Money Market Funds
U.S. 2014 rules vs EU draft 2015 rules

Brian Jackson
Partner
Investment Management
Deloitte

Aisling Costello
Senior Manager
Investment Management
Deloitte

After much debate, the European Institutions (the European Parliament, the Council of the EU and the European Commission) are holding discussions on the latest draft of 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 reflect the approach adopted by the Securities and Exchange Commission (SEC) in 2014, particularly the replacement of the European "3 percent 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 definition of Constant Net Asset Value (CNAV) MMFs; the introduction of liquidity fees and redemption gates; increased disclosure; diversification; and stress testing.

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) published their revised rules on MMFs on 23 July 2014. 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 realize investments in a declining market, potentially jeopardizing 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 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 percent 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 hold securities with a residual maturity of less than 397 days while standard MMFs hold securities with 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 amortized costs to calculate the NAV per share. MMFs which do not stabilize 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 MMFs 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

This level of precision is 10 times greater than that required for other mutual funds and is 100 times greater than the penny rounding method currently utilized by MMFs

Key comparison between the U.S. and proposed EU money market fund reforms

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

1. **CNAV funds and NAV calculation**
   In the United States, the SEC's revised rules restrict the use of amortized cost and/or "penny rounding" to government, retail funds and institutional prime money funds with securities with less than 60 days to maturity. These MMFs may also continue to use a constant NAV (usually US$1). All other MMFs are required to convert to using a floating or variable NAV, calculating their market-based NAV per share to the nearest basis point. This level of precision is 10 times greater than that required for other mutual funds and is 100 times greater than the penny rounding method currently utilized by MMFs.

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 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 draft Regulation provides for three types of CNAV MMFs whose scope broadly reflects the three types in the United States: retail, public debt and Low Volatility NAV (LVNAV). In addition to calculating the actual NAV per unit or share according to the mark-to-model or mark-to-market methods as is the case with variable NAV MMFs, these three may also display a constant NAV when: the amortized cost method is used to value assets with a residual maturity below 90 days and the assets are rounded to two decimal places. However, the authorization of these MMFs lapses five years after the MMF Regulation comes into force.

The chart below compares each of the three types of CNAV funds in the United States and the EU

Types of CNAV MMFs	US	EU
Retail	Restricted to subscription by natural persons only	Only available for subscription by charities, non-profit organizations, public authorities and public foundations
Government /public debt	A MMF which invests 99.5 percent of its total assets in cash, US government securities and/or repurchase agreements collateralized fully in cash or government securities	Public Debt CNAV MMF, which would be required to invest 99.5 percent of its assets in public debt instruments; and to invest 80 percent of its assets in EU public debt by 2020
Institutional OR Low volatility NAV	Institutional prime MMF holding debt securities with 60 days or less to maturity	Low Volatility Net Asset Value MMF (LVNAV MMF), holding assets with a residual maturity of less than 90 days

2. 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 percent of assets for CNAV funds, the EU Regulation proposes a similar system of fees and gates for the three types of CNAV funds. Although all European MMFs will be required to maintain a portfolio of weekly and daily maturing assets of 20 percent and 10 percent respectively, a CNAV's weekly maturing assets must constitute at least 30 percent of its assets. As with the US funds, when these thresholds are breached, a system of gates and fees is triggered, as summarized in the chart below.

The Public Debt and Retail CNAV MMFs will automatically convert to being Variable NAV (VNAV) MMFs or be liquidated where they cannot meet the minimum amount of weekly liquidity requirements within 30 days of using the liquidity fees or redemption gates.

Triggering event	Board action – US	Board action - EU
Weekly liquid assets* fall below 30 percent of total assets	**Allowed** to establish a liquidity fee of up to 2 percent 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 liquidity fees on redemptions that adequately reflect the cost to the MMF of achieving liquidity and ensure that non-redeeming investors are not unfairly disadvantaged; and/or **Allowed** to establish a redemption gate where up to 10 percent of units in the CNAV can be redeemed on any one working day up to 15 dealing days; or **Allowed** to suspend redemptions for up to 15 days; or **Allowed** to take no immediate action
Weekly liquid assets* fall below 10% of total assets	**Required** to establish a liquidity fee of 1 percent, unless the board determines it is not in the best interest of the Fund to do so	**Allowed** to establish liquidity fees on redemptions that adequately reflect the cost to the MMF of achieving liquidity and ensure that non-redeeming investors are not unfairly disadvantaged; or **Allowed** to suspend redemptions for up to 15 days
Weekly liquid assets* rise to 30 percent or greater	**Required** to lift fees and gates of total assets	n/a

* *"Weekly liquid assets" in the United States 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 United States 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?

3. **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 in 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 fall 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 their levels 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:

- The liquidity profile of the MMF including the cumulative percentage of investments maturing overnight and within one week and how that liquidity is achieved
- The credit profile and portfolio composition
- The WAM and WAL of the MMF
- The cumulative concentration of the top five investors in the MMF

CNAV funds must also disclose additional information to their investors including:

- The total value of assets
- The NAV as published on its website
- The daily indicative value at the market rate to four decimal places

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.

4. **Diversification**

The SEC's revised rules require MMFs to:

- Treat certain affiliated entities as single issuers when applying Rule 2a-7's 5 percent 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 percent issuer diversification limit
- Treat the sponsors of asset-backed securities as guarantors subject to Rule 2a-7's 10 percent 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 percent 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 percent)

The EU Regulation is also changing the permitted portfolio diversity limits. The current version proposes that MMFs must not hold over 5 percent of its assets in money market instruments issued by the same body or deposits made with the same institutions. Both the aggregate of all exposures to securities and the aggregate amount of cash provided to the same counterparty of a MMF reverse repurchase agreements must each be capped at 10 percent of the MMFs assets. National regulators can authorize MMFs to invest 100 percent of its assets in different MFFS issued by Central, regional or local authorities or central banks, where: the fund holds money market instruments from at least 6 different issues; and a maximum of 30 percent of its assets are invested in any one issue.

5. **Stress testing and liquidity management**

The SEC's revised rules require MMFs to regularly test their ability to (i) 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 analyzing hypothetical changes in the level of liquidity, credit risk, interest rate changes, and redemptions. They must also establish and apply several internal policies, as well as an in-depth "know your customer' policy to assist them in anticipating potential future investor redemptions. CNAV funds must introduce additional stress testing to assess the difference between the constant and actual NAVs for different scenarios.

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. The requirements for boards are constantly changing: some jurisdictions require boards to appoint directors with different expertise, while others simply require boards to have expertise available to the board. Boards should ensure that they are appropriately skilled and expert in analyzing such data.

The European Institutions are currently holding discussions on the current text of the Regulation

Additional key features of the proposed EU Regulation include:

- Authorization 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 authorization as a MMF at establishment
- 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, investing in other MMFs, taking direct or indirect exposure to ETFs, equities or commodities; 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 stabilize the MMF industry so as to minimize 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 retail investor MMFs in the United States, it is possible that these gates and fees could have greater impact on investors less able to bear liquidity shortages.

Next steps

The European Institutions are currently holding discussions on the current text of the Regulation.
In the United States, 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 the compliance date for the floating NAV amendments and the fees and gates amendments is 14 October 2016.