



10 June 2005

The Committee of European Securities Regulators
11-13 Avenue de Friedland
75008 Paris
France

Dear Sir

CESR advice on clarification of definitions concerning eligible assets for investments of UCITS

The Institutional Money Market Funds Association (IMMFA) is grateful for the opportunity to comment on CESR's draft advice on clarification of definitions concerning eligible assets for investments of UCITS.

IMMFA is the trade body representing providers of triple-A rated money market funds¹. IMMFA members cover nearly all of the major providers of this type of fund outside the USA. Total assets in IMMFA members' funds were in excess of one-quarter of a trillion US dollars as at 3 June 2005². You may obtain further information on triple-A rated money market funds from our website, www.immfa.org.

In view of nature of triple-A rated money market funds, we have restricted our comments to that part of the draft advice which deals with the eligibility of money market instruments, which may be found in an Appendix to this letter. However, we also endorse the recommendations made by the Investment Management Association about other aspects of CESR's draft advice, in particular emphasising:

- That CESR should reduce the level of detail and prescription in its advice, and alternatively place principals-based requirements on the manager to act in the best interest of investors in UCITS;
- That, in view of the complexity of the issues arising, CESR should request an extension of the 31 October 2005 deadline to provide its articulated text to the European Commission;
- That CESR should restrict its advice on structured financial instruments to that requested in Article 53 of its mandate from the European Commission (Box 1);
- That CESR should consider the legal and ethical implications of a UCITS, in compliance with CESR's advice, no longer being able to retain UCITS status; and
- That, in order to reduce the costs of reallocation (which will be borne by investors), CESR should provide a transitional period, at the end of which the UCITS must comply with the new requirements.

¹ References to triple-A rated money market funds in this letter means funds rated, specifically, AAAM by Standard & Poors, Aaa/MR1+ by Moody's and AAA/V-1+ by Fitch.

² Source: iMoneyNet IMMFA Money Fund Report.

We are concerned that aspects of the draft advice relating to money market instruments overly borrows from the French money market fund model. There is another model – the triple-A rated institutional money market fund – which operates to high standards established by an agreed code of conduct, and is of growing significance to the European investment management market. We would like to take the opportunity to meet with the CESR Secretariat to explain the operation of triple-A rated money market funds and the work our association, and will be in touch in due course.

If you have any questions in relation to the above, please do not hesitate to contact me.

Yours sincerely

Travis Barker

CESR advice on clarification of definitions concerning eligible assets for investments of UCITS

Detailed comments of the Institutional Money Market Fund Association (IMMFA)

IMMFA is the trade body representing providers of triple-A rated money market funds³. IMMFA members cover nearly all of the major providers of this type of fund outside the USA. Total assets in IMMFA members' funds were in excess of one-quarter of a trillion US dollars as at 3 June 2005⁴. You may obtain further information on triple-A rated money market funds from our website, www.immfa.org.

In view of nature of triple-A rated money market funds, we have restricted our comments to that part of the draft advice which deals with the eligibility of money market instruments.

Definition of money market instruments

Money market instruments (MMIs) are defined by Article 1(9) of the Directive as:

...instruments normally dealt in on the money market which are liquid, and have a value which can be accurately determined at any time.

CESR's draft advice provides guidance on this definition, specifically on the meaning of 'normally dealt in on the money market', 'liquid' and 'have a value which can be accurately determined at any time'. We deal with each of these in turn.

Normally dealt in on a money market

CESR's draft advice defines 'normally dealt in on the money market' as:

...the fact that the instrument has a low interest risk, where it has a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions at least every 12 months should have to be taken into account.

We understand from parties who were involved the original Directive negotiations that the phrase 'normally dealt in on the money market' was simply intended to distinguish money markets from regulated markets. All MMIs are dealt in on money markets, but not all money markets are regulated markets – therefore, the phrase 'money markets' is capable of encompassing both MMIs that are dealt in on regulated markets and those that are not. The phrase was not intended to define those instruments beyond the subsequent requirements of Article 1(9) that MMIs be liquid and have a value which can be accurately determined at any time. We therefore recommend that this part of CESR's draft advice is deleted – there is no need to define the term 'normally dealt in on the money market', and certainly no need to use a definition which potentially restricts the types of eligible MMIs.

However, if CESR persists with its advice, then we recommend the following amendments:

...the fact that the instrument has ~~a low interest risk, where it has~~ a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions ~~at least every 12 months~~ should have to be taken into account.

³ References to triple-A rated money market funds in this letter means funds rated, specifically, AAAm by Standard & Poors, Aaa/MR1+ by Moody's and AAA/V-1+ by Fitch.

⁴ Source: iMoneyNet IMMFA Money Fund Report.

The reason for deleting the phrase 'a low interest risk', is that it is extraneous. The phrase is copied from a Regulation of the European Central Bank concerning the consolidated balance sheet of the monetary financial institutions sector⁵, which defines MMIs with low interest risk as those which 'have a residual maturity up to one year, or regular yield adjustments in line with money market conditions at least every 12 months'. CESR's draft advice is extraneous because it repeats both the phrase 'low interest risk' and its definition (i.e. 'have a residual maturity up to one year...'). If the phrase low interest risk is not deleted, then there is a risk that it will be deemed to have some other meaning than 'have a residual maturity up to one year...'), for example, it might mean a MMI with low sensitivity to interest rates, which in turn could imply that emerging market MMIs are excluded from Article 1(9).

We also recommend that the phrase 'at least every 12 months' be deleted from CESR's draft advice. By merely requiring this part of the definition to be 'taken into account', this condition appears to be illustrative rather than obligatory, in which case it adds little value. Furthermore, different jurisdictions have different timeframes for such adjustments, so it does not help to be prescriptive about this point.

Finally, we note that CESR has rejected other aspects of the definition given by the Regulation. We strongly support that decision. In particular, CESR is right to reject those parts of the Regulation which define MMIs in terms of 'market depth' and 'low credit risk'. The definition of market depth given by the Regulation is highly qualitative and would be very hard to prove. And the definition of low credit risk copies part, but not all, of Article 19 UCITS Directive, and consequently if it were incorporated into CESR's draft advice, MMIs which were otherwise permitted by Article 19 might then become prohibited by the definition of low credit risk in Article 1(9).

Liquid

CESR's draft advice defines 'liquid' as:

...the liquidity of the MMI must be taken into account in the context of Article 37 of the UCITS Directive. The portfolio must retain sufficient liquidity so that the UCITS can repurchase or redeem its units at the request of any unit holder. At an instrument level, it must be possible to repurchase, redeem or sell the MMI in a short period (e.g. 7 business days), at limited cost, in terms of low fees, narrow bid/offer spread, and with a very short settlement delay.

Elsewhere in its advice, CESR writes that "when assessing whether a given MMI is eligible... consideration must be given to the overall coherence of the provisions set by the UCITS Directive". In the context of liquidity, that means coherence with Article 37, which requires liquidity at portfolio level in order to enable a UCITS to re-purchase or redeem its units at the request of any unit-holder.

The definition of liquidity at portfolio level not only makes regulatory sense, but mirrors market practice. In the case of IMMFA-member money market funds, they must comply with a code of practice (copy enclosed) which establishes minimum liquidity at portfolio level by restricting the weighted average maturity of the fund to 60 days. Similarly, IMMFA's Industry Guide to Understanding Institutional Money Market Funds (copy enclosed) says:

...the liquidity needs of the investors of the fund must be understood. Funds that have high concentrations of shareholders or a highly unstable shareholder base should carry more liquidity to compensate for those risks.

The definition of liquidity at instrument level is of secondary importance to the definition at portfolio level. We therefore recommend that the last sentence (commencing 'At an instrument level...') be deleted from CESR's draft advice.

However, if CESR persists in defining liquidity at instrument level as well as portfolio level, then we recommend an amendment to its draft advice. Typically, the portfolio of a money market fund comprises up to one hundred MMIs, and since they have relatively short maturity dates, the portfolio changes constantly. Evidencing that each MMI satisfies all of the liquidity conditions proposed by CESR will be costly, particularly given the subjective nature of some of those conditions (e.g. 'limited' costs, and 'low' fees). We do not believe that such exhaustive evidence will add any value over and

⁵ 2001R2423 – 01/05/2004

above ensuring liquidity at portfolio level. Also, certain of these conditions can only be realised at portfolio level – for example, only by making block sales of MMIs can costs be limited and fees lowered, in which case it makes no sense to prescribe those conditions at instrument level. In the interests of practicality, we therefore recommend that the list of conditions become optional rather than obligatory, as shown below:

*...the liquidity of the MMI must be taken into account in the context of Article 37 of the UCITS Directive. The portfolio must retain sufficient liquidity so that the UCITS can repurchase or redeem its units at the request of any unit holder. At an instrument level, it must be possible to repurchase, redeem or sell the MMI in a short period (e.g. 7 business days), **and/or** at limited cost, **and/or** in terms of low fees, **and/or** narrow bid/offer spread, **and/or** with a very short settlement delay.*

Also, if CESR persists in defining liquidity at instrument level, then we firmly believe that the fact that a MMI is dealt in on a regulated market means that it ought to be regarded as having satisfied the instrument level liquidity requirement of Article 1(9).

Having a value which can be determined at any time

CESR's draft advice defines 'having a value which can be determined at any time' as:

... UCITS should ensure that accurate and reliable valuations are available so as to meet the obligation by the UCITS Directive to calculate the NAV of the UCITS' units. The valuation of a MMI should be based on market data, when available and relevant, or on valuation models, such as models based on discounted cash flows. When using such models, any changes in the credit risk of the issuer must be taken into account. A method that would discount cash flows using the initial discount rate of the MMI without adjusting that discount rate to take into account changes in the credit spread of the issuer would not comply with these requirements.

We **strongly** recommend that the last two sentences of CESR's draft advice (commencing 'When using such models...') be deleted, since it does not reflect how significant portions of the European (and, for that matter, the global) money market fund industry prices its assets.

Triple-A rated institutional money market funds operated by IMMFA members value MMIs on an amortised cost basis. This is consistent with CESR's advice, which permits 'valuation models'. In order to ensure that valuation models do not deviate significantly from market price, CESR prescribes that '...any changes in the credit risk of the issuer must be taken into account'. IMMFA believes that there are other methods of ensuring that valuation models do not deviate significantly from market price other than that prescribed in CESR's draft advice. In particular, IMMFA's industry code of practice stipulates an alternative method, which monitors all deviations (for whatever reason) on a weekly basis, rather than deviations which are merely due to changes in credit risk on a real-time basis:

Code Part V: Valuation of funds

23. For purposes of valuing the securities in a fund, members should use the straight-line method of amortising assets held in the fund. Where the relevant authorities in the fund's domicile do not recognise this valuation methodology, then the fund must nonetheless put in place arrangements to ensure that data published by the fund reflects the amortised value of the fund's underlying assets.

24. For purposes of ensuring that the fund's stated asset value remains close to its realisable value, members should value the fund also on a mark-to-market basis at regular intervals. In this context, 'regular intervals' means not less than once a week during normal market conditions.

25. Members should ensure that they have in place and adhere to an escalation procedure for occasions when the value of the fund under the straight-line method and under the mark-to-market method differs by more than a marginal amount. The escalation procedure should ensure that any variance in valuation is considered by people competent to act for the fund (usually the Directors of the fund or its Trustees) at an appropriate time. As a guide, the

'appropriate time' could be when the variance in valuation reaches 15bp and again when it reaches 30bp. The purpose of the escalation procedure is to ensure that a fund's objective to preserve principal, and the investment strategy devised to deliver on this objective, are reviewed by individuals independent of the fund's investment management team at times when the portfolio is under stress.

26. Members should ensure that any realised capital gain or loss arising in a fund is dealt with on a consistent basis that is fair to all the investors in the fund. Net realised capital gains or losses that are material may be spread, but should not be fed into a fund for a period longer than 60 days, save where a member elects to follow the provisions of SEC Rule2a-7.

27. Members should take steps to ensure that their pricing sources properly reflect the fair disposal value of the securities in a fund.

28. Securities held in a fund should either be in the base currency of the fund or should be fully hedged back to the base currency of the fund.

US-based money market funds ('2a-7 funds', referring to section of the US Investment Companies Act 1940 which governs the regulation of money market funds in the USA) have similarly valued their assets on an amortised cost basis for many years.

IMMFA-member triple-A rated money market funds are a growing sector of the UCITS market, having doubled in value in just over two-and-a-half years from one-hundred and twenty five billion US dollars to one-quarter of a trillion US dollars as at 3 June 2005. CESR's draft advice threatens the viability of this sector. We do not believe that this is the intention of CESR's draft advice, and certainly do not believe that it is justified.

In any event, CESR's definition goes significantly beyond the equivalent definition given in the European Central Bank's Regulation which merely prescribes that '...their value can be determined at any time or at least once a month'. By deleting the last two sentences of its draft advice as we have recommended, CESR will bring its definition closer to that of the European Central Bank, and eliminate an overly prescriptive definition which fails to take account of differences in valuation models that have evolved in different countries.

MMIs not dealt in on a regulated market

The next part of CESR's draft advice deals with MMIs which are dealt in on money markets which are not 'regulated markets' in the terms of Article 19(1). In particular, CESR's draft advice deals with the definition of 'protecting investors and savings', 'prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law', and certain points relating to asset backed securities. We deal with each of these in turn.

Protecting investors and savings

Article 19(1)(h) of the Directive permits UCITS to invest in:

...money market instruments other than those dealt in on a regulated market, which fall under Article 1(9), if the issue or issuer of such instruments is itself regulated for the purpose of protecting investors and savings...

In its draft advice, CESR provides the following guidance on the term 'regulated for the purpose of protecting investors and savings':

The following key areas should be considered by the UCITS when assessing the eligibility of a MMI:

- *whether an information memorandum providing information on both the issue and the legal and financial situation of the issuer is available prior to the issue of the MMI;*
- *whether this information memorandum is regularly updated (i.e. on an annual basis or whenever a significant event occurs);*
- *whether this information memorandum is subject to control by an independent authority;*
- *whether each issuance has a minimum amount of EUR 150.000 or the equivalent in other currencies; and*
- *whether free transferability and electronic settlement in book-entry form are possible.*

We appreciate CESR's draft advice comprising criteria which 'should be considered', rather than a prescriptive list. We also appreciate the emphasis on disclosure as the relevant mechanism for protecting investors and savings, rather than anything more interventionary.

However, we recommend the following amendments to CESR's draft advice:

The following key areas should be considered by the UCITS when assessing the eligibility of a MMI:

- *whether ~~an information memorandum providing information on both the issue, the~~ **programme** ~~or and the legal and financial situation of the issuer is available prior to the issue of the MMI;~~*
- *whether this information ~~memorandum~~ is regularly updated (i.e. on an annual basis or whenever a significant event occurs);*
- *~~whether this information memorandum is subject to control by an independent authority;~~*
- *~~whether each issuance has a minimum amount of EUR 150.000 or the equivalent in other currencies; and~~*
- *~~whether free transferability and electronic settlement in book-entry form are possible.~~*

The reason for referring to 'the programme' in the first bullet point, is that individual issues are often sold off the back of an issuing programme. It would be repetitive and costly (given the number of issues that are then sold off the back of a given programme) to require an information memorandum to be published at the point of each new issue.

The reason for referring to information (rather than an information memorandum), and for requiring the information to relate to either the issue, the programme *or* the issuer (rather than the issue, the programme *and* the issuer), is that certain forms of certificates of deposit are issued by institutions which may not themselves be 'credit institutions' in the terms of Article 19(1)(f) (for example, local authorities) and so will fall under Article 19(1)(h) and therefore be effected by this draft advice. UCITS managers investing in such CDs (or any CD, for that matter) will not rely on an information memorandum on the issue, but rather financial information on the issuer. Our proposed amendment is also consistent with the wording of Article 19(1)(h) of the Directive, which refers to 'the issue *or* the issuer'.

The reason for deleting the third bullet point, is that the requirement for an information memorandum to be controlled by an independent authority does not reflect current market practice and is not a necessary regulatory requirement. While it is possible that market practice may evolve to provide the optional use of an independent authority, the case for it to be a regulatory requirement across all money market instruments has not been made. In particular, with respect to the Euro-Commercial Paper market, substantial legal due diligence on the information contained in the memorandum is already undertaken. There has never been any suggestion that the information contained in the memorandum is deficient or misleading in any way, and so there is no apparent cost-benefit case for introducing this as a regulatory requirement across all MMIs, rather than allowing market practice evolve naturally. However, if CESR persists with its advice then we recommend that the reference to an 'independent authority' be replaced with a reference to an 'independent entity'. This would allow the use of independent auditors or lawyers to fulfil this role.

The reason for deleting the last two bullet points, is that these do not have anything to do with the protection of investors and savings. Neither the minimum issuance size, nor the electronic settlement provide meaningful protection for UCITS.

Prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law

Article 19(1)(h) third indent permits UCITS to invest in MMIs not dealt in on a regulated market which are:

...issued or guaranteed by an establishment subject to prudential supervision, in accordance with criteria defined by Community law, or by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law...

In its draft advice, CESR provides the following guidance on the term 'regulated for the purpose of protecting investors and savings':

- 1. It is the responsibility of the UCITS to check that the requirement that prudential rules are at least as stringent as those laid down by Community law is met.*
- 2. There is a presumption that establishments located in the European Economic Area and G10 countries (USA, Canada, Japan and Switzerland) or having investment grade rating are subject to prudential rules at least as stringent as those laid down by Community law. Measures to guarantee compliance with the requirements by the UCITS can be tailored accordingly.*
- 3. In all other cases, these measures should be based on an in-depth analysis of issuers.*

We recommend the following amendments to CESR's draft advice:

- ~~*1. It is the responsibility of the UCITS to check that the requirement that prudential rules are at least as stringent as those laid down by Community law is met.*~~
- 2. There is a presumption that establishments located in **member states of IOSCO** ~~the European Economic Area and G10 countries (USA, Canada, Japan and Switzerland)~~ or having investment grade rating are subject to prudential rules at least as stringent as those laid down by Community law. Measures to guarantee compliance with the requirements by the UCITS can be tailored accordingly.*
- 3. In all other cases, these measures should be based on ~~an in-depth analysis~~ **risk assessment** of issuers.*

The reason for deleting the first paragraph, is that the Directive clearly places the requirement to ensure that prudential rules are at least as stringent as those laid down by Community law, with the competent authority rather than with the UCITS.

The reason for referring to members states of IOSCO (rather than the EEA and G10) is that this would otherwise contradict other parts of CESR's draft advice (i.e. box 12) which deems funds operating in member states of IOSCO as having equivalent supervision to that laid down in Community law. This change would therefore enable states such as Australia to be deemed equivalent.

The reason for referred to a risk assessment (rather than an in-depth analysis) of issuers is to remove some of the subjectivity of this requirement.

Asset backed securities

IMMFA is still trying to assess the significance of CESR's draft advice on Article 19(1)(h) 4th indent. Although the advice is only supposed to relate to a particular type of asset backed commercial paper (ABCP) issued in France, we are concerned that CESR's advice may read-across to other types of ABCP. Once we have satisfied ourselves of the scope of CESR's draft advice, we will be back in touch with our comments.

Other eligible money market instruments

We have no comments on CESR's draft advice in relation to other eligible money market instrument.