a narrower scope for ‘CNAV’ funds. It permits only ‘small professional’ investors with a proven track record of not reacting to a decline in the fund’s NAV to invest in CNAV funds. In addition, only CNAV funds will be permitted to use the amortised cost method to value their NAV; other MMFs must use the mark to market or mark to model methods.

As with the new rules in the US, European domiciled CNAV funds will be heavily restricted as to who they can accept as an investor. Although this is a sea-change, and may not survive to the final draft of the Regulation, it is a compromise position between allowing all MMFs to be CNAV funds and abolishing CNAV funds altogether.

The future of CMAV funds has featured in all debates so far and several different solutions have been proposed. Some of these include (either alone or as part of a package of reforms): allowing MMFs to maintain a stable NAV but reducing the number of shares per investor; allowing MMFs to use amortised cost to value securities with up to either 60 or 90 days to maturity; and replacing CNAVs with low volatility NAV funds (LVNAV).

b) Redemption gates and liquidity fees

The SEC's revised rules introduce a system of liquidity gates and redemption fees for MMFs when certain liquidity thresholds are breached, as set out in the chart below. Government MMFs are excluded from this rule, although they may voluntarily chose to comply with it.

In a welcome change from the initial proposal of a capital buffer of 3% of assets for CNAV funds, the Regulation proposes a similar system of fees and gates for CNAV funds. Although all European MMFs will be required to maintain a portfolio of weekly and daily maturing assets of 20% and 10% respectively, a CNAV's weekly maturing assets must constitute at least 30% of its assets. As with the US funds, when these thresholds are breached, a system of gates and fees is triggered, as summarised in the chart below.

Triggering event	Board action – US	Board action - EU
Weekly liquid assets* fall below 30% of total assets	**Allowed** to establish a liquidity fee of up to 2% and/or **Allowed** to suspend redemptions (i.e., establish a "gate") for up to 10 business days within a 90 day period	**Allowed** to establish a liquidity fees of up to 2% ; and/or **Allowed** to establish a redemption gate where up to 10% of units in the CNAV can be redeemed on any one dealing day for up to 15 dealing days; or **Allowed** to suspend redemptions for up to 15 days; or **Allowed** to take appropriate action to protect shareholders.
Weekly liquid assets* fall below 10% of total assets	**Required** to establish a liquidity fee of 1%, unless the board determines it is not in the best interest of the Fund to do so	**Required** to impose liquidity fees of between 1% and 2%, or suspend redemptions for up to 15 days.
Weekly liquid assets* rise to 30% or greater	**Required** to lift fees and gates of total assets	n/a
When aggregated suspensions exceed 15 days within a 90 day period	n/a	The CNAV automatically ceases to be a CNAV MMF and is prohibited from using the amortized cost or rounding method.

*"Weekly liquid assets" in the US generally include cash, direct obligations of the U.S. government, securities that will mature or are subject to a demand feature that is exercisable and payable within five business days. In the EU, these include cash and securities with maturities of a day or a week.

The system of fees and gates allows fund directors increased flexibility to protect the fund and its investors. In the US in particular, the directors can impose the fees and gates on the same day that the redemptions occur, allowing them to react promptly to prevent or slow redemptions. However, this increased flexibility also imposes increased responsibility and accountability for directors. It also exposes the board to what Americans call 'Monday morning quarterbacking' and criticism from those with the benefit of hindsight.

Consequently, boards would be well advised to establish clear policies on how they will design and implement controls to discharge their duties in such a crisis – should fees and gates be imposed automatically once the thresholds are reached, or instead should a breach of the thresholds trigger a special meeting of the directors?

c) Disclosure

The SEC's new rules require the insertion of mandatory wording into the fund's marketing material to increase transparency regarding fund holdings, operations and risks. The SEC's particular concern was to change the expectations of MMF investors and to correct the common misconception that MMFs are without risk. The increased disclosures must be made in the fund's prospectus and advertising materials, on its website and in the Form N-MFP (on which MMFs report portfolio holdings each month) and the Form N-CR.

The additional disclosures in the prospectus include a table outlining fees, historic information on any fees and gates used by the fund over the past ten years and whether the fund's weekly liquid assets below ten percent or thirty percent, and whether the fund received any financial support from a sponsor or fund affiliate over the previous ten years. The fund must include a prominent risk warning regarding the fund's liquidity, the wording of which varies depending on whether the MMF has a constant NAV, a floating NAV, or whether it is a government MMF which has opted out of the fees and gates rule. To discourage 'window dressing' at month end, the funds must disclose daily on their websites level of daily and weekly liquid assets, the imposition of fees and gates, sponsor support, and net shareholder inflows and outflows.

Funds must promptly use Form N-CR to disclose material events within one business day of the trigger event. These include the imposition or removal of fees or gates and for CNAV funds, a decline in the fund's NAV below $0.9975. The amended Form N-MFP will require funds to report information relevant to the assessment of risk. Funds will have to include the 'Legal Entity Identifier' related to each security and at least one other security identifier, the fund's reporting NAV and shadow price, its daily and weekly liquid assets and shareholder flows.

The EU's approach was different – they are supplementing the existing disclosure requirements in AIFMD and UCITS with the following transparency disclosures:

- Whether they are short-term or standard MMFs;
- Whether they are CNAV MMFs;
- That an MMF is not a guaranteed investment;
- That an MMF does not rely on external support for guaranteeing the liquidity of the MMF or stabilising the NAV per unit or share;
- That the risk of loss of the principal has to be borne by an investor;
- The method used by an MMF to value the assets of an MMF and calculate the NAV.

Each MMF manager must report, at least quarterly, to the MMF's competent authority on matters such as the type and characteristics of the MMF, the results of stress tests, the shadow price, information both on the assets within the MMF's portfolio and on the MMF's liabilities.

Unsurprisingly, increased transparency was not a controversial proposal and was included in most of the proposals.

d) Diversification

The SEC's revised rules require MMFs to:

- Treat certain affiliated entities as single issuers when applying Rule 2a-7's 5% issuer diversification limit;
- Exclude certain majority equity owners of asset-backed commercial paper conduits from the requirement to aggregate affiliates for purposes of the 5% issuer diversification limit;
- Treat the sponsors of asset-backed securities as guarantors subject to Rule 2a-7's 10% diversification limit applicable to guarantees and demand features, unless the MMF's board makes certain findings; and remove the basket under which as much as 25% of the value of securities held in a MMF's portfolio may be subject to guarantees or demand features from a single institution. (Tax-exempt MMFs instead have a limit of 15%).

In this instance, although the EU Regulation is also changing the permitted portfolio diversity limits, it instead proposes different limits depending on whether the MMF is a standard or short-term MMF and on the type of money market instruments it holds. Generally, MMFs must not hold combinations of investments which would result in an investment in one body of more than 15% of the MMFs assets. National regulators can authorise MMFs to invest 100% of its assets in different MFFS issued by Central, regional or local authorities or central banks, where: the fun holds money market instruments from at least 6 different issues; and a maximum of 30% of its assets are invested in any one issue.

As the introduction of stricter diversity limits was not overly controversial during debates, they may be voted into the final version of the Regulation.

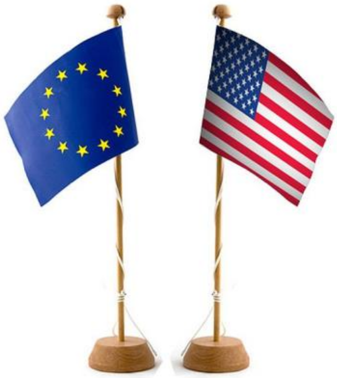
e) Stress testing and liquidity management

The SEC's revised rules require MMFs to regularly test their ability to maintain weekly liquid assets of short-term interest rates; (ii) downgrade or default of particular portfolio security positions, each representing various exposures in a fund's portfolio; and (iii) the widening of spreads in various sectors to which the fund's portfolio is exposed, each in combination with various increases in shareholder redemptions.

The MMFs' advisers must notify the results of this stress testing to the board, including such information as may be reasonably necessary for the board to evaluate the results of the stress testing.

Similarly, in the EU, MMF managers must implement certain stress testing processes, including analysing hypothetical changes in the level of liquidity, credit risk, interest rate changes, and redemptions. They must also establish and apply several internal policies, including an assessment procedure to determine the credit quality of money market instruments as well as an in-depth 'know your customer' policy to assist them in anticipating potential future investor redemptions. CNAV funds will be required to introduce additional liquidity management procedures which remain to be confirmed by later drafts of the Regulation.

As with the introduction of the systems of fees and gates, the rules on stress testing task directors (and the MMF manager) with additional responsibilities – particularly evaluating the results of the stress tests and recommending appropriate action. Some jurisdictions already require funds to appoint directors with different expertise to their boards, and other jurisdictions require funds to at least have expertise available to the board. Boards should ensure that they are appropriately skilled and expert in analysing such data.



Additional key features of the proposed EU Regulation include:

- Authorisation to operate as a MMF is mandatory. Existing funds which fit the profile of a MMF will be required to register as MMFs and to comply with the Regulation. New funds will undergo authorisation as a MMF at establishment.
- Customer profiling policies will be required to help anticipate large-scale redemptions. This is reflected in the type of permitted investor into the new CNAV fund.
- Managers will need to carry out some internal credit risk assessment to avoid an over-reliance on external credit ratings.
- Eligible assets are defined to include money market instruments, deposits with credit institutions, financial derivative instruments and reverse repurchase agreements.
- Restricted investments include short-selling money market instruments, soliciting or financing an external credit rating, taking any exposure to equity or commodities, entering into securities lending agreements or any other agreement that would encumber the assets of the MMF and borrowing or lending cash.

Commentary

MMFs are an important source of short-term financing for financial institutions, corporates and governments. They hold short-term debt securities issued by governments and the corporate sector, as well as short-term debt issued by the banking sector. Because of this systemic interconnectedness of MMFs with the banking sector and with corporate and government finance, their operation has been at the core of international work on shadow banking.

The rationale behind the regulations on both sides of the Atlantic were to stabilise the MMF industry so as to minimise any potential contagion to the 'real economy' from a significant event in the MMF industry. However, as a result of the interconnectedness between MMFs and the real economy, changes in the MMF structuring and operation will have knock-on effects in the real economy. Suspending redemptions during 'investor runs' will protect the fund and its sponsor, however, how will this affect an MMF investor which may in turn be suffering from a liquidity challenges. Since the redemption gates apply to 'small professional investors' MMFs in the EU and to retail investor MMFs in the US, it is possible that these gates and fees could have greater impact on investors less able to bear liquidity shortages.

Next steps

The European Parliament is due to discuss the Regulation in its March plenary session, following which a revised draft of the Regulation is likely to be released. It will be interesting to see which aspects of the various proposals are voted through and how the Regulation develops.

In the US, amendments to the SEC's revised rules became effective 60 days after their publication in the Federal Register on 14 October 2014. Compliance is required on a staggered basis: 14 July 2015 for the new Form N-CR, 14 April 2016 for amendments to diversification, stress testing, disclosure, Form PF and Form N-MFP, while compliance date for the floating NAV amendments and the fees and gates amendments is 14 October 2016.

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