A&L Goodbody

Money Market Fund (MMF) Reform

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 Both categories may include reverse repurchase agreements and cash, which can be terminated or withdrawn, as applicable, with 1 working day's prior notice for daily maturing assets and 5 working days' prior notice for weekly maturing assets. 17.5% of weekly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.
- The permitted weighted average maturity (**WAM**) is 60 days and weighted average life (**WAL**) is 120 days.
- The MMFR also contains additional safeguards, such as liquidity fees and redemption gates, which are designed to prevent and limit the effects of sudden investor runs. 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.

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 European 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 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 technical advice, standards and guidelines

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. On 28 September 2018 ESMA published a consultation paper on the udpate of these guidelines.

Reverse distribution mechanism

The reverse distribution mechanism or RDM is an operational mechanism used by existing constant net asset value MMFs to pass along to investors, in a simple and transparent way, the negative interest arising from investing in Euro denominated securities. It involves the redemption and cancellation of the appropriate number of an investor's shares to offset the negative interest charge. It is based on a standing redemption request from the investor to the MMF to redeem the required number of their shares in accordance with express provisions set out in the fund documentation. The practice of separating capital and yield has formed the basis of maintaining a stable net asset value for existing constant net asset value MMFs for over 20 years, with the positive income distributed to the investors in order to maintain the stable net asset value. RDM is simply an inverse process in a negative interest rate environment.

The current position on RDM is that the Commission issued a response dated 4 October 2018 to ESMA's letter of 20 July 2018 asking the Commission to provide clarity, to market participant and investors, on the issue of the compatibility of RDM with the MMFR. In its response, the Commission broadly restates its earlier position that RDM is not compatible with the legal framework established by the MMFR, notes the need to ensure consistent application of the MMFR in order to prevent divergent supervisory practices but does not call for specific action by ESMA. The content of the Commission's letter will need to be considered by ESMA. The letter could be open to interpretation by ESMA and appears to put the ball back into ESMA's court.

The issue of share cancellation or destruction not being compatible with the MMFR was first raised in a footnote to the ESMA consultation paper in May 2017. In November 2017 ESMA wrote to the Commission requesting its views on the compatibility of RDM with the MMFR. In January 2018, the Commission confirmed ESMA' s view that RDM was not compatible with the MMFR. While the Commission's advices to ESMA were not made public at the time of issue, some limited publication took place in March 2018 following a freedom of information request. Various industry stakeholders (including the MEP negotiating team to the Commission) have written to the Commission making the point that this is a Level 1 matter, which is outside of the Commission's remit and disagreeing with the Commission's legal analysis and misconceptions. In its letter to the Commission in May 2018, EFAMA proposed safeguards in relation to the use of RDM that could provide the basis on which to move forward. ESMA considers that clarity on the issue of RDM is essential to ensure a proper and consistent interpretation and implementation of the MMFR and for this reason wrote to the Commission on 20 July 2018 asking it to make its interpretation clear to the wider public as soon as possible.

Given that we reaching the end of the transitional period for existing MMFs to comply with the MMFR and the operational lead in time required to change procedures, there is, understandably, considerable unease among MMF providers about the current uncertainty surrounding RDM and a sense that time is running out. An unfavourable outcome in relation to the continued use of RDM will influence Euro product offerings going forward. While Euro interest rates may become positive over the next year or so, MMF fund managers would like to retain RDM as an operational mechanism, going forward, as interest rates on other currencies could become negative and while there may be alternatives to the use of RDM, they are regarded as inferior and more costly to implement. RDM is a process which is valued and well understood by investors in existing constant net asset value MMFs. Such investors, who have no appetite for investing in VNAVs, could seek to invest elsewhere.

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.

The Central Bank has issued an application form to facilitate the conversion process under the MMFR, which follows a checklist format. The Central Bank has also written to existing MMF providers 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. This conversion process is well under way. Some MMFs, which are not affected by issues relating to RDM or the Central Bank's current view of historic pricing and dealing and settlement practices, have already converted.

How A&L Goodbody can help you

A&L Goodbody has been advising MMF providers for over 20 years and has considerable experience in the area of MMF establishment and regulation. 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.

Our team

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