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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 179: MONEY MARKET FUNDS

Discussion of legal uncertainties arising from the proposal for a regulation on money market funds

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 179 WORKING GROUP[1]

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1 Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

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1.1. EXECUTIVE SUMMARY AND INTRODUCTION

Executive summary

1.2. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.3. This paper discusses the legal uncertainty arising from the European Commission's proposal for a Regulation on Money Market Funds, published on 4 September 2013 (the "Proposal").[2] The uncertainties which the FMLC has identified in the proposed Regulation (the "Regulation") fall broadly into two categories: (i) inconsistency with existing financial regulations and (ii) lack of clarity in the use and meaning of terminology. The uncertainties arise in connection with: the liability of money market funds managers; the eligible assets requirements and the net asset value buffer. The discussions on the liability of money market funds managers fall squarely within the first category. Discussions on the eligible assets requirements and the net asset value buffer fall under both.

1.4. The Committee on Economic and Monetary Affairs (ECON) of the European Parliament published a draft report on the Proposal in November 2013 (the "draft report"). Although the draft report contains consequential amendments,[3] references in this paper to provisions of the Regulation are to the text as it is set out in the Proposal.

Introduction

1.5. The Proposal follows the international work on shadow banking undertaken by organisations such as the Financial Stability Board ("FSB"), the International Organisation of Securities Commissions ("IOSCO") and the European Systemic Risk Board ("ESRB"). The Proposal seeks to address problems associated with investor runs on money market funds ("MMFs"). Pursuant to this objective, the Proposal: (i) introduces common standards to increase the liquidity of MMFs; (ii) introduces rules to

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[2] 2013/0306 (COD)

[3] The amendments in the draft report include *inter alia*: wider investment choices for MMFs, expunction of the prohibition on soliciting or financing external credit ratings, curtailment of CNAV MMFs so that they should no longer be offered to retail investors and conversion of all CNAV MMFs to value net asset value ("VNAV") MMFs five years after entry into force of the regulations.

guarantee that MMFs invest in high quality and well diversified assets of good credit quality; (iii) prescribes the building up of appropriate cash reserves for MMFs which operate as constant net asset value ("CNAV") MMFs; and (iv) prohibits reliance on external credit rating. The proposed Regulation is intended to build on the developing regulatory framework for investment funds, which includes measures such as the Directives on Undertakings for Collective Investments in Transferable Securities ("UCITS Directive")[4] and on Alternative Investment Fund Managers ("AIFM Directive").[5]

1.6. The discussions in this paper relate to uncertainties arising from:

a. the liability regime for money market fund managers proposed in Article 6(4) of the Commission's Proposal

b. the eligible assets provisions in Articles 8, 12 and 13 of the Commission's Proposal.

c. the operability of the 3% capital buffer requirement for CNAV MMFs in Article 30 of the Commission's Proposal.

2. LIABILITY OF MONEY MARKET FUND MANAGERS

Compatibility with national law

2.1. Article 6(4) of the proposed Regulation provides

> *The manager of the MMF shall be responsible for ensuring compliance with this Regulation. The manager shall be liable for any loss or damage resulting from non-compliance with this Regulation.*

It is unclear how this imposition of a new European standard of liability—which, being set out in a regulation rather than a directive, will have direct effect in Member States' jurisdictions—is to be applied within national legal systems. In particular, national courts will be required to substantiate the provision by making determinations as to: (i) whether events which are outside the manager's control can amount to "*non-compliance*"

4 In particular, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to Undertakings for collective investment in transferable securities ("UCITS IV").

5 Directive 2011/61/EU on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

with the Regulation, i.e. whether the standard of liability is fault-based or strict; and (ii) the nature of the causal link between the loss and the "*non-compliance*" in question which is required to be established in order to satisfy the concept of "*loss or damage resulting from non-compliance*". Where Member States' courts reach different conclusions on these points, the effect will be continuing uncertainty as to the nature of the liability which the proposed Regulation is intended to impose.

2.2. The FMLC would welcome clarification that Article 6(4) establishes a strict causal link between the loss or damage in question and the manager's non-compliance (i.e. a test of *necessity*, not a test of *sufficiency*) as seems likely to have been intended. The FMLC would also welcome clarification as to the nature of the liability standard. It is not within the FMLC's remit to comment on matters of policy and thus the FMLC does not address the wider question of whether a strict liability standard would be fair or proportionate in this context.

Inconsistency with the UCITS and AIFMD

2.3. The Proposal is intended to build on the existing regulatory framework established through the UCITS and the AIFM Directives.[6] A manager of an MMF which is a UCITS is required to comply with both the UCITS Directive and the Regulation, unless otherwise specified.[7] Similarly, a manager of an MMF which is an AIF will be required to comply with both the AIFM Directive and the Regulation, unless otherwise specified.[8] This means that an MMF manager may be subject to a number of overlapping liability standards which are only imperfectly co-extensive: the Regulation and the UCITS Directive or AIFM Directive, respectively. If there is a claim involving elements of the manager's duties under both the Regulation and UCITS or AIFM Directive, it will fall to be determined under two sets of potentially inconsistent liability provisions.

2.4. There are two significant areas of divergence between the liability standards in the Proposal, on the one hand, and those in the UCITS and AIFM Directives, on the other. They are:

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[6] Recital 19 of the Regulation.

[7] Article 6(2) of the Regulation.

[8] Article 6(3) of the Regulation.

a) *Eligible claimants*: in the AIFM and UCITS Directives, the categories of eligible claimant are restricted to the fund and the unit-holders. In contrast, the Proposal does not place any limitation on those who may claim as a result of the manager's non-compliance. It is unclear whether this is a result of a deliberate policy decision—i.e to include non-investors; whether it may be an oversight; or whether the text reflects a decision to leave the features of the liability regime to national law in this respect. The FMLC would welcome clarification.

b) *Duties*: the duties imposed by the Regulation are placed on the manager and not on other parties such as the depositary. In contrast, there are extensive liability regimes for depositaries under the AIFM Directive which are being replicated under legislation introducing revisions to the UCITS regime ("UCITS V")[9] in respect of depositary functions, remuneration policies and sanctions. The FMLC suggests that any liability on the part of the manager for any loss or damage which is otherwise recoverable as a liability of the depositary should be expressly excluded in the Regulation.

3. ELIGIBLE ASSETS REQUIREMENTS

3.1. The Proposal introduces common rules on the investment policies of money market funds ("MMFs"). MMFs are allowed to invest in the financial asset classes in Article 8(1) of the Regulation and prohibited from undertaking the activities specified in Article 8(2). Articles 9 to 13 contain further provisions on the eligible assets.

Prohibited activities

3.2. Article 8(2)(b) prohibits MMFs from short-selling money market instruments. This requirement may conflict with Article 13 (eligible reverse repurchase agreements), which permits an arrangement where an MMF is obliged to redeliver securities at a future date at a price not dependent on market movements affecting the securities. Regulation (EU) No 236/2012 on short selling and certain aspects of credit default swaps (the "Short Selling Regulation") establishes a detailed regime for the control of short selling activities in Europe to which all MMFs are already subject. There are specific requirements in this legislation for the short selling of government securities, which is a matter of particular relevance to MMFs. The Short

[9] 2012/0168 (COD)

Selling Regulation notably does not prohibit covered transactions such as reverse repurchase agreements. Legal certainty would be improved if Article 8(2)(b) were amended simply to require MMFs to comply with the Short Selling Regulation.

3.3. Article 8(2)(d) prevents an MMF from entering into a securities lending or securities borrowing agreement. In times of market stress (e.g. settlement system failures or delays) this provision may prevent an MMF from using secured bank liquidity to facilitate payments to exiting investors. The FMLC is unclear as to whether this is the intended effect of the provision and, if not, would welcome clarification accordingly.

Eligible reverse repurchase agreements[10]

3.4. A condition precedent attached to eligible reverse repurchase agreements under Article 13(1)(b) of the Regulation is that

> *the market value of the assets received as part of the reverse repurchase agreement is at all times at least equal to the value of the cash given out.*

Typically, the haircut value for the non-cash leg of a reverse repurchase will be determined at the time of entering the transaction. At that time, it will not be known whether some extreme market event may occur which could lead to variations in the market price of securities in breach of this provision.

3.5. If it were thought desirable to adopt a more flexible approach to this condition precedent, amendments could be incorporated as follows:

> *the market value of the assets received as part of the reverse repurchase agreement <u>is expected, under normal market conditions</u>, to be at all times at least equal to the value of the cash given out.*

4. NET ASSET VALUE BUFFER

Complying with the NAV buffer requirement

4.1. The first limb of Article 30(1) of the Regulation provides

> *Each CNAV MMF shall establish and maintain a NAV buffer amounting at all times to at least 3% of the total value of the CNAV MMF's assets.*

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10 Article 2(5) of the Regulation defines "reverse repurchase agreement" to mean any agreement in which one party receives securities, or any rights related to that title or security from a counterparty subject to a commitment to sell them back at a specified price on a future date specified or to be specified.

It is unclear, who will be responsible for financing the buffer. Presumably, it is the MMF manager, or the MMF sponsor, or other affiliate of the MMF manager or sponsor. The uncertainty is exacerbated, however, by the second paragraph of Article 30(4) which refers independently to the manager and to "*any other entity financing the NAV buffer"* and by Article 30(7) which states

> *The CNAV MMF shall establish in writing clear and detailed arrangements with the entity expected to fund the replenishment of the NAV buffer…*

4.2. The FMLC believes that the Regulation should identify the party or parties that are to be responsible for fulfilling the obligation of financing the NAV buffer.

Composition and holding of the NAV buffer

4.3. The NAV buffer shall be composed only of cash.[11] According to Article 30(4) of the Regulation, it is to be held in a reserve account opened with a single credit institution. This requirement raises two immediate concerns:

a. *Interaction with the diversification requirements under Article 14 of the Regulation*: given that Article 14(1)(b) of the Regulation proscribes MMFs from investing no more than 5% of its assets in deposits made with the same credit institution, it is uncertain whether this 5% requirement would be calculated so as to include or exclude the NAV buffer.

b. *Exclusion from bail-in under the Banking Recovery and Resolution Directive ("BRRD")*:[12] in the event of the credit institution entering into resolution, it is unclear whether the NAV buffer may be subject to bail-in under the BRRD. The provisions of the BRRD exclude from bail-in

> *any liability that arises by virtue of the holding by the institution or entity referred to in points (b), (c) or (d0 of Article 1 of client assets or client money , including client assets or client money held on behalf of UCITS as defined in Article 1(2) of Directive 2009/65/EC or of AIFs as defined in Artcile 4(10(a) of Directive 2011/61/EC …on Alternative Investment Fund Managers, provided that such client is protected under applicable insolvency law.*

11 Article 30(3) of the Regulation

12 Directive establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, currently awaiting publication of the final text in the Official Journal.

Considering the protection extended to UCITS and Alternative Investment Funds under these provisions of the BRRD and considering that the Regulation is intended to run parallel to these legal regimes, it is strongly arguable that a similar safeguard must be extended to the NAV buffer. The FMLC would welcome clarification that the NAV buffer will be excluded from the operation of the bail-in tool under the BRRD.

4.4. The second limb of Article 30(4) of the Regulation requires that the reserve account shall be segregated from any other account of the MMF, from the accounts of the manager of the MMF, from the accounts of other clients of the credit institution, and from the accounts of any other entity financing the NAV buffer. The FMLC draws attention to the fact that under some European legal systems, including English law, the correct legal classification of cash on deposit is a right to repayment wherein the account provider is the debtor and the account holder is the creditor. Thus, the isolation of cash in a segregated bank account may not be effective automatically to create a proprietary entitlement of the sort which may be contemplated by this provision. The question whether or not a proprietary entitlement to funds in the account can be established (and the nature and ownership of that entitlement) will depend on the objective construction of any agreement(s) relating to the account.

<u>Transfer of funds from the reserve account</u>

4.5. Under the Regulation, a transfer of funds from the reserve account will be made under two conditions. These are: (i) where the CNAV at which a unit or share is subscribed is lower than the NAV, the negative difference shall be debited from the reserve account;[13] and (ii) where the CNAV at which a unit or share is redeemed is higher than the NAV per unit of the share, the negative difference shall be debited from the reserve account.[14] The Regulation does not appear to contemplate that the MMF manager may reclaim surplus amounts in excess of the 3% minimum requirement. Also, where the services of the manager (or the sponsor or other entity financing the buffer) are terminated by the MMF's Board[15] and the manager (or the sponsor or other entity financing the buffer) has been responsible for financing the reserve account, it is unclear whether the manager (or the sponsor or other entity financing the buffer) will be able to reclaim its funds. In these circumstances, the better view is that the CNAV MMF (and its board or

13 Article 31(2)(b) of the Regulation.

14 Article 31(3)(a) of the Regulation.

15 Many CNAV MMFs have independent boards which are not controlled by the manager or its affiliates.

equivalent) should ensure the prompt replacement of the manager, the repayment of the buffer amount to the outgoing manager (or the sponsor or other affiliate) and the establishment of the required buffer by the replacement manager. The FMLC would welcome clarification as to whether this is the intention of the Regulation.

4.6. If the manager (or the sponsor or another affiliate) is the entity financing the buffer; it is most likely to account for the sums deposited in the reserve account as an asset on its balance sheet.[16] In the case of the insolvency of the manager (or the sponsor or another affiliate), provision should be made in the context of Article 30(4) of the Regulation for the eventual return of the buffer amount to the liquidator (or equivalent) or the entity for the benefit of its creditors and shareholders following the appointment of a replacement buffer provider by the MMF.

4.7. The FMLC is concerned that Article 30 makes no provision as to how the NAV buffer should be treated on the occurrence of (i) the termination of the fund whether upon maturity or by way of insolvency; and (ii) conversion to a variable NAV ("VNAV") MMF. The FMLC would welcome clarification on these points.

5. CONCLUSION

5.1. The FMLC welcomes legislative efforts to address problems associated with investor runs on MMFs. It is concerned, however, that legal uncertainty may arise from certain provisions of the Regulation. These uncertainties are broadly identified as those: (i) arising from the liability standard in Article 6(4) of the Regulation; (ii) arising from the eligible assets provisions in Articles 8, 12 and 13 of the Proposal; and (iii) regarding the operability of the 3% capital buffer requirement for CNAV MMFs in Article 30. Throughout this paper, possible solutions—suggestions and recommended approaches—are highlighted for the consideration of the European Commission.

16 This amount will not be freely available to it under restrictions imposed by the Regulation.

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