COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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CONSULTATION PAPER

A common definition of European money market funds

Deadline for contributions: CESR invites responses to this consultation paper by **31 December 2009**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests their submission to be confidential.

Executive Summary

This paper sets out CESR's proposals for a common definition of European money market funds. The key purpose behind a harmonised definition of 'money market fund' is improved investor protection. This reflects the fact that investors in money market funds expect the capital value of their investment to be maintained while retaining the ability to withdraw their capital on a daily basis. A common definition will also help provide a more detailed understanding of the distinction between funds which operate in a very restricted fashion and those which follow a more 'enhanced' approach.

CESR proposes a two-tiered approach for a definition of European money market funds:

- Short-term money market funds
- Longer-term money market funds

This approach recognises the distinction between short-term money market funds, which operate a very short weighted average maturity and weighted average life, and longer-term money market funds, which operate with a longer duration and weighted average life.

The definitions will apply to harmonised (UCITS) European money market funds. CESR recommends that the same approach is followed at national level for non-UCITS money market funds which are authorised by the Member States.

In both cases specific disclosure should be required to draw attention to the difference between the money market fund and investment in a bank deposit. It should be clear, for example, that an objective to preserve capital is not a capital guarantee. Longer-term money market funds should be required to provide sufficient information to explain the impact of the longer duration on the risk profile.

The definition of money market funds will take the form of Level 3 CESR Guidelines. CESR Members have agreed that any fund labelling or marketing itself as a money market fund authorised after the introduction of these guidelines must comply with the agreed definition. Existing European money market funds will have a transitional period of 12 months after the introduction of the guidelines to comply with criteria set out in the agreed definition.

The proposed definitions of short-term and longer-term money market funds are set out in Appendix 1 to this paper.

A Common Definition of European Money Market Funds

Introduction

1. Money market funds invest in short-term high quality money market instruments and are used by investors as an alternative to bank deposits. However money market funds are an investment product and subject to risks not associated with bank deposits. Through their investments in time deposits, certificates of deposit, commercial paper, including asset-backed commercial paper, money market funds are important participants in the overnight and term money markets and provide short term funding to banks and other financial institutions.

2. Money market funds have been authorised within the European Union for many years under investment fund legislation and generally as UCITS. While individual Member States apply local requirements to the authorisation and supervision of these funds, there was no consideration of any regulatory issues at a European level. However, unlike other UCITS, the role played by money market funds in the money markets has led to calls for consideration of the issues which they present at a European level with appropriate regulatory action where necessary.

Recent market events

3. Some money market funds experienced difficulties in 2007 due to their holdings of certain highly rated asset-backed securities which were downgraded by the relevant rating agencies and which showed a poor level of liquidity. In September 2008, the Lehman Brothers failure, the general unease in the money markets and the cash needs of investors led to significant levels of redemption activity. The poor level of liquidity demonstrated by a significant number of money market instruments added to the problems experienced by money market funds at that time. Moreover, deposit guarantee schemes put in place by certain governments made money market funds a less attractive alternative to bank deposits and this also resulted in increased redemptions. As a result of redemption requests there was a significant shift of money market fund assets into overnight deposits and away from longer dated paper, which worsened the situation in the money markets themselves. The European industry requested assistance from national monetary authorities, the European Commission and the European Central Bank to increase liquidity in the money markets and help prevent a run on the funds.

4. The pressure on money market funds eased considerably due to lower interest rates and following actions taken by authorities. Liquidity in the funds increased due to a reduction in redemption activity and new subscriptions and short-term investments including significant holdings of overnight deposits.

5. In the light of the market events, however, the CESR Members, at the Plenary on 12 December 2008, agreed that better coordination between members on money market funds and funds in general is needed, as well as better understanding of the categorisation of money market funds as there is no harmonised definition.

6. More recently, the de Larosière report[1] of February 2009 considers that there is a '*need for a common EU definition of money market funds and a stricter codification of the assets in which they can invest in order to limit exposure to credit, market and liquidity risks*.'

Current practice

7. A review by CESR on the situation of money market funds in the EU indicates that practice varies widely – some Member States provide a definition or classification system in domestic law / domestic regulation. In other cases, local industry associations have applied a definition. In

[1] http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

the majority of cases, recognition as a money market fund requires predominant investment in money market instruments and restrictions on maturity of investments.

8. Within Europe there are two types of money market fund – those with a constant or stable net asset value and those with a fluctuating or variable net asset value. A constant NAV money market fund accounts for portfolio holdings at amortised cost. Strict requirements apply to credit quality, diversification and maturity of these holdings and the portfolio must be marked to market on a regular basis[2]. Variable net asset value money market funds account for portfolio holdings at market value, although some short-dated instruments, under three months' maturity, may be valued at amortised cost.

9. There are two existing definitions of money market fund in European regulation. The **European Central Bank** defines money market funds as follows:

'C*ollective Investment Undertakings of which the units are, in terms of liquidity, close substitutes for deposits and which primarily invest in money market instruments and/or in money market funds shares/units and/or in other transferable debt instruments with a residual maturity of up to and including one year, and/or in bank deposits, and/or which pursue a rate of return that approaches the interest rates of money market instruments*'.[3]

10. The ECB definition was devised for statistical purposes only. Money market funds which meet specific criteria are determined by the ECB as falling within the category of 'other monetary financial institutions' or 'MFIs' as their units may be regarded as close substitutes for deposits with credit institutions. The ECB requires regular data on MFIs.

11. A definition of money market fund was later provided in the MiFID Level 2 Directive in the context of acceptable investments for client money. That definition is as follows:

a 'qualifying money market fund' means a collective investment undertaking authorised under Directive 85/611/EEC, or which is subject to supervision and, if applicable, authorised by an authority under the national law of a Member State, and which satisfies the following conditions:

(a) its primary investment objective must be to maintain the net asset value of the undertaking either constant at par (net of earnings), or at the value of the investors' initial capital plus earnings;

(b) it must, with a view to achieving that primary investment objective, invest exclusively in high quality money market instruments with a maturity or residual maturity of no more than 397 days, or regular yield adjustments consistent with such a maturity, and with a weighted average maturity of 60 days. It may also achieve this objective by investing on an ancillary basis in deposits with credit institutions;

(c) it must provide liquidity through same day or next day settlement.

For the purposes of point (b), a money market instrument shall be considered to be of high quality if it has been awarded the highest available credit rating by each competent rating agency which has rated that instrument. An instrument that is not rated by any competent rating agency shall not be considered to be of high quality. For the purposes of the second subparagraph, a rating agency shall be considered to be competent if it issues credit ratings in respect of money market funds regularly and on a professional basis and is an eligible ECAI within the meaning of Article 81(1) of Directive [2006/48/EEC].

[2] UCITS money market funds are permitted to use an amortised cost method of valuation under Commission Directive 2007/16/EC and the related CESR guidelines concerning eligible assets for investment by UCITS (Ref. CESR/07-044).

[3] See Annex 1 of regulation (EC) n°2423/2001 of the European Central Bank of 22 November 2001

12. MiFID requires investment firms, when holding funds belonging to clients, to 'make adequate arrangements to safeguard the clients' rights'.[4] The Level 2 Directive provides that such funds may be placed solely with a central bank, credit institution or 'qualifying money market fund'[5].

13. CESR considered whether it would be appropriate to use the MiFID definition as the basis for the classification of all European money market funds. Members considered that the MiFID definition could be clarified in certain areas, specifically whether a qualifying money market fund could have a fluctuating NAV and/or use derivatives. CESR has therefore incorporated the MiFID criteria into its proposal with additional clarification in certain areas.

<u>Questions</u>

1. Do you agree that such clarification is desirable?

14. In July 2009 EFAMA[6] and IMMFA[7] issued an industry recommendation for a European classification and definition of money market funds. This advocates a two-tiered approach which encompasses a comprehensive regime for 'short-term' and 'regular' money market funds.

<u>Proposal</u>

15. The purpose behind a harmonised definition of 'money market fund' is two-fold:

- Investors in money market funds do not expect to lose capital value and they also expect that capital invested may be withdrawn on a daily basis. While this is particularly the case in short term money market funds, investors, including institutional investors, use all money market funds as cash management vehicles and do not expect any significant investment risk.

  Accordingly, only those funds which operate with the sole objective of preservation of capital, combined with daily liquidity, should be capable of calling themselves a money market fund. This applies to money market funds with constant or fluctuating NAVs.

  That is not to say that other money market-type funds cannot continue to be authorised as UCITS. The key difference is that the other money market funds could not use the money market fund label.

- Secondly, because of the important role played by money market funds in the money market, as significant investors in short-term paper, it is important to have a common understanding of the distinction between those funds which operate in a very restricted fashion and those which follow the more 'enhanced' approach, including those which place yield ahead of capital preservation. The issues presented in that context are of primary concern to the monetary authorities but it is important that CESR can provide information on the types of money market fund authorised by its Members to assist those authorities.

16. CESR is proposing a two-tiered approach for a definition of European money market funds, which is broadly in line with the industry recommendation made by EFAMA and IMMFA. The

[4] Article 13(8) of the Level 1 Directive

[5] Article 18(1)(d)

[6] The European Fund and Asset Management Association (EFAMA) is the representative association for the European investment management industry. EFAMA represents through its 24 member associations and 44 corporate members about EUR 11 trillion in assets under management of which EUR 6.1 trillion was managed by around 53,000 investment funds at end 2008.

[7] The Institutional Money Market Funds Association (IMMFA) represents providers of EU-based 'constant net asset value' money market funds, with assets of EUR 407 billion at end 2008.

definitions will apply to harmonised (UCITS) European money market funds. CESR recommends that the same approach is followed at national level for non-UCITS money market funds which are authorised by the Member States. This approach recognises the distinction between short-term money market funds, which operate a very short weighted average maturity and weighted average life, and longer-term money market funds, which operate with a longer duration and weighted average life.

17. In both cases, specific disclosure should be required to draw attention to the difference between the money market fund and investment in a bank deposit. It should be clear, for example, that an objective to preserve capital is not a capital guarantee. Longer-term money market funds should be required to provide sufficient information to explain the impact of the longer duration on the risk profile.

18. The definition of money market funds will take the form of Level 3 CESR Guidelines. CESR Members have agreed that any fund labelling or marketing itself as a money market fund authorised after the introduction of these guidelines must comply with the agreed definition. Existing European money market funds will have a transitional period of 12 months after the introduction of the guidelines to comply with criteria set out in the agreed definition. After this period money market funds which do not satisfy the criteria must cease to label or market themselves as money market funds and must amend their documentation and inform investors accordingly.

19. The proposed definitions of short-term and longer-term money market funds are set out in Appendix 1 to this paper. For a number of the proposed criteria, two different options are set out with a view to getting targeted feedback from stakeholders on the most appropriate approach to take.

20. **Deadline for contributions:** CESR invites responses to this consultation paper by **31 December 2009**. All contributions should be submitted online via CESR's website under the heading 'Consultations' at www.cesr.eu. All contributions received will be published following the close of the consultation, unless the respondent requests their submission to be confidential.

Questions

2. Do you agree with the proposal to have a common definition of European money market funds? If not, please explain why.
3. Do you agree with the proposal to apply the definition to harmonised (UCITS) and non-harmonised European money market funds?
4. Do you agree with the proposed two-tier approach?
5. Do you have any alternative suggestions?
6. Do you consider that the proposed transitional period for existing money market funds is sufficient to enable funds to comply with the definition?

Appendix 1

A money market fund must indicate in its prospectus and, in the case of UCITS, the KII whether it is a ***Short-Term Money Market Fund*** or a ***Longer-Term Money Market Fund***.

A Short-Term Money Market Fund may have a constant or fluctuating net asset value and must:

- Be a collective investment undertaking authorised under Directive 2009/65/EC, or which is authorised by an authority under the national law of a Member State and which is subject to supervision.

- Have the primary investment objective of maintaining the net asset value of the undertaking.

<u>Option 1A</u>

- Invest in high quality money market instruments or deposits with credit institutions. A money market instrument will be considered to be of high quality if it has been awarded the highest available credit rating by each recognised rating agency which has rated that instrument, or it is of a comparable credit quality, as determined by the management company or self-managed investment company, if not rated.

  OR

<u>Option 1B</u>

- Invest in high quality money market instruments or deposits with credit institutions. A money market instrument will be considered to be of high quality if it has, at a minimum, been awarded the highest available credit rating by each recognised rating agency which has rated that instrument. An instrument which is not rated by any recognised rating agency shall not be considered to be of a high quality.

- In assessing the quality of a money market instrument in which the money market fund invests, the management company or self-managed investment company must consider other factors in addition to the credit rating of the instrument. In particular, when investing in asset-backed securities this should include a review of the specific risks attaching to such securities including information on the underlying assets, on the entities involved in the vehicle and their respective role, and on the legal framework of the vehicle.

<u>Option 2A</u>

- Limit investment in securities to those with a legal maturity or residual maturity of less than 397 days. It may also invest up to a maximum of 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. Floating rate securities should reset to a money market rate or index.

  OR

<u>Option 2B</u>

- Limit investment in securities to those with a legal maturity or residual maturity of less than 397 days.

- Provide daily liquidity through same day or next day settlement.

- Have a weighted average maturity (WAM) of no more than 60 days.

Option 3A

- Have a weighted average life (WAL) of no more than 120 days.

OR

Option 3B

- Have a weighted average life (WAL) of no more than 3 months.

Option 4A

- When calculating the WAL for floating rate securities including structured financial instruments, the maturity calculation must be based on the stated 'legal final maturity' of the instrument, i.e. the final date for repayment of capital.

OR

Option 4B

- Not invest in structured financial instruments or asset-backed commercial papers.

- Comply 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 investment by UCITS. These include criteria for liquidity and valuation. Non-UCITS money market funds must ensure that the liquidity and valuation of the portfolio is assessed on an equivalent basis.

- Not take direct or indirect exposure to equity or commodities, including via derivatives; and only use derivatives in line with the money market investment strategy of the fund. Derivatives which give exposure to foreign exchange may only be used for hedging purposes.

- Limit investment in other investment funds to those which comply with the definition of a Short-Term Money Market Fund.

- Have an appropriate risk management function. This must include a prudent approach to the management of currency, credit, interest rate and liquidity risk which incorporates a proactive stress-testing regime. In addition, managers of money market funds must have specific expertise and experience in managing these types of fund.

Questions

7. Do you agree with the proposed criteria for the definition of short-term money market funds?
8. Do you have alternative suggestions?
9. Do you think that the proposed criteria adequately capture the risks attaching to such funds, in 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[8], 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 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)?

10. In relation to the proposed requirements regarding structured financial instruments, do you prefer Option 4A or Option 4B above?
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?
12. In relation to the proposed requirements on ratings 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?

A Longer-Term Money Market Fund must:

- Be a collective investment undertaking authorised under Directive 2009/65/EC, or which is authorised by an authority under the national law of a Member State and which is subject to supervision.

- Have the primary objective of preservation of capital.

- Have a fluctuating net asset value.

- Invest in high quality money market instruments or deposits with credit institutions. A money market instrument will be considered to be of high quality if it has been awarded the highest available credit rating by each recognised rating agency which has rated that instrument or if it is of a comparable credit quality, as determined by the management company or self-managed investment company, if not rated.

- In assessing the quality of a money market instrument in which a money market fund invests, the management company or self-managed investment company must consider other factors in addition to the credit rating of the instrument. In particular when investing in asset-backed securities this should include a review of the specific risks attaching to such securities, including information on the underlying assets, on the entities involved in the vehicle and their respective role, and on the legal framework of the vehicle.

- Limit investment in securities to those with a legal maturity or residual maturity of less than 397 days. It may also invest up to a maximum of 10 per cent of assets in floating rate

[8] excluding any option exercise or mechanism that cannot be triggered at the fund's sole discretion

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. Floating rate securities should reset to a money market rate or index.

- Provide daily liquidity through same day or next day settlement.
- Have a weighted average maturity (WAM) of no more than 6 months.

<u>Option 1A</u>

- Have a weighted average life (WAL) of no more than 12 months.

OR

<u>Option 1B</u>

- Have a weighted average life (WAL) of no more than 6 months.

- In the case of floating rate securities including structured financial instruments the maturity calculation must be based on the stated 'legal final maturity' of the instrument i.e. the final date for repayment of capital.
- Comply with the criteria for money market instruments as set out in UCITS implementing Directive 2007/16/EC and CESR guidelines concerning eligible assets for investment by UCITS. These include criteria for liquidity and valuation. Non-UCITS money market funds must ensure that the liquidity and valuation of the portfolio is assessed on an equivalent basis.
- Not take direct or indirect exposure to equity or commodities, including via derivatives; and only use derivatives in line with the money market investment strategy of the fund. Derivatives which give exposure to foreign exchange may only be used for hedging purposes.
- Limit investment in other investment funds to those which comply with the definition of a Short-Term Money Market Fund or a Longer-Term Money Market Fund.
- Have an appropriate risk management function. This must include a prudent approach to the management of currency, credit, interest rate and liquidity risk which incorporates a proactive stress-testing regime.
- Provide information to investors on the impact of the longer duration on the risk profile.

Glossary of Terms

Weighted Average Maturity: WAM is a measure of the length of time to maturity of all of the underlying securities in the fund weighted to reflect the relative holdings in each instrument, assuming that the maturity of a floating rate instrument is the time remaining until the next interest rate reset, rather than the time remaining before the principal value of the security must be repaid. In practice, WAM is used to measure the sensitivity of a money market fund to changing interest rates. The sensitivity to changes in interest rates is also commonly known as 'modified duration'.

Weighted Average Life: WAL is the weighted average of the remaining life (maturity) of each security held in a fund, meaning the average time until the principal is repaid in full (disregarding interest and not discounting). Contrary to what is done in the calculation of the WAM, the calculation of the WAL for floating rate securities and structured financial instruments does not permit the use of interest rate reset dates and instead only uses a security's stated (legal) final maturity. WAL is used to measure the credit risk, as the longer the reimbursement of principal is postponed, the higher is the credit risk. WAL limits also help to limit the effects of changes in interest rate spreads (i.e., the additional yield paid on a security above the risk-free rate of return on their funds' portfolio).

Questions

13. Do you agree with the proposed criteria for the definition of longer-term money market funds?
14. Do you have alternative suggestions?
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?
16. 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?
- Would you recommend taking structured financial instruments into account in the WAL calculation through their expected average life[9], 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 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?

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?
18. Do you think that longer-term money market funds should have the ability to invest in lower-rated securities?
19. Do you consider that a longer-term money market fund should have the ability to have a constant NAV?

[9] excluding any option exercise or mechanism that cannot be triggered at the fund's sole discretion