



Association of the Luxembourg Fund Industry

Luxembourg, 20 November 2009

ALFI Response to CESR consultation paper 09-850 "A common definition of European money market funds"

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership over 1,300 funds and asset management groups from around the world and a large range of service providers. According to the latest CSSF figures, on 31 October 2009, total net assets of undertakings for collective investment were 1,778 trillion euros.

There are 3,454 undertakings for collective investment in Luxembourg, of which 2,081 are multiple compartment structures containing 10,874 compartments. With the 1,373 single-compartment UCIs, there are a total of 12,247 active compartments or sub-funds based in Luxembourg.

According to December 2008 EFAMA figures, Luxembourg's fund industry holds a market share of 29.1% of the European Union fund industry, and according to 2008 Lipper data, 75.2% of UCITS that are engaged in cross-border business are domiciled in Luxembourg. As one of the main gateways to the European Union and global markets, Luxembourg is the largest cross-border fund centre in the European Union and, indeed, in the world.

Preliminary views

ALFI welcomes the *CESR's Consultation on the A common definition of European money market funds* issued on 20 October 2009.

The global financial crisis has highlighted the need to make the financial system more robust, stable and transparent. Exceptional and largely unforeseeable circumstances – in which previously highly liquid markets such as commercial paper became largely illiquid – lie behind the problems experienced by money market funds in recent months. A number of money market funds in the EU have faced temporary difficulties in meeting investors' redemption demands because of the unexpected contraction of liquidity in the previously highly liquid markets.

The industry has recognised the need for clarification of classification of money market funds due to the fact that European regulators and associations maintain a wide variety of definitions and classifications of money market funds with no clear and consistent restriction on what can and cannot be classified as such. As a result, many different types of funds may be labelled as “money market funds” making any distinction difficult for potential investors.

In July 2008, the Group of Thirty (G30) launched a project on financial reform under the leadership of a Steering Committee. This Committee issued in January 2009 the report “Financial Reform – A Framework for Financial Stability”. The report focuses on how the financial system might reasonably be organised once the present crisis has passed, to better assure a reasonable degree of stability. Notable amongst the committee’s proposals for money market funds was they should only offer a conservative investment option with modest upside potential at relatively low risk. In the wake of the recent market turmoil the BVI launched the discussion for a harmonised European classification and definition of Money Market Funds at EFAMA level. ALFI has strongly supported this initiative from the outset and continues to do so and thus welcomes the “report on European classification and definition of money market funds” published 9 July 2009, in particular the proposed harmonised categorisation of money market funds.

CESR has broadly taken up by its consultation the recommendations made by EFAMA and IMMFA for a European classification and definition of money market funds which aims to define clear-cut rules that investment funds would need to respect in order to obtain the label “money market” and to define rules that clearly inform investors about the risk characteristics of particular money market funds.

CESR is proposing a two-tiered approach for a definition of European money market funds, which distinguishes between short-term and longer-term money market funds. CESR notes that its proposal is broadly in line with the industry recommendation made by EFAMA and IMMFA. This is true indeed but there are nevertheless a number of criteria in CESR’s proposal that differ from those set out in the EFAMA/IMMFA definition. CESR proposes in particular tighter limits for the weighted average life for both short-term and longer-term money market funds, as well as a tighter limit for the weighted average maturity of longer-term money market funds.

General remarks

We cannot afford to ignore the specific lessons of the crisis for the fund industry. Investor protection has always been the cornerstone of the UCITS regime. But there is still room for some improvement. The recent crisis in the financial markets has highlighted the critical role that accurate, understandable and meaningful classifications

and definitions can play. CESR's consultation and the EFAMA and IMMFA for a European classification and definition of money market funds can assist regulators in developing a path towards renewed investors trust. We agree with CESR's analysis in paragraph 3 of the consultation. However, we would have welcomed a more detailed and stronger statement with regard to the investor perception of money market funds, the marketing of those and the risk associated with money market funds.

Question 1: Do you agree that such clarification is desirable?

In light of the subsequent events of the financial crisis, especially the default of Lehman, a systemically relevant bank, proved that such clarification is desirable.

Question 2: Do you agree with the proposal to have a common definition of European money market funds? If not, please explain why.

We welcome very much CESR's intention to enforce a common definition of money market funds across Europe. This step will greatly contribute to restore investor confidence and will reduce confusion about the risk characteristics of money market funds. Thus achieving a more integrated and transparent European market for money market funds.

We also fully supports CESR's proposal to move outside the perimeter of money market funds those funds which place yield ahead of capital preservation.

We do not agree with CESR's comment as noted in paragraph 15 of the consultation paper, that "only those funds which operate with the sole objective of preservation of capital" should be capable to obtain the label money market funds. We believe that it is sufficient that money market funds operate with the primary (rather than the sole) objective of preserving capital and maintaining strong liquidity. It should be clear indeed that the objectives of short-term and longer-term money market funds are not exactly the same, i.e. both types of funds share as their primary objective the preservation of capital but they differ to the extent that longer-term money market funds give a slightly lower importance to liquidity requirement than short-term money market funds in order to offer a slightly higher yield.

Question 3: Do you agree with the proposal to apply the definition to harmonised (UCITS) and non-harmonised European money market funds?

We agree with CESR's proposal to apply the harmonised definition of money market funds to both UCITS and non-UCITS money market funds. Although we agree to have a common definition of European money market funds we see a risk of diluting the taken approach by extending the definition to non-harmonised funds. This might possibly result in irreparable damage to the money market funds label and UCITS as a world wide accepted brand. Whereas it is appropriate we urge CESR to ensure an equivalent degree of regulatory requirements to avoid very lightly or unregulated vehicles from being labelled as money market funds. Therefore, non-harmonised money market funds should have the possibility under certain circumstances (i.e. compliance with the criteria for money market instruments as set out in the UCITS implementing Directive 2007/16/EC and CESR's guidelines concerning eligible assets for instruments by UCITS. These include criteria for liquidity and valuation. Non-UCITS money market funds must ensure that the liquidity and valuation on an equivalent basis) to obtain the money market funds-label.

Question 4: Do you agree with the proposed two-tier approach?

We appreciate that the two-tier approach proposed by CESR is broadly in line with the EFAMA/IMMFA recommendation, which indeed includes two types of money market funds. This approach has the advantage of distinguishing one type of money market fund from another in terms of risk/return profiles and investment strategies and provides enough flexibility.

Question 5: Do you have any alternative suggestions?

Furthermore, we believe that the distinction between the two types of money market funds facilitate investor choice. To ensure and achieve this we recommend that fund managers commit to indicate in their funds' prospectus and marketing materials to which type their money market funds belongs to and remind the investors about the objective and risk characteristics of the type of money market fund to make them comfortable about their choice

Question 6: Do you consider that the proposed transitional period for existing money market funds is sufficient to enable funds to comply with the definition?

We agree with the proposed transitional period of 1 year. This would grant money market funds sufficient time to adjust their portfolio, investment strategy and marketing documentation to the agreed definition.

Furthermore, we recommend that all existing money market funds falling outside the agreed definition after this one-year transitional period should be regrouped in a separate category in national fund classifications, under the name “other” money market funds, to give sufficient time to those money market funds that will have to change their policies in significant ways to comply with the agreed definition.

It should be clear, however, that at the latest on 30 June 2012, the funds that would continue to fall outside the agreed definition will no longer be classified as money market funds. At this time, the “other” money market funds categories would cease to exist.

Question 7: Do you agree with the proposed criteria for the definition of short-term money market funds?

Subject to the clarifications made in our answers to questions 8-12, we agree with the criteria proposed by CESR to define short-term money market funds.

Question 8: Do you have alternative suggestions?

We have reservation regarding the proposal to request that short-term money market funds provide daily liquidity *through same day or next day settlement* for the following reason. In our view, what is crucial for money market funds is to allow investors to redeem their shares daily. On the other hand, the actual payment to investors should be made according to the standard settlement cycle for securities (T+2 or T+3), which varies across Europe.

To support the importance of offering daily trading of units and shares, the EFAMA/IMMFA proposal recommends limiting the liquidity risk of short-term money market funds by setting the following requirements:

- Short-term money market funds should implement internal standard to be able to meet reasonably foreseeable liquidity demand of their clients, taking into account client concentration and client segments, industry sectors and instruments, and market liquidity conditions.
- Short-term money market funds should comply with two portfolio liquidity requirements:
 - o A minimum of 5 percent of their assets must be held in cash, Treasury securities, or other securities and repurchase agreements that would be accessible within one day.
 - o At least 20 percent of the fund's assets should be held in cash, Treasury securities, or other securities that would be accessible within seven days.

These requirements should only apply when a security is purchased. A temporary breach is acceptable if the liquidity position is used to meet a redemption that causes the fund liquid assets to fall below the 5 and/or 20% requirements. New investments should be in such liquid instruments.

Question 9: Do you think that the proposed criteria adequately capture the risk attaching to such funds, particular currency, interest rate, credit and liquidity risk?

In particular

- Do you consider that Option 3A (120 days) or Option 3B (3 months) is more appropriate for the WAL limit? Should it be lower or higher?
- Subject to your views on question 10 below, would you recommend taking structured financial instruments into account in the WAL calculation through their expected average life, or through their legal final maturity?
- Do you consider that the WAM limit of 60 days is appropriate? Should it be lower or higher?
- In relation to investments in securities, do you agree with Option 2A (allowing investments up to 10 per cent of assets in floating rate securities with a legal maturity or residual maturity of between 397 days and 2 years, provided that the time remaining until the next interest rate reset date is less than 397 days) or Option 2B (limiting investments in securities to those with a legal maturity or residual maturity of less than 397 days)?

Do you consider that Option 3A (120 days) or Option 3B (3 months) is more appropriate for the WAL limit? Should it be lower or higher?

ALFI considers short-term money market funds should be granted greater flexibility in managing credit/credit spread risk and allowed to maintain a WAL of maximum 6 months. This approach would be inline with the EFAMA/IMMFA recommendation and does not contradict with more conservative approaches e.g. money market funds represented by IMMFA, which certainly will maintain a WAL of maximum 120 days. According to Fitch's recently revised money market fund ratings, and we believe this perfectly illustrates that a WAL of 6 month does not contradict the overall objective of capital preservation, the WAL of "AAAmmf", "AAMmf" and "Ammf" rated money market funds can be as high as 120, 180 and 240 days, respectively. Fitch considers that those limits are consistent with the ability of "AAAmmf", "AAMmf" and "Ammf" rated funds to preserve an extremely strong capacity, very strong and strong to achieve the objective of preserving capital, respectively.

Subject to your views on question 10 below, would you recommend taking structured financial instruments into account in the WAL calculation through their expected average life, or through their legal final maturity?

We consider that in respect of structured finance instruments the maturity calculation may be based for the following reasons on the most likely "expected life scenario" rather than the stated "legal life" of the instrument. We believe a calculation of WAL based on the much longer legal life concept would unnecessary shorten the expected WAL of the portfolio to the detriment of the investor, especially against the background that the vast majority of ABS are paid/called within the most likely expected life scenario.

Do you consider that the WAM limit of 60 days is appropriate? Should it be lower or higher?

We fully support CESR's proposal to limit the WAM to maximum 60 days.

In relation to investments in securities, do you agree with Option 2A (allowing investment of up 10 per cent of assets in floating rate securities with a legal maturity or residual maturity of between 397 days and 2 years, provided that the time remaining until the next interest rate reset date is less than 397 days)

or Option 2B (limiting investment in securities to those with a legal maturity or residual maturity of less than 397 days)?

ALFI strongly recommends that short-term money market funds should be allowed to invest up to a maximum of 10 percent of their assets in floating rate securities with a legal or residual maturity of between 397 days and 2 years (provided that the time remaining until the next interest rate reset date is less than 397 days). We deem the 10 percent limit is sufficiently restrictive to address interest rate risk and credit risk in a very conservative manner and provide a reasonable opportunity for investment in floating rate securities. Hence we support Option 2A.

Question 10: In relation to the proposed requirements regarding structured financial instruments, do you prefer Option 4A or Option 4B above?

As already noted above, ALFI suggested that the calculation of the WAL for floating rates securities including structured financial instruments should be based on their expected life scenario. Furthermore, we are strictly opposed to restrictions that would forbid investment in structured financial instruments or asset-backed commercial papers as suggested by option 4B. There is no reason to consider a priori that high-quality structured financial instruments and ABCP would increase the overall level of risk of short-term money market funds. We strongly believe that the success of short-term money market funds depends upon thorough credit review processes to ensure that those funds invest in money market instruments and securities with the highest credit quality at the time of purchase.

To address the risk of investing in new and complex instruments, ALFI recommend that all short-term money market funds be required to establish strong risk management and valuation procedures including new products procedures to review and approve novel securities, structured financial instruments or investment techniques.

Question 11: In relation to currency exposure, do you think that short-term money market funds should limit the extent to which they invest in or are exposed to securities not denominated in their base currency?

We have strong reservation concerning generally allowing money market funds from taking any economic exposure to foreign currencies. Nevertheless, we believe that this should not preclude a fund to invest in assets denominated in foreign currency as long as

the currency risk is perfectly hedged at any time. We believe this possibility should be left to the discretion of the management company (or the investment company if self-managed) and that money market funds that have taken the decision to invest in foreign currencies or securities should have the obligation to disclose this along with the hedging techniques in the prospectus. We strongly believe, as long as the economic exposure born by foreign currencies is adequately hedged, investors could benefit from additional interest without taking additional risk.

Question 12: In relation to the proposed requirements on rating of instruments, do you prefer Option 1A or Option 1B above? In this context, do you believe that a money market instrument should be considered of high quality if the issuer of the instrument has been awarded the highest possible credit rating, even if the instrument itself has not been rated?

We have strong reservation concerning Option 1B for the following reasons. Firstly, we consider that CESR should accept a mechanism to assess the credit quality of instruments that are not rated by any recognised rating agency. Secondly, we believe there are a lot of high quality debt instruments fulfilling the credit quality criteria both for short-term and long-term money market funds, which are not rated by a credit agency. As a result the proposed requirement of a rating made by a credit rating agency would substantially impact the investment horizontal by reducing the eligible investments.

Furthermore, we believe that the credit rating system has not worked well in recent years and that credit rating agencies played an important role in the financial crisis last year. They clearly underestimated the risk that the issuers of certain more complicated financial instruments may not repay the debts. As they gave the highest possible ratings to many of those complex instruments, investors felt encouraged to purchase them, even without assessing properly the risks. As market conditions were worsening, CRAs failed to reflect this promptly in their ratings. As a result, credit was granted even if it would not be justified by economic fundamentals. As a result, we believe that credit analysis of money market instruments and securities should not necessarily be made by credit agencies. Internal (e.g. credit department) or external body (e.g. competent rating agency, broker) that is independent from the fund manager should be allowed to assess the credit quality of any portfolio investment. Hence, we propose as an alternative to Options 1A and B the following text:

Invest in high quality money market instruments, securities or deposits with credit institutions. A money market instrument or security will be considered to be of high quality if it has been awarded the highest available credit rating by a recognized rating agency which has rated that instrument, or it is of comparable credit quality, as determined by an internal or external body that is independent from the management company or self-managed investment company.

It is of the utmost importance to define the concept of “highest available credit rating”. In our view, short-term money market funds must invest exclusively in money market instruments and securities with the highest credit quality at the time of purchase (e.g. F1 or F1+ by Fitch, P1 by Moody's, A1 or A1+ by Standard & Poor's or equivalent other external or internal rating) or, in its absence, the equivalent long-term credit assessments (e.g. AAA to A by Fitch and Standard and Poor's, and Aaa to A3 by Moody's or equivalent other external or internal rating).

In the event of default or downgrading of an investment, the portfolio adjustment should be done in the best interests of investors in money market funds.

<u>Question 13: Do you agree with the proposed criteria for the definition of longer-term money market funds?</u>

We agree with the approach taken by CESR to define longer-term money market funds, but we have reservations about the limitations on some proposed risk-limiting criteria. Furthermore, we believe that the suggested name does not contribute any additional value. The proposed classification by EFAMA/IMMFA referred to “regular money market funds” which is also commonly used in the European Fund Classification and accepted by its members: fund providers and rating agencies/data vendors.

In general, ALFI recommends providing longer-term money market funds greater flexibility than foreseen by CESR in order to differentiate sufficiently between the two types (short-term and longer-term) and the average risk/return profile of these types of money market funds. This approach has the advantage of giving fund managers a wider range of possibilities to shift their position on the interest rate curve in line with their expectations about short-term interest rates, whilst avoiding concentrations on some points of the curve. Whereas CESR's approach with regards to its classifications bears the risk, due to too many similarities, of contributing to investors confusion rather than reducing them.

Question 14: Do you have alternative suggestions?

Please see below.

Question 15: Do you think that the proposed criteria adequately capture the risks attaching to such funds, in particular currency, interest rate, credit and liquidity risk?

Please see below.

Question 16: In particular

- *In relation to the WAL limit, do you consider that Option 1A (12months) or Option 1B (6 months) is appropriate? Should it be lower or higher?*
- *Would you recommend taking structured financial instruments into account in the WAL calculation through their expected average life, or through their legal final maturity?*
- *Do you consider that the WAM limit of 6 months is appropriate? Should it be lower or higher? Can this criterion be expressed in terms of interest rate sensitivity (corresponding limit set at 0.5)?*
- *In relation to investments in securities, do you believe that investment up to 10 per cent of assets in floating rate securities with a legal maturity or residual maturity of more than 2 years would be appropriate, provided that the time remaining until the next interest rate reset date is less than 397 days?*

In particular:

In relation to the WAL limit, do you consider that Option 1A (12 months) or Option 1B (6 months) is appropriate? Should it be lower or higher?

In line with our response to question 9, we consider that longer-term money market funds should be offered greater flexibility in managing their WAL. We therefore propose to set the WAL limit at 1.5 years with a view to differentiating sufficiently longer-term money market funds from short-term money market funds. Thereby, greater flexibility and the possibility to diversify “longer-term” money market funds towards floating rate securities with a residual maturity of between 2 and 5 years will be provided.

Would you recommend taking structured financial instruments into account in the WAL calculation through their expected average life, or through their legal final maturity?

ALFI recommends that the calculation of the maturity of structured financial instrument should be based on the most likely “expected life” scenario rather than the stated “legal life” of the instrument.

Do you consider that the WAM limit of 6 months is appropriate? Should it be lower or higher?

We believe that the maximum WAM of longer-term money market funds should be increased to 1 year. In our view it was the credit and liquidity risks, not interest rate risk that has caused problems for money market funds in relation to the unfolding financial crisis. To this extent we believe that a one year WAM or modified duration is a sound interest rate risk limit for “longer-term” money market funds. This proposal should also be seen in the light of the proposal to prohibit longer-term money market funds from investing in securities with a maturity or residual maturity of more than 397 days or in floating rate securities with a time remaining until the next interest rate reset of more than 397 days. We believe that this restriction ensures that the portfolio average WAM or modified duration will always be significantly lower than 1 for longer term money market funds.

Can this criterion be expressed in terms of interest rate sensitivity (corresponding limit set at 0.5)?

It has become practice to use the WAM, which is also commonly known as “modified duration”, to measure the interest rate risk of money market funds. We therefore recommend confirming the use of this criterion.

In relation to investments in securities, do you believe that investment of up to 10 per cent of assets in floating rate securities with a legal maturity or residual maturity of more than 2 years would be appropriate, provided that the time remaining until the next interest rate reset date is less than 397 days?

ALFI believes that long-term money market funds should be allowed to invest up to a maximum of 10 percent of their assets in floating rate securities with a legal or residual maturity of between 2 days and 5 years (provided that the time remaining until the next interest rate reset date is less than 397 days). The 10 percent limit is sufficiently restrictive to address credit risk in a very conservative manner and provide a reasonable opportunity for investment in floating rate securities.

Question 17: In relation to currency exposure, do you think that longer-term money market funds should limit the extent to which they invest in or are exposed to securities not denominated in their base currency?

Please see question 11.

Question 18: Do you think that longer-term money market funds should have the ability to invest in lower-rate securities?

As already noted above, the credit quality assessment of the money market fund investment is first and foremost the duty of the fund manager. Hereby the fund manager could have recourse to internal (e.g. credit department) or external body (e.g. competent rating agency, broker) that are independent. As such, the final responsibility for the assessment lies with the management company. In our view, long-term money market funds should be allowed to invest high quality investment grade money market instruments and securities at the time of purchase. High quality investment grade means investment grade short-term credit assessment (e.g. P1-P3 by Moody's or equivalent other external or internal rating) or equivalent long-term credit assessments (e.g. Aaa to Baa3 by Moody's or equivalent other external or internal rating).

Question 19: Do you consider that a longer-term money market funds should have the ability to have a constant NAV?

We believe that the flexibility given to longer-term money market funds to manage their overall portfolio is not consistent with the commitment to keep a constant NAV. Hence, we recommend reserving the possibility of maintaining a constant NAV to short-term money market funds only.