A&L Goodbody

Money Market Fund (MMF) Reform

Introduction

Regulation (EU) 2017/1131 of the European Parliament on MMFs (the **MMFR**) came into effect on 20 July 2017. The MMFR was subject to a twelve month transitional period which ended on 21 July 2018. MMFs established before 21 July 2018 have an additional six month transitional period in which to comply with the MMFR which will end on 21 January 2019.

Under the MMFR, the traditional constant net asset value MMF has been replaced with a Public Debt Constant Net Asset Value MMF (**Public Debt CNAV**) and a Low Volatility Net Asset Value MMF (**LVNAV**). The Variable Net Asset Value MMF (**VNAV**) has been retained with some modifications. Public Debt CNAVs and LVNAVs can only be established as short term MMFs. A VNAV can be established as either a short term or a standard MMF.

The MMFR applies to all MMFs which are established, managed or marketed in the EU. As well as providing for three categories of MMF, the MMFR introduces new requirements for MMFs in areas such as portfolio composition, valuation of assets, diversification, liquidity management and credit quality of investment instruments. The rules will apply to all MMFs, whether they are UCITS or alternative investment funds **(AIFs).**

Types of MMF

The principal features of the three MMF product types permitted under the MMFR are as follows:

1. PUBLIC DEBT CNAV

- At least 99.5% of fund assets must be invested in EU or non-EU government securities, securities issued by central banks and other prescribed international financial institutions. See details below on other eligible investments for a Public Debt CNAV. Amortised cost valuation is permitted for all securities.
- In order to meet liquidity requirements, 10% of assets must be invested in daily maturing assets and 30% in weekly maturing assets. Both categories may include reverse repurchase agreements and cash which can be terminated or withdrawn, as applicable, with 1 working day's prior notice for daily maturing assets and 5 working days' prior notice for weekly maturing assets. 17.5% of weekly maturing assets may comprise public debt securities with a maturity of up to 190 days.
- Where the proportion of weekly maturing assets falls below 30% of gross assets or the level of redemptions on a single dealing day exceeds 10% of gross assets, liquidity fees and redemption gates may apply. The application of liquidity fees and/or a suspension of dealing will apply where the proportion of weekly maturing assets falls below 10% of gross assets.
- The permitted weighted average maturity (**WAM**) is 60 days and weighted average life (**WAL**) is 120 days. There are also additional safeguards, such as liquidity fees and redemption gates, designed to prevent and limit the effects of sudden investor runs.

2. LVNAV

- See details below on eligible investments for an LVNAV.
- Amortised cost valuation is permitted for securities with a maturity of up to 75 days. Where the amortised valuation of an asset diverges from the mark to market/model value (**Market Valuation)** by more than 10 bps, the amortised cost valuation may not be used. Shares will only be capable of being issued and redeemed at a constant net asset value per share so long as the constant net asset value per share does not diverge from the Market Valuation by more than 20 bps.
- There is no limit on acquiring securities with a maturity of over 75 days (subject to a limit of 397 days) but these securities must be valued at Market Valuation.
- The liquidity requirements, WAM and WAL and the operation of liquidity fees and gates are the same as those for a Public Debt CNAV.

3. VNAV

- See details below on eligible investments for a VNAV.
- Valuation of assets is based solely on Market Valuation.
- The liquidity requirements are that 7.5% of assets must be invested in daily maturing assets and 15% in weekly maturing assets. Both categories may include reverse repurchase agreements and cash which can be terminated or withdrawn, as applicable, with 1 working day's prior notice for daily maturing assets and 5 working days' prior notice for weekly maturing assets. 7.5% of weekly maturing assets may be held in money market instruments or in shares/units of other MMFs.
- The permitted WAM is 60 days for a short term VNAV and 120 days for a standard VNAV. The permitted WAL is 120 days for a short term VNAV and 360 days for a standard VNAV. There is no requirement to apply liquidity fees or gates.

Principal Features of the MMFR

Designation and Labelling

Only UCITS and AIFs authorised under the MMFR will be permitted to use the designation **"money market fund"** or **"MMF"** in any external documents such as a prospectus, advertisement, communication or other material, distributed or intended for distribution to existing or prospective investors, whether in written, oral or electronic form. An MMF must also clearly indicate whether it is a short term MMF or standard MMF in all such documentation.

Eligible Investments

MMFs will be permitted to invest in money market instruments; deposits (on demand or with less than 12 months maturity) with eligible credit institutions; eligible securitisations (**STS**) and asset backed commercial paper (**ABCPs**); reverse repurchase agreements (with the ability to close out the agreements on no more than 2 working days' notice); repurchase agreements (for liquidity management purposes, with the ability to close out the agreements on no more than 2 working days' notice); financial derivative instruments (solely to hedge interest rate or exchange

change rate risks); and shares/units of other MMFs (subject to short term MMFs only investing in shares/units of other short term MMFs). As outlined above, Public Debt CNAVs are subject to additional restrictions in relation to fund asset composition. The Commission's Delegated Regulation (EU) No. 2018/990, which amends and supplements the MMFR in relation to STS and ABCPs, sets out requirements for assets received as part of a reverse repurchase agreement and the criteria for credit quality assessment methodologies, came into effect on 21 July 2018 (with the exception of Article 1 which shall apply from 1 January 2019).

Investment Restrictions

MMFs will be prohibited from short selling money market instruments, securitisations, ABCPs and shares/units of other MMFs; entering into securities lending agreements or securities borrowing agreements; taking direct or indirect exposure to equities or commodities; and borrowing or lending cash.

Diversification and Concentration

The MMFR contains detailed rules on diversification and concentration levels aimed at limiting risk taking by MMFs. These include issuer concentration limits, limits on exposure to credit institutions and counterparties and limits on investments in other MMFs.

Portfolio Maturity

MMFs will be subject to portfolio maturity limitations. These limitations are designed to reduce portfolio risk, strengthen an MMF's ability to deal with redemptions and prevent an MMF's assets from being liquidated at heavily discounted prices.

Credit Assessment

The manager of an MMF (or where no manager has been appointed, the MMF) will be required to apply an internal credit quality assessment procedure to determine the credit quality of investments, taking into account the issuer and the characteristics of the investment itself. Regard to credit ratings of an investment will be permitted, provided there is no reliance (mechanical or otherwise) on such ratings.

Stress Testing

The MMFR requires that a sound stress testing process is put in place for each MMF that identifies possible events or future changes in the economic conditions that could have unfavourable effects on the MMF. The frequency of stress testing may be decided by the manager (or where no manager has been appointed, the MMF) but must be carried out at least bi-annually. Where necessary, the manager or the MMF, as applicable, is required to take action to strengthen the robustness of the MMF following the results of the stress testing.

Reporting and Transparency requirements

The MMFR includes increased transparency requirements. The reporting requirements apply to MMFs in addition to the requirements under AIFMD and the UCITS Directive (the **Directives**). The activities of the managers (where one has been appointed) will continue to be subject to the Directives but the product rules contained under the UCITS framework and the AIF Rulebook will be supplemented by the product rules contained in the MMFR.

External support

The MMFR prohibits sponsor support from third parties, including banks, that is intended to or which would result in guaranteeing the liquidity of the MMF or stabilising the net asset value per share/unit of the MMF.

Review

The MMFR includes a clause requiring the European Commission to undertake a review on the functioning of the MMFR 5 years after its implementation, to consider whether any changes should be made. The review will include the issue of a report on the feasibility of establishing an 80% EU public debt quota for Public Debt CNAVs based on the availability of such securities.

ESMA's Final Report on its Consultation on MMFR

On 13 November 2017 ESMA issued its Final Report on Technical Advice, Draft Implementing Technical Standards and Guidelines under the MMFR. The key requirements relate to asset liquidity and credit quality and assessment, the establishment of a reporting template and stress testing. This final report follows on from an earlier consultation issued by ESMA in May 2017 and has taken into account feedback received from Irish Funds and other stakeholders on a number of key points. On 21 March 2018 ESMA published its stress testing guidelines under article 28 of the MMFR.

Reverse Distribution Mechanism

The issue of share cancellation/destruction not being allowed under the MMFR was first mooted in ESMA'S consultation paper in May 2017. Share cancellation/destruction is also known as the reverse distribution mechanism or RDM. It involves a process of cancelling shares/units in an MMF in order to support a constant net asset value in a negative interest rate environment (which currently applies to the Euro). ESMA subsequently sought the advices of the legal services of the European Commission on this issue. On 19 January 2018 the Commission advised ESMA that, in its opinion, RDM was not compatible with the MMFR.

The Commission's legal opinion on this matter was released on 22 March 2017, following a request under freedom of information provisions. Irish Funds has worked with EFAMA and other key stakeholders in preparing and submitting a response to the Commission on its legal opinion setting out their reasons as to why RDM should be retained. However, the issue of RDM remains unresolved. On 20 July 2018 ESMA wrote to the Commission asking it to provide clarity to market participants and investors on the issue of the compatibility of RDM with the MMFR. ESMA considers that clarity on this issue to investors and market participants is essential to ensure a proper and consistent interpretation and implementation of the MMFR. The Commission's response to ESMA's letter is awaited.

Conversion Process for Existing MMFs

Existing UCITS or AIFs that invest in short term assets and have, as distinct or cumulative, objectives offering returns in line with money market rates or preserving the value of the investment must, within 18 months of entry into force of the MMFR, submit an application to their relevant national competent authority to demonstrate compliance with the MMFR. Competent authorities will then assess whether the MMF is in compliance and must issue a decision within two months of receipt of a completed application.

Irish Funds have been actively engaging with the Irish Central Bank on the process for existing MMFs to convert to one of the three permitted MMF product types (whether Public Debt CNAV, LVNAV or VNAV). The Central Bank has issued an application form to facilitate the conversion process. The Central Bank has also written to existing MMF Promoters advising them of the need to submit their fund documentation for review by the Central Bank by September 2018 in order to ensure that all documentation is cleared of comment by the end of November 2018 to facilitate compliance with the MMFR by 21 January 2019, which is the end of the extended transitional period for existing MMFs. These submission timelines may slip given that the issues around the use of RDM and its compatibility with the MMFR have yet to be resolved.

How A&L Goodbody can help you

A&L Goodbody has been working closely with colleagues on the Irish Funds Money Market Funds Working Group for many years. We are, therefore, well placed to advise clients who are thinking of establishing new money market funds or who have existing money market funds which will need to comply with the new requirements by 21 January 2019.

MMFR Key Features Table

MMF Type	Asset Composition	Method of Valuation	Liquidity Requirements	WAM	WAL	Fees and Gates
Public Debt CNAV	≥ 99.5% in EU or non-EU government securities issued by central banks and other prescribed international financial institutions	Amortised cost for all securities	10% in daily and 30% in weekly maturing assets. Both categories may include reverse repurchase agreements and cash which may be terminated or withdrawn, as applicable, with 1 working day's prior notice for daily maturing assets and 5 working days' prior notice for weekly maturing assets. 17.5% of weekly maturing assets may comprise government securities with a maturity of < than 190 days.	60 days	120 days	Where the proportion of weekly maturing assets falls below 30% of gross assets or the level of redemptions on a single dealing day exceeds 10% of gross assets, liquidity fees and redemption gates may apply. The application of liquidity fees and/or a suspension of dealing will apply where the proportion of weekly maturing assets falls below 10% of gross assets.
LVNAV	Permitted money market instruments or securities with a maturity of ≤ 397 days	Amortised cost for securities with a maturity of ≤ 75 days. Market valuation for longer dated securities or where the amortised cost valuation for a security diverges from its market valuation by more than 10bps. Shares will only be capable of being issued and redeemed at a constant net asset value per share so long as the constant net asset value per share does not diverge from the Market Valuation by more than 20 bps.	Same as for a Public Debt CNAV	Same as for a Public Debt CNAV	Same as for a Public Debt CNAV	Same as for a Public Debt CNAV
VNAV	Permitted money market instruments or securities a maturity of ≤ 397 days for a short term MMF and < 2 years for a standard MMF	Market Valuation	7.5% in daily and 15% in weekly maturing assets. Both categories may include reverse repurchase agreements and cash which may be terminated or withdrawn, as applicable, with 1 working day's prior notice for daily maturing assets and 5 working days' prior notice for weekly maturing assets. 7.5% of weekly maturing assets may be held in money market instruments or in shares/ units of other MMFs.	60 days (short term MMF) 120 days (standard MMF)	120 days (short term MMF) 360 (standard MMF)	No liquidity fees or redemption gates apply.

KEY CONTACTS

Brian McDermott
Partner and Head of Asset Management & Investment Funds
+353 1 649 2307
bmcdermott@algoodbody.com

Michael Barr
Partner
+353 1 649 2327
mbarr@algoodbody.com

Stephen Carson
Partner
+44 20 7382 0820
scarson@algoodbody.com

Mary McKenna
Partner
+353 1 649 2344
mmckenna@algoodbody.com

Nollaig Greene
Knowledge Lawyer
+353 1 649 2359
ngreene@algoodbody.com