J.P. Morgan Asset Management's Response to ESMA/2013/1974
Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS issues

This submission reflects the views of J.P. Morgan Asset Management ("JPMAM"), the investment management division of JPMorgan Chase & Co. JPMAM manages nearly 170 UCITS funds with €175,000 million assets as at 31 December 2013. JPMAM is one of the largest money market fund managers in the world, with fund assets under management of approximately €281 billion globally. In Europe, JPMAM is the largest provider of stable NAV UCITS short term money market funds, with assets of €93 billion, including the largest stable NAV money market fund in Europe, the US Dollar Liquidity Fund, with assets of €51 billion. The European fund range includes nine ESMA-compliant "short-term money market funds" and one ESMA-compliant "money market fund".

We are grateful for the opportunity to contribute to the discussion of these important issues for the UCITS regime. It is of vital importance to the continued confidence of investors in UCITS that the rules regarding the use of repurchase agreements provide appropriate safeguards.

Background: the consultation addresses the cap at 20% of NAV on aggregate use of reverse repurchase agreements in Short-Term Money Market Funds and Money Market Funds offering credit exposure to a single sovereign issuer, permitting such funds to raise issuer concentrations in collateral received to 100% provided they comply with rules for a maximum 30% of NAV per issue and a minimum holding of 6 different issues.

Q1 Do you believe that ESMA should revise the rules for the diversification of collateral received by UCITS that take the form of Money Market Funds in the context of efficient portfolio management techniques and OTC transactions? If yes, do you agree with ESMA's proposal?

Yes, we believe that a revision is required for both Short-Term Money Market Funds and Money Market Funds. A reverse repurchase agreement secured on sovereign bonds combines high liquidity with high credit quality. In Short-Term Money Market Funds and Money Market Funds the need to maintain adequate liquidity can cause portfolio managers to raise overnight and short-term placings to 50 to 60% of NAV. Certain Short-Term Money Market Funds and Money Market Funds whose investment objectives restrict credit exposure to the single sovereign issuer associated with a given currency have consisted solely of reverse repurchase agreements traded with a minimum five highly rated financial institutions, all secured on bonds issued or guaranteed by the relevant sovereign with an appropriate haircut. The 20% limit on issuer exposure in collateral received introduced by paragraph 43(e) of ESMA/2012/832 capped at 20% the access of such Short-Term Money Market Funds and Money Market Funds to reverse repurchase agreements, effectively capping the liquidity bucket, and forced them into the less liquid market for government bills and bonds approaching maturity. In addition this gave investors direct exposure to interest rate risk and credit risk, whereas in reverse repurchase agreements such risks were mitigated by the counterparty credit quality, collateral haircut and short-dated investment tenor.

We do have significant comment on the details of ESMA's proposal. These are covered under question 3.

Q2 Do you think that ESMA should introduce additional safeguards for government bonds received as collateral (such as a specific issuer limit) in order to ensure a certain level of diversification? Please give reasons for your answer.

We agree with the stance of existing UCITS legislation that government bonds represent lower default and liquidity risk, as seen in the higher issuer concentrations permitted in articles 52 3. and 54 1. of the UCITS Directive. Rather than creating any additional safeguards, reliance should be placed on the variations in haircuts applied by the markets to collateral received.

Q3 Do you agree with the proposed requirement to diversify the government securities across at least six different issues?

In preparing our response to this question we considered (a) the procedures by which collateral is selected and delivered by counterparties, (b) the state of preparedness of collateral agents and of clearing houses such as CREST and Euroclear, (c) the objectives of the diversification, and (d) the most efficient control mechanisms to achieve those objectives.

The selection of issues to deliver as collateral and the quantity of each issue is made by multiple counterparties acting independently. The overall quantity is determined by reference to the value of the particular transaction to be covered, modified slightly by a schedule of haircut levels. There is no requirement for an individual counterparty to know the current net asset value of the Short –Term Money Market Fund or Money Market Fund, a figure which is subject to considerable variation, or to know which particular issues and sizes are being delivered by other counterparties. The collateral agent which receives the collateral is not aware of the particular issues and sizes held by the various counterparties, hence cannot select the collateral to ensure that specific limits are met. Many reverse repos are dealt for same day settlement, leaving little or no time for the renegotiation of the issues and sizes to be delivered.

We sent enquiries to our collateral agents about their systems functionality and investigated the functionality available at clearing houses. This was to establish whether their systems could handle trigger points by value for the application of limits, limits of individual issues by value, and diversification by the number of issues. The conclusion that we drew was that the systems used by the reverse repurchase agreement market do not have control mechanisms sufficient to ensure reliable compliance with a count of six issues and a cap 30% of NAV per issue.

The proposed diversification requirement, which is drawn from article 54 paragraph 1 of the UCITS Directive, prevents excessive exposure of the Short-Term Money Market Fund or Money Market Fund to the limited liquidity of a particular issue. The maximum exposure permitted to a single issue is set at 30% of NAV. The count of six is a less effective control in that no minimum value is set per issue, producing a worst case scenario of, say, three holdings of 30% and three of 3.33%.

We would propose that a diversification mechanism in the form of a 20% cap on the gross exposure to each counterparty should be applied to Short-Term Money Market Funds and Money Market Funds which make use of the proposed derogation. This is for the following reasons:

It is the default of a counterparty which occasions the need to liquidate collateral. In the event that a counterparty delivers only one line of collateral the maximum amount of one issue that the money market fund will have to sell in the market is 20% of the NAV of the money market fund, compared with 30% in the current proposal. It would take the combined simultaneous default of two counterparties to breach the alternative 20% limit, plus selection of identical issues by both.

Control of exposure against the diversification standard lies entirely with the portfolio manager in the form of gross exposure limits. These can be readily enforced by pre-trade and post-trade compliance tests.

There is no requirement to keep counterparties informed of current net asset values and no requirement for coordination between different counterparties.

No changes are required to the systems of Short-Term Money Market Funds and Money Market Funds, collateral agents, counterparties and clearing houses. The 7 day maximum tenor permitted for reverse repurchase agreements would permit Short-Term Money Market Funds and Money Market Funds to quickly implement a 20% cap on gross counterparty exposure by rolling maturing deals into reverse repurchase agreements capped at 20% gross exposure per counterparty.