European Money Market Fund Reform

J.P. Morgan Global Liquidity

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J.P. Morgan Global Liquidity is committed to working with our clients to adapt to an ever-changing environment. Over the last several years we have engaged actively with policymakers on the EU's Money Market Funds Regulation, and have gained an extensive understanding of the incoming rules. Now, we look forward to working with clients to explore and understand their needs and requirements during the implementation phase, analysing investment options and providing insights and solutions under the new requirements. As a leader in the global liquidity business, we will continue to strive to meet investors' liquidity management needs in the same way we have historically – with a prudently managed portfolio of liquid, high-quality money market instruments. In the coming months, we plan to communicate with you more details about these new rules and their implications.

Executive summary

The detail of the *Regulation of the European Parliament and of the Council on Money Market Funds* has been approved by the key European policymaking bodies, the Ambassadors of the Council ("COREPER") and by the Economic and Monetary Affairs ("ECON") Committee in the European Parliament. While a legal and linguistic review of the text is still to occur, the detail of the Regulation has been set, which paves the way for final approval of the new rules during the first quarter of 2017.

The Regulation provides investors with a high degree of optionality for investing their short-term cash, providing for two types of money market funds ("MMFs"):

- Short-term MMFs
- Standard MMFs

In addition, three structural options:

- Public debt constant NAV ("CNAV") MMFs
- Low volatility NAV ("LVNAV") MMFs
- Variable NAV ("VNAV") MMFs

Implementation period

Following the final adoption of the Regulation, there will be an 18-month period of implementation for existing MMFs; this is measured from the date of its publication in the Official Journal, which is likely to occur in the first quarter of 2017.

As a result, **the approved changes are not anticipated to have an immediate impact to the operation of our money market funds.** We expect the Regulation to become effective in the second half of 2018.

Optionality for investors

The Regulation allows for the development of a number of types of MMFs, giving a range of choices for investors.

MMFs must be classified as either a Short-term MMF or a Standard MMF. **Short-term MMFs** are funds that maintain the existing conservative investment restrictions currently provided under the ESMA[1] Short-Term Money Market Fund definition, including a maximum WAM[2] of 60 days and maximum WAL[3] of 120 days, while **Standard MMFs** reflect the existing ESMA Money Market Fund definition, including a maximum WAM of 6 months and maximum WAL of one year.

MMFs may be structured as a public debt CNAV MMF, an LVNAV MMF or a VNAV MMF:

- **Public debt CNAV MMFs** must invest 99.5% of their assets into government debt instruments, reverse repos collateralised with government debt, cash, and are permitted to maintain a constant dealing NAV.
- **LVNAV MMFs** are permitted to maintain a constant dealing NAV provided that certain criteria are met, including that the market NAV of the fund does not deviate from the dealing NAV by more than 20 basis points.
- **VNAV MMFs** price their assets using market pricing and therefore offer a fluctuating dealing NAV.

[1] European Securities and Markets Authority

[2] Weighted average maturity

[3] Weighted average life

Overview of MMF options

	SHORT-TERM MMF			STANDARD MMF
	Public debt CNAV	**LVNAV**	**VNAV**	**VNAV**
WAM (max)	60 days	60 days	60 days	6 months
WAL (max)	120 days	120 days	120 days	12 months
Maturity (max)	397 days	397 days	397 days	2 years, with 397 days reset
Daily liquid assets (min)	10%	10%	7.5%	7.5%
Weekly liquid assets (min)	30%	30%	15%	15%

Source: J.P. Morgan Asset Management, Proposal for a regulation of the European Parliament and of the Council of Money Market Funds, as at 30 November 2016.

Liquidity fees and redemption gates

Similar to existing rules and practices in Europe, the text provides for the use of liquidity gates and redemption fees to protect public debt CNAVs and LVNAVs in times of stress. Under the new rules, the application of a fee/gate would be optional if weekly liquidity falls below 30% and net redemptions from the fund exceed 10% in one day, while if weekly liquidity falls below 10%, some form of action (either a gate or a fee) would be mandatory.

Portfolio diversification and transparency

The new rules strengthen requirements for portfolio diversification and transparency for all money market funds, providing for weekly disclosure of portfolio information and formalising reporting to regulators.

Credit analysis and stress testing

The Regulation contains 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.

Fund ratings

An earlier proposal to ban MMFs from soliciting an external fund rating has been abolished. Going forwards, MMFs may continue to carry external fund ratings, and the manager must disclose in the prospectus and marketing materials that the rating has been solicited or paid for by the manager.

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 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 positive steps for the industry's ability to manage potential MMF risks.

VNAV MMF best practices

The Regulation provides for two types of VNAV MMFs - short-term VNAV MMFs and standard VNAV MMFs, with each fund type having different investment guidelines, as shown in the above table. Within these two MMF types, we see the potential for further differentiation of products, as managers may choose to provide a more conservative, more prudently-managed VNAV MMF than has traditionally been offered in Europe, focusing on the key attributes that have distinguished responsible MMF management, such as:

- Using recognised independent pricing sources rather than portfolio manager driven "internal models" to price assets in the MMF
- Achieving liquidity in MMF portfolios by investing in genuinely liquid instruments such as government paper, short-dated deposits and overnight reverse repurchase agreements with a diversified set of counterparties, as opposed to deriving liquidity through the use of leverage
- Avoiding cross investment into other less liquid MMFs

NEXT STEPS

For further information, please contact your J.P. Morgan Global Liquidity Client Adviser or Client Services Representative at:
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