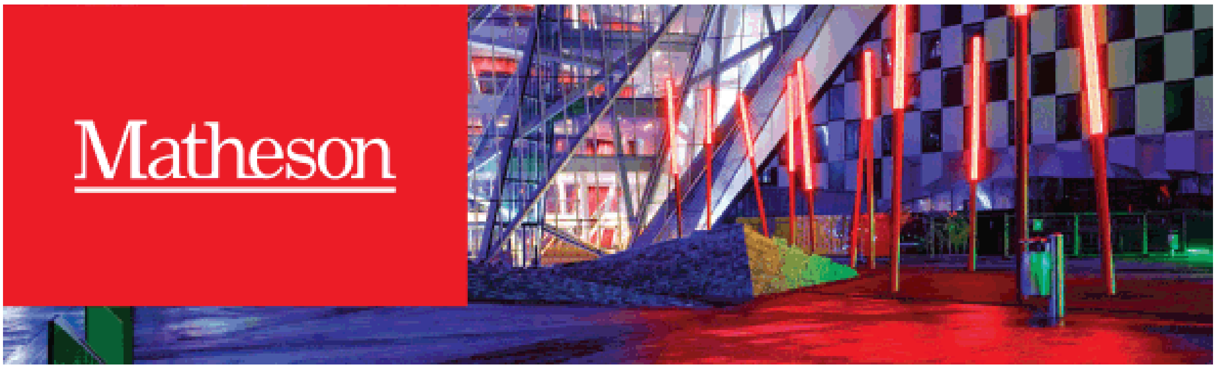

EU Money Market Fund Reform Regulation Finally Published

Almost four years after the European Commission proposed new rules to regulate money market funds ("**MMFs**"), the regulation on money market funds ("**MMF Regulation**") has been published, starting the clock ticking on the implementation timeline. The MMF Regulation will apply to all MMFs, whether they are UCITS or alternative investment funds ("**AIFs**"). Existing MMFs have until 21 January 2019 to comply, whereas new MMFs created after 21 July 2018 must comply from inception.

The MMF Regulation permits four types of MMF:

Public debt constant NAV MMFs ("Public Debt CNAV MMFs")	Invests 99.5% in government securities and maintains a constant NAV
Low volatility NAV MMFs ("LVNAV MMFs")	Invests in "prime" money market fund assets and maintains a constant NAV (within certain parameters)
Short-term variable NAV MMFs	Invests in "prime" money market fund assets and maintains a variable NAV
Standard variable NAV MMFs	Same as the short-term variable NAV MMF, but invests in assets with long maturity

The majority of existing Irish MMFs are constant NAV MMFs ("**CNAV MMF**") and the table below details, at a high level, the main differences between the existing Irish CNAV MMFs and the two new types of CNAV MMF:

	CURRENT	NEW	
	UCITS Short-Term CNAV MMF	**LVNAV**	**Public Debt CNAV**
Dealing NAV	Constant NAV	Constant NAV, but must use mark-to-market NAV where the constant NAV deviates from mark-to-market NAV by 20 basis points	Constant NAV
Valuation	Amortised cost	Amortised cost for instruments with remaining maturity of ≤ 75 days; mark-to-market for others	Amortised cost
Daily liquidity requirement	No regulatory requirement	10%	10%
Weekly liquidity requirement	No regulatory requirement	30%, of which 17.5% can be government instruments with residual maturity of < 190 days	30%, of which 17.5% can be government instruments with residual maturity of of < 190 days
Portfolio Rules	WAM: 60 days WAL: 120 days Maturity: 397 days	WAM: 60 days WAL: 120 days Maturity: 397 days	WAM: 60 days WAL: 120 days Maturity: 397 days
Credit Rating	Instruments must have one of two highest short-term credit ratings	Internal credit assessment, which can consider but not solely rely on external ratings	Internal credit assessment, which can consider but not solely rely on external ratings

	CURRENT		NEW			
	UCITS Short-Term CNAV MMF		LVNAV		Public Debt CNAV	
Redemption Gates / Fees	Technically possible but never used and in most cases not even disclosed		If weekly liquidity <30% and net daily outflows >10%, must consider liquidity fees, gates or suspension If weekly liquidity <10%, must impose either liquidity fees or suspension		If weekly liquidity <30% and net daily outflows >10%, must consider liquidity fees, gates or suspension If weekly liquidity <10%, must impose either liquidity fees or suspension	
Eligible Assets	Money market instruments, overnight deposits, reverse repo, certain securitisations or ABCP, other short-term MMFs		Money market instruments, overnight deposits, reverse repo, certain securitisations or ABCP, other short-term MMFs		99.5% government assets, cash or reverse repo backed by government assets	
Diversification	Money market instruments: UCITS 5/10/40 rules		Money market instruments: 5% per issuer		Money market instruments: N/A	
	Government assets:	100%, but at least 6 issues and max 30% per issue	Government assets:	100%, but at least 6 issues and max 30% per issue	Government assets:	100%, but at least 6 issues and max 30% per issue
	Deposits:	Max 20% with one institution	Deposits:	Max 10% with one institution	Deposits:	Max 10% with one institution
	Reverse repo:	Max 20% per counterparty	Reverse repo:	Max 15% per counterparty	Reverse repo:	Max 15% per counterparty
	Reverse repo collateral:	Max 20% per issuer (save govt.)	Reverse repo collateral:	Max 15% per issuer (save govt.)	Reverse repo collateral:	N/A
	Other MMFs:	Max 20% in any one	Other MMFs:	Max 17.5% total, 5% in any one	Other MMFs:	N/A
	Aggregate:	Max 20% between money market instruments, deposits and FDI with a single body	Aggregate:	Max 15% of money market instruments, deposits and FDI with a single body	Aggregate:	N/A
	Concentration:	Max 10% of money market instruments of a single issuer	Concentration:	Max 10% of money market instruments of a single issuer	Concentration:	N/A

Valuation

Valuation using amortised cost is a key component of CNAV MMFs and its use will still be permitted under the MMF Regulation:

- Public Debt CNAV MMFs may use amortised cost accounting in a way very similar to how they do so today;

- LVNAV MMFs, on the other hand, may only use amortised cost accounting in relation to assets that have a residual maturity of up to 75 days and for assets with an amortised cost price within 10 basis points of their mark to market price.

Dealing NAV

The defining feature of a CNAV MMF is the fact that its units can be bought and sold at a constant price. This is still permitted under the MMF Regulation:

- The units of a Public Debt CNAV MMF are always bought and sold at a constant price;

- The units of an LVNAV MMF are bought and sold at a constant price, unless the constant NAV deviates from the mark to market NAV by more than 20 basis points, in which case units are bought and sold at a price equal to the mark to market NAV.

For LVNAV MMFs, this 20 basis point threshold is lower than the existing “break-the-buck” figure of 50 basis points but market reaction to date indicates that it is at least feasible for most fund types, though there may be challenges operationally and in terms of the yield cost of having to hold shorter dated assets than would otherwise have been the case.

Liquidity

Existing CNAV MMFs are not subject to any regulatory liquidity requirements, though many MMF managers adopt liquidity limits as a result of rating agency requirements, industry body requirements or for alignment with how they manage their US funds.

Under the MMF Regulation, both Public Debt CNAV MMFs and LVNAV MMFs must have:

- 10% of NAV held in daily maturing assets; and

- 30% of NAV held in weekly maturing assets, save that 17.5% can be government instruments with a residual maturity of < 190 days.

Those MMF managers that voluntarily adopt a 30% weekly requirement often allow themselves to include highly liquid government securities in the calculations, even where their maturities are longer dated. The MMF Regulation also allows MMFs to include government securities that are highly liquid (ie, can be redeemed and settled within one business day and which have a residual maturity of up to 190 days), but only in the weekly liquidity bucket and only up to a maximum of 17.5% of assets. Again, while more restrictive than the current landscape, the new rules are nonetheless workable.

Redemption Fees and Gates

Technically speaking, redemption fees and gates have always been a tool in the arsenal of Irish regulated funds but, for obvious reasons, they have never been deployed by MMFs, even in stressed market environments. That mostly likely will not change in the new regime, but MMFs will at least be obliged to formally consider them in certain cases. Where the proportion of weekly maturing assets of a LVNAV MMF or Public Debt CNAV MMF falls below the 30% threshold and the net daily redemptions on a single business day exceed 10% of total assets, the MMF's board must consider whether or not to apply liquidity fees, redemption gates or a suspension of redemptions. Where the proportion of weekly maturing assets falls below 10%, the board must implement either liquidity fees on redemptions or a suspension of redemptions. If, within a period of 90 days, total duration of the suspensions exceeds 15 days, a LVNAV or Public Debt CNAV MMF will automatically cease to be a LVNAV or Public Debt CNAV MMF.

Eligible Assets

The assets which an MMF can purchase under the MMF Regulation are similar to the current rules:

- Money market instruments (high quality and subject to maturity limits);
- Securitisations and ABCPs (subject to liquidity, credit and other limits);
- Deposits (on demand and with a credit institution);
- Repurchase agreements (temporary, only for liquidity management);
- Reverse repurchase agreements (with diversified, high quality, non-correlated collateral);
- Units or shares of other MMFs (pursuant to diversification and concentration limits); and
- Financial derivative instruments (for hedging only, with regulated counterparties, with daily, verifiable valuation and capable of fair value sale at any time).

An MMF may not invest in assets other than those above and also may not engage in short selling, in securities lending (or any agreement that encumbers its assets) or have any exposure (direct or indirect) to equities or commodities.

The MMF Regulation also contains detailed diversification rules, which are generally (but not significantly) more restrictive than the existing rules.

Internal Credit Assessment

The manager of an MMF must establish, implement and consistently apply a prudent internal credit quality assessment procedure to determine the credit quality of the MMF's assets. The MMF Regulation sets out some detail regarding the type of information that is used in the assessment, what factors should be taken into account, how often the assessments should be reviewed and how often the procedures themselves should be reviewed. As noted below, further and more detailed requirements will be published by the European Commission on this topic.

Transparency

The MMF Regulation requires that the manager of an MMF make certain information available to investors on a weekly basis, including the maturity breakdown of the portfolio, the MMF's credit profile, the WAM and WAL, the net yield and details of the top ten holdings of the MMF.

The MMF Regulation also imposes certain requirement on external documents, including marketing materials and reports or statements. In particular, these must clearly indicate the type of MMF and include a number of required statements (eg, the MMF is not a guaranteed investment and does not rely on external support).

Regulatory Reporting

In addition to the existing UCITS or AIFMD, as applicable, regulatory reporting requirements, the MMF Regulation introduces new requirements. The reports will cover portfolio indicators (such as the total value of assets, NAV, WAM, WAL, maturity breakdown, liquidity and yield), stress tests results, information on the assets held in the portfolio, information on the liabilities of the MMF and, for LVNAV MMFs, information regarding valuation. As noted below, a reporting template will be published, detailing all of the information required in a precise manner.

External Support

Under the MMF Regulation, an MMF will be prohibited from receiving external support, which is broadly defined to mean direct or indirect support from a third party (including the MMF sponsor) that is intended for or in effect would result in guaranteeing the liquidity of the MMF or stabilising the NAV per unit or share of the MMF.

Credit Rating

The original MMF reform proposals envisaged a prohibition on an MMF obtaining a credit rating. The final MMF Regulation allows an MMF to solicit or finance an external credit rating, provided it complies with the Credit Rating Agencies Regulation and the prospectus states that the rating was solicited or financed by the MMF or its manager.

KYC Policy

The manager of an MMF is responsible for establishing, implementing and applying a "know your customer" ("**KYC**") policy, with a view to understanding the MMF's investor base, to the extent that large redemptions can be anticipated. The KYC policy should take into account the type of investor, the number of units or shares in the fund owned by a single investor, and the behaviour of inflows and outflows. The policy should "look through" nominee accounts, portals or any other indirect buyer to the underlying identity of investors.

Stress Testing

The manager of an MMF must regularly (at least twice a year) conduct stress testing for different possible scenarios (*Article 28*). The tests should seek to identify possible events or future changes in economic conditions that could have unfavourable effects on the MMF and must consider certain required hypothetical factors (such as changes in liquidity levels, credit risk, interest or exchange rates and redemption levels). As noted below, guidance will be published with a view to establishing common reference parameters of the stress test scenarios.

Delegated acts, technical standards and guidelines

The MMF Regulation gives the European Commission power to adopt delegated acts relating to specific issues and requires the European Securities and Markets Authority ("**ESMA**") to produce certain technical standards and guidelines. ESMA has published a public consultation, which closes on 7 August 2017, on these. The particular topics covered include:

- quantitative and qualitative liquidity and credit quality requirements applicable to assets received under reverse repurchase agreement;

- criteria for the validation of credit quality assessment methodologies, for quantification of credit risk and the relative risk of default, and to establish qualitative credit indicators for issuer;

- guidelines with a view to establishing common reference parameters of the stress test scenarios; and

- template for the regulatory reports, to contain all the information required.

European Commission Review

In 2022 the European Commission must review the adequacy of the legislation, including the impact on investors, MMFs and the managers of MMFs, the role played by MMFs in purchasing debt issued or guaranteed by EU member states, the impact of the MMF Regulation on the short-term financing markets and any regulatory developments at an international level.

Authorisation process

An MMF currently authorised as a UCITS or an AIF will need to go through an authorisation process with the Central Bank to become one of the four new types of MMF. According to the MMF Regulation, the application for this must be submitted by 21 January 2019, however the majority of MMF managers are likely to want to receive authorisation in advance of that date. The Central Bank is currently, in consultation with the Irish Funds Industry Association ("**Irish Funds**"), determining exactly what this process will involve (including as regards timing) in the context of UCITS and retail AIFs. For qualifying investor AIFs, the usual 24-hour approval process will likely apply.

Variable NAV MMFs

Although uncommon in Ireland, variable NAV MMFs (or "**VNAV MMFs**") are common in other parts of Europe, particularly France. As noted above, the MMF Regulation permits two types of VNAV MMF, a short-term VNAV MMF and a standard VNAV MMF. The primary differences between the VNAV MMF and the CNAV MMF are

- The dealing NAV is always variable;

- Valuation is mark-to-market (or mark-to-model);

- There are no required redemption dates or liquidity fees;

- The daily / weekly liquidity limits are 7.5% and 15% respectively, with the weekly bucket including up to 7.5% of other MMF units or shares;

- More flexible asset diversification requirements;

- In the case of the standard VNAV MMF, longer maturity, WAM and WAL limits.

Comment

The reforms of MMFs are of particular interest to the Irish funds industry, as MMFs represented 23% of the assets of all Irish domiciled funds as at July 2016. Fortunately for that industry, and in no small part thanks to the efforts of industry participants during the legislative process, the MMF Regulation offers a viable regime for CNAV MMFs to continue to thrive. As with most financial services legislation, the story does not end with the primary regulation. As noted above, the MMF Regulation provides for level 2 regulations to be issued by the European Commission and for guidance and technical standards to be issued by ESMA. Therefore, while for all involved the bulk of the work on MMFs reform has been done and the end is in sight, there is a still significant amount of fine-tuning to be tackled. The partners at Matheson continue to work with clients, Irish Funds and the Central Bank of Ireland to ensure that the outcome of this work represents the best possible result for industry and investors.

Please get in touch with your usual Asset Management and Investment Funds Group contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this update.

Full details of the Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Asset Management and Investment Funds team, can be accessed at www.matheson.com.

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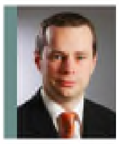

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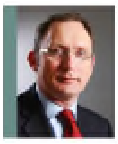

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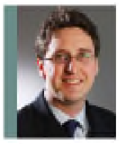

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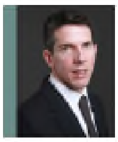

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