



Overview of New European Money Market Fund Regulations

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Background

As a result of the 2008 financial crisis, and to help make money market funds (“**MMFs**”) more resilient to the potential for heavy redemptions in times of stress, the European Commission issued a proposal for a regulation on MMFs, which has been in the pipeline since 2013.

Further compounding the need for reform was the fact that the guidelines on a common definition of European MMFs, adopted by the Committee of European Securities Regulators (now the European Securities and Markets Authority (“**ESMA**”) on 19 May 2010 (“**Guidelines**”) to create a minimum level playing field for MMFs in the EU, were not applied across all EU Member States.

After much debate, final agreement on MMF reform was eventually reached by the various European regulatory bodies, the final result being [Regulation \(EU\) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on MMF \(“**Regulations**”\)](#).

The Regulations are seen by the European regulatory authorities as an essential step in adopting a uniform set of rules that are designed to ensure that MMFs are, as far as possible, in a position to honour redemption requests from investors, especially during stressed market conditions, and therefore remain a reliable tool for investors' cash management needs.

The Regulations follow on from developments across the Atlantic where the U.S. Securities and Exchange Commission (“**SEC**”) had adopted two separate sets of reforms to address these concerns, including amendments to Rule 2a-7 and other rules under the Investment Company Act of 1940 in 2010 and 2014. The compliance date for the most recent U.S. MMF reforms took effect in October 2016.

The Regulations therefore represent a trend for global reform in the MMF space with the two most important global regulators introducing wholesale reforms, which although closely aligned (on a superficial basis at least) may lead to very different MMF markets in Europe and the United States. The Appendix at the end of this Dechert OnPoint provides a snapshot comparison of the European and U.S. MMF regulatory regimes.

Application Date

The Regulations are directly effective and will apply as of 21 July 2018. Any new MMFs created after that date will therefore have to comply with the Regulations from inception.

Existing MMFs benefit from an 18 month transitional period and are required, by 21 January 2019, to submit an application to their competent authority, together with all documents and evidence necessary to demonstrate compliance with the Regulations. The relevant competent authority must assess the application within two months of receiving the complete application. The key matter for existing MMFs will be the choice of which type of MMF to convert into, as further explained below.

New funds seeking to be established as MMFs will have to apply for authorisation under the existing UCITS and AIF regimes and demonstrate compliance with the requirements of the Regulations as part of the authorisation process.

Current Irish Regulatory Regime

MMFs can be established in Ireland as UCITS or AIFs, although, in practice, the vast majority of MMFs are established as UCITS funds. A MMF is currently required to be categorised as either a 'Short-Term Money Market Fund' or a 'Money Market Fund' based on the residual maturity of investments, the weighted average maturity ("**WAM**") and the weighted average life of the portfolio ("**WAL**") as outlined in the Appendix.

A MMF must pursue the investment objective of maintaining the fund's principal and provide a return in line with interest rates of money market instruments. MMFs must limit their investments to 'high quality' money-market instruments and deposits with credit institutions. Furthermore, MMFs must comply with certain European Central Bank reporting requirements, including the obligation to file additional periodic returns.

Only Short-Term Money Market Funds are permitted to be established as constant net asset value ("**CNAV**") MMFs and to utilise amortised cost accounting methodology to calculate NAV per share.

An Additional Layer of Regulation

The Regulations build on the existing legal framework established by the UCITS and AIFMD regimes as implemented into national law. While the Regulations are more prescriptive and, in some cases (e.g. liquidity requirements), restrictive than the existing regime in Ireland, they are generally complementary. Going forward, MMFs will be obliged to comply with all applicable provisions of both the UCITS/AIF regimes and the Regulations when they become effective.

The Regulations set down rules covering authorisation, portfolio composition, diversification, credit quality assessment, risk management, portfolio composition, know your customer, stress testing and valuation.

The main provisions of the Regulations are summarised as follows:

Types of MMFs – Introducing the LVNAV MMF

Under the existing regime, a MMF can either be classified as a Money Market Fund or a Short-Term Money Market Fund with most MMFs being structured as Short-Term Money Market Funds with the resultant ability to have a constant NAV and utilise amortised cost.

The Regulations provide that MMFs must be set up as one of the following:

1. VNAV MMF

The variable net asset value ("**VNAV**") MMF will comply with the Regulations, but will be permitted to invest in assets with longer permitted maturities at the expense of the ability to apply a constant NAV with short-term or standard variants.

2. Public Debt CNAV MMF

A Public Debt CNAV MMF is required to invest at least 99.5% of its assets in government debt (and may, in the future, be required to invest 80% of its assets in EU public debt) and is permitted to use the amortised cost method of valuation.

3. LVNAV MMF

The Regulations introduce a new permanent category of MMF – the low volatility net asset value MMF (“**LVNAV MMF**”). LVNAV MMFs may also use the amortised cost method where the assets have a residual maturity of up to 75 days provided that the mark to market calculation does not deviate from the amortised cost valuation by more than 10 basis points. Transactions may take place based on the constant NAV, but the mark to market NAV must be used if there is a deviation of more than 20 basis points between the constant NAV and the mark to market NAV.

In addition to the rules on WAM and WAL, the Regulations subject both Public Debt CNAV MMFs and LVNAV MMFs to the following liquidity requirements:

- 10% of NAV held in daily maturing assets; and
- 30% of NAV held in weekly maturing assets (17.5% of which can be government instruments with a residual maturity of less than 190 days).

Portfolio Composition

1. Eligible Investments

A MMF may only invest in the following ‘eligible’ financial assets:

- money market instruments;
- securitisations;
- asset-backed commercial paper (“**ABCPs**”);
- deposits with credit institutions;
- financial derivative instruments;
- repurchase agreements;
- reverse repurchase agreements; and
- units or shares of other MMFs.

The Regulations provide further eligibility criteria for each of these asset classes.

2. Ineligible Investments

A MMF is prohibited from undertaking any of the following activities:

- investment in any other assets other than those listed above;
- short sales of any of the following: money market instruments, securitisations, ABCPs and units/shares of other MMFs;

- taking direct or indirect exposure to equity or commodities, including via derivatives, certificates representing them, indices based on them, or any other means or instrument that would give an exposure to them;
- entering into securities lending agreements or securities borrowing agreements, or any other agreement that would encumber the assets of the MMF; and
- borrowing or lending cash.

3. Diversification and Concentration

MMFs will have diversification requirements separate to the UCITS regime.

Under the Regulations, a MMF may:

- not invest more than 5% of its assets in money market instruments, securitisations and ABCPs issued by the same issuer (subject to the normal UCITS derogation permitting 100% in government assets). A 10% limit applies for VNAV MMFs subject to the UCITS 5/10/40 rules);
- not invest more than 10% of its assets in deposits with the same credit institution (which may be increased to 15% under certain limited circumstances);
- hold no more than 15% exposure to securitisations and ABCPs (which may be increased to 20% once the proposed regulation on STS (simple, transparent and standardized) securitisations is implemented for STS securitisations);
- hold no more than 15% exposure to a single body, which includes investments in money market instruments, securitisations and ABCPs issued by that body, deposits made with that body and any counterparty risk exposure via OTC derivatives;
- have a maximum 5% counterparty exposure from permitted OTC derivative transactions;
- not provide cash exceeding 15% of assets to counterparties in reverse repurchase agreements;
- invest up to 10% in bonds issued by a single European credit institution (subject to the 5/10/40 rule), which may be increased to 20% for exposures to extremely high quality covered bonds; and
- not invest more than 10% in money market instruments, securitisations and ABCPs issued by a single body (subject to the normal UCITS derogation permitting 100% in government assets).

4. Investment in other MMFs

MMFs may invest in other MMFs provided that:

- no more than 10% of the assets of the target MMF can be invested in other MMFs – this is a standard UCITS requirement;
- the target MMF does not hold shares in the acquiring MMF;
- no more than 5% of the MMF's assets are invested in a single MMF and no more than 17.5% of the fund's assets are invested in other MMFs; and

- the target MMF is authorised under the Regulations.

Stress Testing

The Regulations require MMFs or MMF managers to have stress testing processes in place based on hypothetical scenarios and that such stress testing should take place at least bi-annually. Where vulnerabilities are revealed, the MMF manager shall draw up an extensive report and an action plan and take action to strengthen the MMF's robustness.

The report should be submitted to the MMF board and the competent authority who will also submit it to ESMA.

Stress events should take account of the following factors: (1) the liquidity of portfolio assets; (2) the credit risk of assets; (3) the levels of redemptions; (4) interest and exchange rates; and (5) macro systemic economic conditions. The MMF manager will be required to produce a report on any vulnerability, including an action plan that will need to be submitted to the regulatory authority.

Internal Credit Quality Assessment

MMFs are required to invest in high quality eligible assets and the Regulations require a MMF manager to put in place a prudent and well documented internal credit quality assessment procedure to determine the credit quality of the money market instruments, securitisations and ABCPs in which the MMF will invest. The credit quality assessment methodologies will be subject to annual review and validation based on back-testing. The MMF manager must comply with principles set out in the Regulations which may take into consideration ratings provided by an authorised Credit Rating Agency but may not mechanically over-rely on those ratings.

Know Your Customer Policy

The Regulations provide that knowing investors is an important tool in liquidity management, primarily in order to anticipate large redemptions especially from large shareholders.

The MMF manager (or intermediary) should have procedures in place to monitor redemption trends, particularly where the value of shares held by a single investor is greater than the daily liquidity requirements of the MMF when enhanced due diligence is required.

Liquidity

Public debt CNAV and LVNAV MMFs must have liquidity management procedures in place to ensure compliance with weekly liquidity thresholds. In order to be able to mitigate potential investor redemption in times of severe market stress, the Regulations provide that public debt CNAV and LVNAV MMFs should have in place provisions for liquidity fees and redemptions gates to ensure investor protection and prevent a 'first mover advantage'.

Where weekly maturing assets fall below 30% of total assets and redemptions exceed 10% of total assets, the MMF board may take one or more of the following measures;

- liquidity fees;
- redemption gates to a maximum of 10% of shares to be redeemed on any one dealing day for any period up to 15 days;

- suspension of redemptions for any period up to 15 days; and/or
- take no action.

When within a period of 90 days aggregated suspensions exceed 15 days, a CNAV or LVNAV MMF will automatically become a VNAV MMF and investors must be notified.

No External Support

During the financial crisis, many MMF promoters supported MMFs in order to ensure that they did not “break the buck”. This practice has now been prohibited as regulators were concerned that redemption pressure could exceed available reserves or that support could be withdrawn. External support includes cash injections from third parties, purchase of the assets at an inflated price, purchase of units to provide liquidity, the issuance of an implicit or explicit guarantee or any other action that maintains the liquidity profile.

Transparency and Reporting to Investors

MMFs will be required to make available certain other information to investors on a weekly basis, including the maturity breakdown of the portfolio, the credit profile, the WAM, the WAL and details of the 10 largest holdings in the MMF. All marketing documentation must clearly indicate the risk of loss of principal and that the MMF is:

- not guaranteed;
- is not a deposit; and
- is not relying on external support to guarantee liquidity or stabilise the NAV.

Reporting to Regulators

In addition to the reporting obligations required under UCITS and AIFMD and to ensure that competent authorities are able to detect, monitor and respond to risks in the MMF market, the Regulations provide that MMFs should report to their competent authorities, on at least a quarterly basis (annually for sub €100 million MMFs), a detailed list of information on the MMF, including the type and characteristics of the MMF, portfolio indicators, information on the assets held in the portfolio and (in the case of LVNAV MMFs) any reportable deviations with regard to amortised cost or constant NAV. This data will then be transmitted to ESMA and maintained on a central database.

Other Issues

A number of matters are required to be set out in the MMF's instrument of incorporation or constitution:

- type of MMF;
- permitted government issuers or guarantors;
- internal credit quality assessment;
- liquidity management procedures; and

- ancillary liquid assets.

These requirements should be borne in mind particularly by existing MMFs.

It is important to note the differing roles to be undertaken by the board of the MMF and the MMF manager.

ESMA Final Report

On 13 November 2017, ESMA issued its final report providing technical advice on the Regulations covering:

- quantitative and qualitative liquidity requirements and credit quality requirements for assets received as collateral as part of a reverse repurchase agreement;
- ensuring that the credit quality assessment methodology is subject to validation and is prudent, systematic and continuous;
- criteria for quantification of credit risk and risk of default;
- criteria for establishing qualitative indicators on issuers;
- establishing overrides to the methodology;
- actions on a material change of credit quality; and
- provision of a reporting template.

Comparison with U.S. Reforms

The Regulations follow similar regulatory developments in the United States where the SEC's most recent set of reforms went into compliance in October 2016. However, it has been stated that these reforms, while relatively similar, will have different effects on the MMF markets in the United States and in Europe. For example, assets in government MMFs have grown significantly in the United States, because those MMFs have been able to continue to operate with a CNAV and without the possible imposition of liquidity fees and redemptions gates. In Europe, however, most government MMFs are CNAV MMFs invested in U.S. government debt. However, the Regulations contain a review mechanism, which may, following the review, require public debt CNAV MMFs to apply an 80% EU public debt to the exclusion of U.S. public debt. This provision was not introduced immediately owing to the scarcity of EU public debt.

Overall, the Regulation will likely conclude nearly a decade of proposals for new MMF reforms in Europe and the United States. While the European and U.S. reforms may yield different results, the new rules end this period of regulatory uncertainty and will allow MMF sponsors to move forward and adapt to a post-reform market.

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Appendix

	EUROPE				U.S.		
MMF Type	Public Debt CNAV MMF	LVNAV MMF	Short-Term VNAV MMF	Standard VNAV MMF	U.S. Government MMF ¹	U.S. Retail Prime and Municipal MMF ²	U.S. Institutional Prime and Municipal MMF
Variable Constant NAV	Constant	Hybrid	Variable	Variable	Constant	Constant	Variable
Redemption fees and Gates	Yes	Yes	No	No	No, unless the MMF reserves the ability and previously discloses that ability to investors	Yes	Yes
WAM	60 days	60 days	60 days	180 days	60 days	60 days	60 days
WAL	120 Days	120 Days	120 Days	365 days	120 Days	120 days	120 days
Residual Maturity	397 days	397 days	397 days	2 years (with reset)	397 days	397 days	397 days
Liquidity Requirements	10% daily 30% weekly	15% daily 30% weekly (if amortised cost) otherwise 7.5% daily and 15% weekly	7.5% daily 15% weekly	7.5% daily 15% weekly	10% daily 30% weekly	10% daily ³ 30% weekly	10% daily ³ 30% weekly
Valuation of underlying assets	Amortised cost	Amortised cost up to 75 days otherwise mark-to-market or mark-to-model	Mark-to-market or mark-to-model	Mark-to-market or mark-to-model	Amortised cost	Amortised cost	Mark-to-market ⁴

Footnotes

- 1) A U.S. Government MMF is a MMF that invests 99.5% or more of its total assets in cash, government securities and/or repurchase agreements that are collateralized fully by cash and/or government securities.
- 2) A Retail MMF is a MMF that has policies and procedures reasonably designed to limit all beneficial owners of the MMF to natural persons.
- 3) The 10% daily liquid assets requirement does not apply to tax exempt funds.
- 4) A MMF may use amortised cost for securities that have a maturity of 60 days or less, subject to following certain SEC guidance.

Thank You

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