CFA Institute

Rue du Champ de Mars, 23
1050 Brussels
Belgium

+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

13 May 2022

DG Directorate-General for Financial Stability,
Financial Services and Capital Markets Union
European Commission
2, Rue de Spa
1000 Brussels, Belgium

European Securities and Markets Authority
201-203, Rue de Bercy
75012 Paris, France

Subject : Comment letter on European Commission Consultation Document – Targeted Consultation on the Functioning of the Money Market Fund Regulation, and on ESMA opinion on the review of the Money Market Fund Regulation

Dear Mr Berrigan and Ms Ross,

CFA Institute[1] appreciates the opportunity to comment on the European Commission Consultation on the Functioning of the Money Market Fund Regulation (MMFR or the Regulation and the European Securities and Markets Authority ("ESMA" or the "Authority") regarding its proposed reforms to the MMFR). The purpose of these proposed reforms is to enhance "the resilience of the E.U. MMF industry as well as underlying money markets."[2] We have constructed this response so that it can also serve as a comment letter to the European Commission's ongoing consultation on the functioning of the money market fund regulation[3].

As a global organization with more than 180,000 investment professionals as members spread across 160 markets, CFA Institute advocate for consistent rules on a global basis. We do this to prevent creating advantages or disadvantages for members who function in any single market, region, or sector of the global financial market system. When considering the regulation of money market funds (the "Funds"),

[1] CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow. There are more than 180,000 CFA® charterholders worldwide in more than 160 markets. CFA Institute has nine offices worldwide and there are 160 local societies. For more information, visit www.cfainstitute.org or follow us on LinkedIn and Twitter at @CFAInstitute.

[2] Sec. 2, paragraph 3, Final Report: ESMA opinion on the review of the Money Market Fund Regulation.

[3] European Commission, Consultation Document: Functioning of the Money Market Fund Regulation, April 2022

Rue du Champ de Mars, 23
1050 Brussels
Belgium
+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

CFA Institute seeks to find solutions, developed with guidance from our members, that are appropriate regardless of domicile, sector, or role.

Key to meeting this objective is the consistent application of principles inherent in our Code of Ethics and Standards of Professional Conduct. Consequently, we will present positions on regulatory matters in the European Union as consistently as possible with positions taken on similar matters in other markets. Regarding the regulation of money market funds, we can look to positions presented over the years to ESMA as well as those presented to the U.S. Securities and Exchange Commission ("SEC"), the International Organization of Securities Commissioners, and the Financial Stability Board.

In mid-April, CFA Institute responded to SEC proposals to change money market fund regulation in the United States, which covered many of the issues ESMA raised in its Final Report on MMFR[4]. The positions we advocate in this letter will where relevant and possible, recommend positions consistent with and similar to positions advocated in our response to the SEC. At the same time, we recognize that regulatory authorities and market participants may approach supervision in their markets differently. Where the approaches to regulation and practice differ, we will advocate for positions that are as consistent as possible with those advocated in other markets while most applicable in the specific market-seeking comment.

Background on Money Market Fund Regulation

The Regulation, as implemented in 2018, established a uniform regulatory structure for the European money market fund industry (the "Industry") applicable in all Member States. The Regulation sought to remedy weaknesses not just in the Industry but also in the money market that arose in the 2008 financial crisis. Specifically, it sought to remedy the potential for mass redemptions from the Industry due to concerns about funds' asset quality. The Industry's problems became systemic at that time because their unique problems exacerbated mortgage-loan problems that had developed within commercial and investment banks, investment funds, insurance companies, and, at least in the United States, government-sponsored enterprises. The concentration and deterioration of credit quality that began in U.S. financial institutions quickly spread globally, ultimately affecting financial institutions and markets in the European Union, among nearly every other major financial market globally. Concerns over credit quality because so elevated that even parties to interbank overnight lending were unable to discern the magnitude of their counterparties' exposures to toxic assets, a situation that ultimately required central-bank intervention to remedy.

The situation faced in March 2020 replayed in part the 2008 crisis while introducing an entirely different cause. As in 2008, institutional investors in 2020 were the primary culprit for trouble by seeking *en masse* to redeem interests in money market funds that bore any risk beyond that of sovereign securities issuers. Unlike 2008, however, the antecedent for this run on money market funds was the near-universal decision by government institutions globally to temporarily shutter commerce to slow the spread and lethality of the Covid-19 virus. A consequence of these decisions was a flight to quality by institutional investors seeking easily saleable money market instruments, leading to a rise in yields and a decline in prices for non-government securities.

[4] Final Report: ESMA opinion on the review of the Money Market Fund Regulation.

CFA Institute

Rue du Champ de Mars, 23
1050 Brussels
Belgium

+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

It is not certain when or in what circumstances the Industry would have faced mass redemptions of the sort without the commercial shutdowns implemented in March 2020. Regardless, the circumstances endured did highlight several weaknesses that ESMA now seeks to remedy. We will discuss these in our discussion below.

Suggested Policy Proposals for Updating the MMFR

A.1. Threshold Effects

In the shortlist of recommended changes proposed in the final report on the review of the Regulation[5] (the "Final Report"), ESMA included two proposals relating to so-called "threshold effects." The first seeks to end the use of amortised costs for low-volatility net asset value funds, or LVNAV funds. The second would decouple regulatory thresholds from implied or mandated imposition of redemption suspensions or redemption gates for both LVNAV and constant NAV funds ("CNAVs"). We discuss each in turn.

A.1.1. Amortised-Cost Valuation of LVNAV Funds. The only distinction made for individual or retail investors in the Regulation is provided in discussions relating to employee savings schemes in Article 16. Otherwise, MMFR does not differentiate between natural-person investors and institutions that invest available cash on a short-term basis with a Fund. Nor does it appear that neither market participants nor observers make such distinctions. It is further implied that the primary investors in Funds are institutional investors. Even if this is not the case, the regulatory structure of the Industry is such that the two are seemingly blended.

This approach is different in substance from the money market fund market in the United States where both regulation and practice of investment management focus on the type of customer served. The distinction has proved valuable in the prudential oversight of the nation's money market funds. In particular, the two types of money market investors have behaved in entirely different fashions to the market turmoils experienced in both 2008 and 2020.

One such difference is that while some individual money market fund investors moved to redeem their fund interests in both market crises, in neither case did such investors redeem *en masse* in the same manner that institutional investors did in both cases. In 2020, for example, total individual investor redemptions during the week ending 20 March 2020 amounted to just 4.8%. By comparison, overall institutional prime fund redemptions were 20.1%, more than four times greater than those for retail prime funds over the same period. Even when reviewing redemptions from funds where Weekly Liquid Assets ("WLA") had fallen below 36% (the regulatory threshold at the time was 30%), retail investor redemptions were 8.8%, versus 27.5% for institutional redemptions from funds under similar stress.

The significant differences in the urgency of redemptions for the two types of investors have affected how each is regulated. Because institutions' urgency to redeem is borne of their need for access to their funds to meet debt, tax, payroll, and supplier obligations, among others, regulations adopted in the wake of the 2008 financial crisis limited institutions' investment options to either VNAV funds with a wider spectrum of private-sector and tax-exempt money market instruments, or CNAV government funds, where portfolios are restricted similarly to CNAV public debt funds in the European Union.

---

[5] Final Report: ESMA opinion on the review of the Money Market Fund Regulation.

CFA Institute

Rue du Champ de Mars, 23
1050 Brussels
Belgium

+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

Given the lack of distinction between individual and institutional investors in the European Union, it is thus prudent to restrict the use of anything resembling a CNAV fund structure only to funds limited to investing almost exclusively – at least 95% of their portfolios – in public debt instruments. It is our view that the consequence of the blending of institutional and natural-person investors in terms of amendments to the Regulation is that LVNAV funds should not be permitted to value their portfolio holdings based on amortised cost.

<u>A.1.2. Decoupling of Regulatory Thresholds from Suspensions and Gates.</u> We further support ESMA's proposal to amend MMFR to decouple its Article 24 liquidity minimum thresholds for LVNAV and CNAV instruments from the potential imposition of suspensions and gates. To reinforce the wisdom of these amendments, one can look at how SEC regulations for U.S.-based money market funds before the 2020 crisis contained similar provisions. While the rules gave full discretion for implementation of redemption gates or fees to the investment manager, and while none took advantage of the tools – only one fund was reported to have breached the 30% WLA threshold but did not use either tool – institutional investors saw their potential imposition as too great a risk to take and set about redeeming their shares.

These perspectives were highlighted in two proximate and highly revealing footnotes in the SEC's proposal. One described how a large percentage of treasury managers surveyed by a broker indicated concern over the potential use of "redemption hurdles" were an important factor in deciding to redeem.[6] In the other footnote, the SEC noted how both the Investment Company Institute and another manager indicated their prime institutional clients were more concerned with access to their funds than "losing a few pennies" paying for dilution costs.[7]

While these comments to U.S.-based firms regarding their redemption decisions appear to echo those of other respondents to the SEC's queries, it remains to be seen whether decoupling in the U.S. or the E.U. will largely alleviate institutional investors' proclivity for future runs. Nevertheless, eliminating the coupling of liquidity breaches with barriers to redemptions does have promise given the indications of primary concern about access among U.S. institutional investors. That promise was an important reason we advocated for a smaller increase in WLA and daily liquid asset ("DLA") thresholds than the SEC proposed.

A.2. Addressing Liquidity

As is the case with all other types of financial institutions, liquidity is imperative if Funds are to meet the redemption needs of their investors. This is particularly curious given the relative liquidity of the instruments in which Funds invest their clients' money. Generally speaking, the weighted-average life ("WAL") of a short-term money market fund is limited under the Regulation to 120 days, while its weighted-average maturity ("WAM") is 60 days.

---

[6]See footnote 73 on p. 29. See the cited comment from Federated Hermes Inc., that 87% of treasury managers surveyed who had reduced their prime money fund investments in March 2020 "mentioned the potential of 'redemption hurdles' as a factor in" deciding to redeem their shares.
[7] See footnote 75, also on p. 29. Responses from both Invesco and the Investment Company Institute indicate institutional prime investors were more worried about access to their money than about "losing a few pennies."

CFA Institute
Rue du Champ de Mars, 23
1050 Brussels
Belgium
+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

In this category of proposed amendments, ESMA's recommendations begin by seeking to require Funds to maintain at least one liquidity management tool ("LMT") to be available for managers to use if circumstances warrant. LMTs include i) swing pricing, which adjusts a Fund's NAV to account for purchase or sales costs of the fund; (ii) anti-dilutive levies ("ADL") – allocation of similar liquidity costs as swing pricing, but imposed as entry and exit charges of the fund, imposed outside of the fund's NAV; and (iii) redemption fees implemented as an adjustment of the exit charges of the fund, also imposed outside the NAV. The second proposed change is to WLA and DLA for LVNAV and VNAV, together with what constitutes WLA and DLA. The third proposal is the temporary use of liquidity buffers.

<u>A.2.1. LMTs.</u> The recommendations suggest that LMTs help reduce redemption requests in stressed markets by ensuring they can quickly implement one of three types of LMTs noted above. It is the view of CFA Institute that if this happens, it will occur because the perceived possibility and likelihood for gates in stressed markets has been removed, not because an LMT will pass along a couple of pennies of cost to a redeeming investor.

We see very little economic difference in any of these LMTs. All three reduce the net proceeds an investor will receive upon redemption in stressed markets. One - swing-pricing - is complicated and likely to add overhead costs, time pressures, and difficulty to the operation of a fund just as it is under a barrage from investors trying to redeem. Anti-dilutive levies would calculate a fee similar to the costs netted from the NAV in swing pricing but would do so as a fee that doesn't directly reduce a fund's NAV. Redemption fees would attempt to recreate liquidity costs that would be applied as an additional charge to existing exit fees for such funds.

Whether or not any of these cover the true cost of liquidation in fire-sale conditions they do at least attempt to mitigate the reduced NAV left for remaining shareowners by mass redemptions. While we do not foresee LMTs discouraging investors from seeking redemptions, imposition of LMTs will nevertheless mitigate the dilution mass redemptions have created for remaining investors in the past. Consequently, we support this proposed revision to the Regulation.

We also support the proposal to leave determination for when and how to apply LMTs to fund managers to avoid the potential for unintended consequences arising from a universal application of LMTs by one or more national authorities.

We also agree with the mandate for adoption and implementation of detailed policies and procedures to address the activation and deactivation of chosen LMT, together with the operational and administrative arrangements for use of the tool. The more systems and structures in place before the stress of a market in turmoil, the better the fund/firm will emerge *ex-post*. Likewise, descriptions of the tool and conditions for its use in fund rules or instruments of incorporation, as well as in the fund's prospectus will help investors understand the processes the fund will implement in market turmoil. The better prepared a fund is shown to be through such disclosures, the less restive investors are likely to be at the outbreak of turmoil.

On the matter of a delegated act "specifying the circumstances under which these LMTs shall be used," we are concerned the circumstances the delegated act would specify might fall into the category ESMA noted as potentially too soon, too late, or disproportionate. We believe a better approach would be to specify the circumstances in which the chosen LMTs cannot be used, such as fund-specific events that are unrelated to broader, system-wide functioning.

<u>A.2.2. Changes to WLA and DLA for VNAV and LVNAV funds.</u> In our letter to the SEC, we advocated against the proposed 150% increase in DLA, to 25% from 10%, and proposed 60% increase in WLA to 50% from

CFA Institute

Rue du Champ de Mars, 23
1050 Brussels
Belgium

+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

30%. Beyond the unique circumstances that created the March 2020 event, we reasoned that the elimination of the threat of gates in the SEC's Rule 2a-7 would likely alleviate much of the incentive for institutional investors to redeem at the first hint of difficulty. At the same time, we argued that the significant increases in required liquidity buffers would a) reduce yields on money fund instruments; b) encourage investors to look elsewhere to temporarily invest free cash; both of which might lead to c) a reduction of investment capital devoted to productive economic activities of private companies. We also note the potential that alternative venues for institutions to invest their free cash might operate without the regulation of the type that currently protects money market fund investors and the financial system. We've seen this happen in loan markets in the wake of regulatory structures erected in response to the financial crisis of 2008. To avoid such unintended consequences while testing the need for liquidity increases, we argued for smaller increases in DLA and WLA, to 15% and 35%, respectively. If it were determined later that these liquidity levels were insufficient, we suggest the SEC could raise the minimums then.

We also warn against complacency on VNAV funds, including the low liquidity mandates for such funds. As noted above, the impetus to redeem is often borne of a need for access to funds, not a concern about NAV, as indicated by U.S. investors after the turmoil experienced in March 2020. Just because the NAV is variable does not mean the urge for redemption is diminished. The experience in the United States over this same period was most pronounced in variable NAV prime institutional fund products, where redemptions topped 20% during one week alone. The SEC found that banning non-government stable NAV products for institutional investors in favor of variable NAV products did not prevent these investors' urgency for redemption a dozen years later under different circumstances.

Finally, we not only discourage increasing the mandated holdings of public sector debt securities, but we also recommend ESMA take steps to help build demand for instruments that heretofore have lacked secondary market liquidity. Specifically, we recommend that ESMA adopt rules to permit government funds to increase holdings of commercial paper with rankings in the highest category and with maturities within seven days. We also recommend increasing the amount of commercial paper of issuers with ratings in the highest category and with remaining maturities of no more than 14 days to be included in WLA measures. We believe including these instruments in these liquidity structures would increase the demand for such paper, including in times of market stress, in the primary and secondary markets. Such a provision would have the further benefit of enhancing the short-term funding market for private firms, albeit directly only for those with the highest ratings. Nevertheless, such a rule would increase the flow of capital to the productive side of the economy.

<u>A.2.3. Temporary Use of Liquidity Buffers.</u> We fully support the recommendation to make liquidity buffers available for Funds to use to meet redemptions in periods of market stress. We believe this is an appropriate use for such investments.

<u>B. Complementary/crisis preparedness reforms</u>

The reforms listed in this section of the recommendations are expressly "aimed at enhancing" Industry "resilience as a whole." We consider each of the specific recommendations below.

<u>B.1. Enhanced Fund Reporting Requirements.</u> ESMA recommends enhancing and harmonizing crisis-specific data-sharing to give regulatory and prudential authority greater awareness and understanding of

CFA Institute

Rue du Champ de Mars, 23
1050 Brussels
Belgium

+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

risks that might be developing within the Industry. This, in turn, would enable authorities to introduce more targeted policies to mitigate damage to money markets and the financial system, in general.

Among the data proposed for collection and delivery to competent authority would be left to a delegated act, but would likely include information concerning total assets, NAVs, liquidity levels, daily and weekly maturing assets, investment inflows and outflows, and Fund investors, including Fund managers. Beyond these fund data, ESMA also recommends collection of information on money market instruments and their markets, average interest rates per issuer category, maturities, ratings, and post-trade data such as volume and price.

We see the need for collection and reporting of such information to the competent authorities, and for the competent authorities to share this information with ESMA and with complementary institutions in the European Union. We support the standardization of the information suggested for collection, as well. Our only recommendation is to make this information available to investors, as well. If there is any delay in this type of disclosure to investors to enable competent authorities time to digest the data and develop policy actions when needed, we believe it should be short-lived, lasting no more than a business day.

B.2. Enhancement of Stress-Testing Regime. We generally support the proposed amendments to the Regulation for stress-testing, though our trust in such scenario-testing activities is limited given the difficulty to imagine what types of market stresses might appear in the future. Nevertheless, such practices are appropriate to actively prepare for market turmoil.

B.3. Clarification of Requirements on External Support. The Regulation's Article 35 expressly prohibits external support, including:

a) cash injections from a third party;
b) purchase by a third party of a fund's assets at an inflated price;
c) purchase by a third party of a fund's units or shares to provide liquidity for the fund;
d) any kind of third-party guarantee, warranty, or letter in support of a fund;
e) any action by a third party to maintain a fund's liquidity profile and NAV per unit or share.

We understand the need for most of these prohibitions. Guarantees, for example, may send a signal to investors that a fund or type of fund will maintain a stable NAV which could enhance the risk of an investor run in stressed markets. Cash injections or share purchases, on the other hand, are not market-based transactions.

We do believe a fund sponsor's purchase of an affiliated fund's select assets can be beneficial. However, because Article 35(2)(b) does not define what is an inflated price, it is likely fund sponsors will refrain from providing such support for fear of violating the rule's intent which are largely based on events in past crises.

During the 2008 financial crisis, in particular, the purchase of asset-backed securities or asset-backed commercial paper at amortised cost might rightly have been seen as occurring at an inflated price. Such assets were a key contributor to the crisis and were therefore out of favor because many investors feared such instruments' creditworthiness. The circumstances that befell money markets in March 2020, however, were not due to the credit impairment of a specific type of instrument as in 2008 but by the uncertainty created by a market-wide shutdown mandated on a near-universal basis by governments globally.

Rue du Champ de Mars, 23
1050 Brussels
Belgium
+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

It is also true that sponsor support of money market funds can have systemic implications by giving investors a false impression that there is a pool of funding available for Funds to tap when a fund has difficulties. We believe ESMA could prudently permit sponsor support by providing guidelines on what constitutes an inflated price.

For example, Article 35's limitations should apply where a fund pays par to acquire long-dated and poorly rated securities from an affiliated fund in a rising interest rate environment. Among the factors that would lead to violation of Article 35(2)(b) in this case are the instrument's term to maturity, its higher default risk as indicated by its lower credit rating, and the negative effect on price from rising interest rates.

Conversely, a sponsor should be able to pay amortised cost to an affiliated money market fund for highly rated commercial paper that is scheduled to mature in 30 to 45 days. In this case, the relevant factors for determining whether the price is inflated are principally its credit rating and its limited term to maturity. Even though interest rates may be rising, a price equal to amortised cost would still be appropriate given that the limited remaining life will limit the effect of interest rate changes.

This kind of acquisition would already benefit from regulatory changes made since 2008 to limit money market funds' portfolio concentrations and restrict holdings of longer-dated and lower-rated securities. The higher-quality portfolios of commercial paper and/or government securities these regulatory changes have produced have already reduced the default risk from any one instrument, as well as lowering the risk that an accumulation of holdings in one issuer or one type of instrument could put a fund in jeopardy of failure. Paying amortised cost, therefore, would not reflect an inflated price per Article 35(b)(2). Nor would it put the sponsor's financial condition at risk because the instrument will pay in full in a few days or weeks. On the other hand, the support would provide a legitimate buyer for the commercial paper and a source of cash for a fund facing larger-than-expected redemptions.

SEC rules permit U.S. money market funds to receive support from fund sponsors with limited restrictions. Its latest proposal even considered making such support mandatory. We did not address this issue in our letter because the SEC had already rejected the idea. In the past, however, we have seen sponsor support as an important investor protection,[8] and such support helped a few funds avoid breaching liquidity thresholds in 2020, stemming portfolio deterioration, NAV dilution, and a potential market meltdown.

The prospect for sponsor support, therefore, combined with elimination of the threat of gates when WLA approaches minimum thresholds and the availability of WLA and DLA funds to address redemption requests should provide funds with sufficient tools and means to manage large redemptions.

<u>B.4. New Disclosure Requirements on Money Market Fund Ratings.</u> In the Final Report, ESMA indicates three important concerns relating to money market fund ratings.

First, they note the methodologies used may limit a manager's flexibility in dealing with large redemption volumes. A fund might face a downgrade depending on whether to use its LMT options described above.

---

[8] Page 4 of CFA Institute letter to U.S. Securities and Exchange Commission, 19 September 2013: "...the willingness of sponsors to support the funds in times of stress is an important investor protection, though we would prefer a structure whereby the funds and/or their sponsors provide a capital support structure that wouldn't rely upon sponsor discretion." See: https://www.cfainstitute.org/-/media/documents/comment-letter/2010-2014/20130919.pdf.

CFA Institute

Rue du Champ de Mars, 23
1050 Brussels
Belgium

+32 (0) 2207 12 10 tel
info@cfainstitute.org
www.cfainstitute.org

Second, it notes that money market fund ratings do not analyse the credit risk of a fund. Rather, it considers a Fund's ability to preserve capital and maintain liquidity. Consequently, the CRA Regulation does not regulate these ratings.

Finally, the recommendation notes the required disclosure already included in Article 26 mandating that Funds communicate that they solicited or financed the rating. The implied disclosure is important in that it reminds investors of the conflicts of interest inherent in ratings of this type.

There were no complementary new disclosure recommendations or disclosures included in the SEC's proposal. In Part C of the Monthly Schedule of Portfolio Holdings of Money Market Funds, the SEC already mandates disclosure of security ratings considered for investments.

Regardless of the differences in current changes, we support ESMA's proposal to clarify and enhance disclosures relating to money market fund ratings as providing useful supplemental information for the benefit of investors in those funds.

* * * * *

Should you have any question or have a further discussion concerning our views on the review of the MMFR, please do not hesitate to contact Olivier Fines at Olivier.Fines@cfainstitute.org or Josina Kamerling at Josina.Kamerling@cfainstitute.org.

Olivier Fines, CFA

Head, Advocacy, EMEA

CFA Institute

Josina Kamerling

Head, Regulatory Outreach, EMEA

CFA Institute