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AmCham EU's position on the European Commission's Money Market Funds Regulation proposal

Money market funds ("MMFs") perform a vital role as intermediaries between borrowers in search of short-term funding and investors seeking low risk cash management solutions. In particular, MMFs offer important alternative liquidity in financial markets, which more than ever is crucial to the funding needs of the European Economy. It is important to understand that both European companies and businesses worldwide, including AmCham EU member companies, favour MMFs primarily as liquidity management tools, and a way to limit the counterparty exposure risk inherent in bank deposits. Preservation of these solutions/roles is especially important at a time where current market outlooks make it difficult for companies to adequately plan their treasury inventory.

We believe that the key features of MMFs offer protection to investors while enabling them to play an important role in the capital markets. These features include constraints on a fund's liquidity and maturity of holdings, diversification and credit quality requirements, portfolio transparency and clear governance requirements. All of these practices/measures have proven effective in establishing the resilience of MMFs in the United States and the EU.

It is our concern that if EU and US policy makers fail to develop a framework that will allow MMFs to invest in a wide range of money market instruments, there is a real risk that liquidity issues for sovereigns as well as lending to the economy will deteriorate.

Need for international consistency

AmCham EU have been concerned with the divergent implementation of the G20 agenda in the US and the EU and the threat that this poses to not only Transatlantic, but global markets. It remains crucial that the international follow-up to the shadow banking agenda, and specifically MMF reform, be coordinated to the greatest extent possible. Any new reforms to MMFs should be based upon sound economic analysis of the effects of any chosen policy outcome.

The European Commission's proposal contains a number of policy measures including enhanced portfolio restrictions, enhanced client and supervisory disclosure, a capital buffer for Constant Net Asset Value (CNAV) MMFs and a ban on external credit ratings, many of which are inconsistent with policy developments elsewhere in the world. We provide comments on these proposals below.

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POSITION STATEMENT

Enhanced portfolio restrictions

Article 13 of the European Commission's proposal imposes limits on the types of collateral an MMF can receive in a reverse repurchase transaction (repo) to high quality securities issued or guaranteed by an EU Member State, ECB, EU, ESM or EIB. This will eliminate the role of MMFs in providing financing for non-government securities on dealer balance sheets. However, given that financial market participants will continue to need financing for their securities collateral, it is likely that entities subject to less regulation than MMFs may fill the void if MMFs no longer are engaged in these repo transactions.

The Securities and Exchange Commission's (SEC) proposals out for consultation do not propose investment limitations for repo collateral.

Furthermore, we have concerns regarding restrictions on MMF investments in asset backed commercial paper, and believe the limits in Article 10 on asset-backed commercial paper (ABCP) will have broader and negative economic effects. We estimate that over 80% of underlying ABCP assets represent loans to businesses and consumers. The limitation would result in higher costs for end users and fewer loans to certain businesses.

AmCham EU would encourage more consideration to be given to the amendments made in the US to SEC Rule 2a-7 in 2010. Certain provisions in the 2010 amendment were useful in strengthening the resilience of MMFs, including the imposition of daily and weekly liquidity requirements, tightening of credit and diversification limitations and requirements of public portfolio holdings disclosure.

Enhanced disclosure

AmCham EU supports the Commission's proposals for enhanced disclosure to investors in Article 37. To ensure that investors clearly understand the underlying volatility in MMF investments, many fund sponsors in the industry have begun voluntarily disclosing the market-based NAV of the underlying investments. This information is very valuable and allows investors to compare the relative risks across MMFs, and should be required of all MMFs as part of any regulatory reform.

Credit ratings

The Commission proposes banning the solicitation of credit ratings by managers of MMFs in Article 23. A ban on the solicitation of credit ratings will set a dangerous precedent. No other piece of EU legislation has gone as far as to remove the right of market participants to ask for credit ratings. Moreover, such a prohibition would contradict the approach of the CRA3 Regulation (amending the EU CRA Regulation) [and the accompanying Directive amending the UCITS, AIFM and IORP Directives].

Rather than restricting the use of solicited ratings, a more appropriate policy approach would be to encourage a higher number of assessments on MMFs.

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AmCham EU considers it more appropriate to gradually remove regulatory mandates that require the use of credit ratings as set out in the Financial Stability Board's "Principles for reducing reliance on CRA ratings" of October 2010. These FSB principles also set out a balanced approach regarding the use of credit ratings in investment mandates and funds' investment rules.

Similarly, AmCham EU opposes the prescriptive requirements for how managers of MMFs would conduct internal ratings of securities in Article 17. This proposal overreaches into the credit analysis of MMF managers and is closer to prudential regulation associated with banks, rather than the capital markets regulation applicable to MMFs. Furthermore, it is not consistent with the approach taken in the CRA3 Directive which states that AIF and UCITS managers "*shall not solely or mechanistically rely on credit ratings issued by credit rating agencies*".

Constant NAV

CNAV MMFs serve a broad range of investors, and have a range of characteristics that make them useful cash and liquidity management vehicles, including daily liquidity, administrative efficiency in respect of tax (where interest is recognised as a dividend rather than a capital gain – as in VNAV), simplicity from the perspective of financial bookkeeping, professional credit risk management, fund-level credit ratings, competitive returns and sound governance.

AmCham supports the Commission's choice not to mandate conversion of CNAV MMFs to Variable Net Asset Value (VNAV) MMFs. However, the Commission proposal includes a capital buffer of 3% of total asset value for CNAV funds based on the assumption that CNAV MMFs are particularly susceptible to runs.

The objective of both CNAV and VNAV MMFs is to provide investors with security of capital and high levels of liquidity. They achieve that objective by investing in a portfolio of high quality, short maturity money market instruments.

AmCham EU stresses that the likelihood of investors redeeming is most impacted by the quality of the assets held by the fund and the levels of liquidity held, and not by the accounting procedure used. There is no material difference between the underlying assets and therefore no greater susceptibility to runs in CNAV MMFs as compared to VNAV MMFs. Therefore we do not believe a conversion from CNAV to VNAV MMF will prevent client redemptions in times of market stress.

We are, however, concerned that the proposed capital buffer for CNAV MMFs would challenge the economic viability of these funds. Bank-like capital requirements are inappropriate for MMFs, which are neither banks nor unregulated. They manage risks very differently from banks - MMFs are required to hold highly diverse and liquid portfolios designed to limit risk. MMF sponsors will establish a capital buffer only if, in comparison with other possible uses of their capital, they can earn a market determined rate of return appropriate to the risks taken. MMF managers have indicated that such use of capital is not economic and would call into question the future viability of CNAV MMFs in the EU. Because of the unique characteristics of CNAV funds, we do not believe that the current holdings of CNAV MMFs would automatically move to VNAV. Instead, investors are likely to look to bank deposits, and/or non-EU investment solutions, which would disrupt the crucial role these funds play in the European economy.

There is evidence that even some VNAV MMF in Europe had issues during 2007 and 2008 and faced substantial decreases in value over very short time periods.

In summary, a requirement for CNAV MMFs to float NAVs would fundamentally reshape the product and its ability to deliver these core benefits to investors, making MMFs less attractive to investors, many of whom may turn to other instruments to store their cash. One stated benefit of floating the NAV is to provide benefits of providing transparency of market values to investors; it should be noted that daily disclosure of the market-based NAV can accomplish the same benefit. Floating the NAV may also reduce the possibilities for transaction activity that result in non- equitable treatment across all shareholders; however, it will likely give rise to a number of consequences for investors and market participants that should be examined rigorously and addressed in order to arrive at a constructive solution.

Redemption gates

The European Commission has chosen not to propose redemption gates as a possible means to prevent runs on the fund. AmCham EU would like to stress that many funds in Europe already provide for a gate, whereby redemptions in excess of 10% of the NAV of the fund may be deferred. This is/has proven to be a very useful tool in slowing a run on a fund and should be considered by decision-makers.

Variable NAV

In addition to the above, AmCham would like to make the following points to ensure a better solution for VNAV funds.

First, we recommend that VNAV funds be permitted to use amortized cost accounting for assets with a remaining maturity of 60 days or less. Amortized cost accounting is typically the most accurate and fair methodology for ascertaining the value of short-dated instruments; it reduces unnecessary volatility, and removes the subjectivity inherent in the models used when marking to model.

Additionally, we recommend VNAV MMFs not be required to transact to four decimals. While we support requiring VNAV funds to disclose their NAV to four decimal points to provide transparency to the market and investors, transacting at this level will place VNAV MMFs at a disadvantage relative to other short duration UCITS products, which are not subject to this obligation.

We also recommend that consideration be given to tax and accounting standards, to ensure that VNAV MMFs can be considered as cash equivalents.

Finally, because a transition from CNAV to VNAV, including re-programming both shareholder and manager systems used to facilitate transactions for CNAV funds, will take considerable time and effort, we recommend that the European Commission allow a significant transition period – at least two years from the date that the new rules become effective – to implement these changes.

Conclusion

It is evident that there is no single "solution" to address regulatory concerns around MMFs. A combination of several measures as outlined in this paper, selectively applied and rigorously implemented, could significantly improve the resilience of these funds to ensure their continued value for investors, including AmCham EU member companies, and short-term market participants.

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AmCham EU speaks for American companies committed to Europe on trade, investment and competitiveness issues. It aims to ensure a growth-orientated business and investment climate in Europe. AmCham EU facilitates the resolution of transatlantic issues that impact business and plays a role in creating better understanding of EU and US positions on business matters. Aggregate US investment in Europe totalled €1.9 trillion in 2012 and directly supports more than 4.2 million jobs in Europe.

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