On 4 September 2013, the European Commission (the “Commission”) released a proposal for a new regulatory regime for money market funds, aimed at ensuring the stability of the short-term fixed income markets in Europe. This paper summarises certain key impacts of this proposed regulation and the regulatory process.

Background

J.P. Morgan Asset Management (“JPMAM”) supports regulatory reforms that address structural vulnerabilities and decrease systemic risk associated with money market funds (“MMFs”). The reforms enacted in the US in 2010, some of which were subsequently reflected in the IMMFA Code, in conjunction with the guidelines set down by ESMA, were very effective in reducing risk taking and improving liquidity and disclosure. These have been important in establishing the future stability of the short-term fixed income markets, although concerns remain about the susceptibility of MMFs to run risk, as well as the central role that MMFs play in the real economy.

In addition to these regulatory enhancements, JPMAM, as well as other MMF managers, have taken certain elective steps to strengthen investor awareness by voluntarily providing important information to investors, most notably daily disclosure of market-based net asset values (“NAVs”). This enhanced transparency gives investors a better understanding of the nature of MMF risks and allows them to make more informed decisions regarding their investments.

Proposed regulation for money market funds

The Commission has released a document, “Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds”, which looks to specifically provide for MMFs under EU regulations, and is intended to enhance the liquidity of MMFs and to ensure their stability and that of the European short-term debt markets.

Impacts for investors of the draft regulation

At this stage, the proposed regulation is in draft form only. A lengthy process to negotiate and agree the final regulation between the EU institutions will now follow. This process is likely to take a significant period of time, and the proposal may change significantly over this time.

What follows is a brief summary of certain key investor impacts of the regulation as currently drafted.
1. Optionality for stable NAV MMFs

The Commission has set out draft provisions that would give stable NAV MMFs the option to either maintain a capital buffer of at least 3% of its assets under management, or to float the NAV of the MMF.

The Commission has sought to provide choice for stable NAV MMF managers. In reviewing these options, we are looking for the solution that provides the optimal balance of reducing systemic risk and preserving MMFs as an efficient and viable tool for investors and the financial markets.

While capital (in the form of support from the fund sponsor) has generally been effective in preventing idiosyncratic risk in MMFs and protecting investors, it is important to ensure that both the size and structure of a capital buffer should effectively align sponsors’ and shareholders’ interests; a dynamic risk-based calculation of capital may be an alternative worthy of further investigation.

With respect to the floating NAV alternative proposed by the Commission, clients have raised a number of concerns, which continue to be the subject of discussion with policymakers:

- Accounting treatment – ensuring that a floating NAV fund would retain “cash and cash equivalent” status for accounting purposes.
- Tax treatment of gains and losses – ensuring that tax regimes across Europe adequately account for the complexity of managing daily gains and losses at the client level.
- Operational enhancements to investor systems – technology infrastructure such as sweep mechanisms, accounting systems, etc., will take time to amend.

2. Prohibition on fund ratings

The Commission considers that investors place too much emphasis on the rating of a MMF, and therefore import the risk of a run in the event of a negative watch announcement or downgrade. The Commission has therefore proposed to prohibit MMFs from paying for or soliciting a rating from an external credit rating agency.

We understand that investors see credit rating agencies as playing a key role in providing a “first filter” of independent analysis of MMFs, before they undertake their own due diligence. They view the credit rating agencies as providing a level of transparency over the activities of MMFs, and see a benefit in an independent “second pair of eyes”.

3. Portfolio restrictions

The Commission has adopted a number of key concepts from the IMMFA Code and US SEC rule 2a-7, such as restrictions on the weighted average maturity (“WAM”) and weighted average life (“WAL”) of MMF portfolios, and minimum holdings in securities maturing within one day and one week. These are powerful changes, which should better prepare MMFs to manage through stressed market conditions. These changes are consistent with standards already operated by JPMAM.

Other requirements proposed by the Commission will restrict MMFs’ use of instruments such as reverse repurchase agreements and asset-backed commercial paper. When used appropriately, these secured investments provide appropriate risk-return profiles for MMFs.

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6 US Securities and Exchange Commission Rule 2a-7 of the Investment Company Act of 1940
4. Client information

Experienced MMF managers seek to maintain active relationships with their clients, in order to understand their liquidity needs, trading patterns and level of risk aversion. This should enable managers to most effectively manage their portfolios, and ensure that adequate liquidity is maintained to meet investor requirements at all times.

The proposed regulation includes requirements for all managers to conduct appropriate due diligence and understand the behaviour of their investors. Requiring managers to gain a better understanding of the types of investors in their MMFs is intended to limit the risk arising from high shareholder concentration and to assist managers to better monitor subscription and redemption cycles. These are likely to be positive steps for the industry's ability to manage potential MMF risks.

5. Credit analysis and stress testing

The Commission has included in the proposed regulation requirements that MMF managers perform a rigorous internal credit quality assessment of money market instruments, as well as implement a prudent stress testing regime. In particular, such credit analysis is to be performed by individuals separate from the individuals responsible for the day-to-day management of the MMF portfolio. Many experienced MMF managers already use forms of internal credit analysis and stress testing, and the requirement for all MMF managers to also engage in such practices will benefit investors and the broader industry.

What happens next? The regulatory process

The proposed regulation will now undergo a lengthy and important legislative negotiation process called EU codecision. We expect that the regulations will evolve further during this legislative process.

The Commission’s proposed regulation will now be sent to the European Parliament and EU Member States in the European Council, who will put forward amendments in their respective institutions.

The EU institutions must then meet in a series of private meetings called “Trialogues” to reconcile their respective positions, and agree on a final compromise text. This process may take a significant period of time (perhaps from six to eighteen months, or longer), which will depend on the positions of the institutions and the nature of the political negotiations. Once agreed in final form, ESMA and the Commission must specify and expand the technical detail further through the so-called “Level 2” process before implementation across EU Member States.
Money Market Funds Proposed EC Regulation

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