Frankfurt am Main,
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BVI´s preliminary position on the Draft Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds

BVI[1] welcomes the initiative by the European Commission to create a European legal framework for all money market funds (MMF). Given the declining credit availability from banks, MMF should play a more important role in short term financing of public and private institutions as well as provide investment opportunities for both retail and institutional investors. Our members offer MMF in Germany since 1993. However, since the beginning of the financial market crisis and in particular since the then CESR and now "ESMA Guidelines on a Common Definition of European Money Market Funds", the sector has shrunk from a high of over 108 billion EUR in AuM in July 2007 to currently about 10 billion EUR in April 2013.

While we recognize that a European legal framework may help to improve stability and transparency of the product, we fear that the plans for further regulation will make the offering of MMF economically unattractive in the current yield environment. This will lead to further consolidation and less choice for investors. We believe that the existing regulatory framework for MMF, namely the UCITS directive and the ESMA MMF guidelines, already provide a balanced and sufficient level of investor protection. Against this background we have analyzed the regulatory proposals. We see considerable room for improvement and would welcome if our suggestions could be taken into consideration before the proposals are made public. In particular we urge the Commission

- to implement a robust internal credit assessment process which builds on the existing framework and which is workable in practice, and

- to base the regulation in principle on the time tested eligible assets, diversification, and valuation rules provided for by the UCITS framework.

Specific comments:

Article 2: Scope

The definition of MMF exceeds the current definition of the ESMA Guidelines on MMF. The Proposal should be limited to the definition under which only MMF that wish to carry the "label" MMF are subject to specific regulatory requirements. This means that funds such as short-term-bond funds, total return funds or absolute return funds which invest in money market instruments, deposits or enter into reverse repos and have the objective of offering returns in line with money market rates and/or of preserving the value of the investment but do not label themselves as "MMF", should not be subject to the Proposal. From the perspective of investor protection there is no reason to include these types of funds in the Proposal.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 78 members currently handle assets of EUR 2.0 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programmes support students and citizens to improve their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households.
(BVI's ID number in the EU register of interest representatives is 96816064173-47). For more information, please visit www.bvi.de.

Article 3: Definitions

The CESR/ESMA definition of the European money market funds distinguishing “short-term MMF” and “MMF” should not be changed. This definition makes sufficiently clear that the universe of “MMF” includes short-term MMF as short-term MMF have to comply with some stricter rules than MMF. There is no need to rename MMF especially from a systemic risk perspective since investors are very well accustomed to this definition and perfectly aware of their respective characteristics.

Article 5: Applicable rules

We have strong reservations against the presumption that the manager of a MMF should be automatically and presumably strictly liable for any loss or damage resulting from non-compliance with the proposed regulation. The question of responsibility should be settled in court in full compliance with the provisions of civil law. This is the standard practice accepted for UCITS.

Article 7: Eligible assets

The Proposal narrows the eligibility of assets for MMF to a substantial extent. It limits the flexibility of the fund manager on the investment side to meet investors´ needs as well as his flexibility in terms of risk and liquidity management.

In detail:

Units/shares of MMF as eligible assets (Article 7.2 (a))

There is no valid reason to prohibit units/shares of MMF as eligible assets. The omission of units/shares of other MMF as eligible assets would prevent using master/feeder structures which allow managers to optimize the operation of funds across jurisdictions and diversify liquidity risks. Widening the scope of eligible assets to MMF (including extended maturity MMF) would give fund managers more flexibility on the investment side without reducing rigorousness in terms of measurement and management of the associated risks. This added flexibility wouldn’t reduce the high quality standards designed to protect investors; on the contrary, it would provide fund managers with more tools to meet the investors’ needs.

Short term notes/bonds

For reasons of clarification it should be explicitly stated that short term maturing notes/bonds are eligible.

Exclusion of repurchase agreements (Article 7.2 (d))

MMF shall be prohibited from entering into repurchase agreements. Instead of excluding this type of assets completely, we suggest that the possibility remains open for a limited percentage of the fund (ex 10%) due to the importance of repos in efficient liquidity management.

Exclusion of ABCP (Article 7.2 (e))

MMF shall be prohibited from investing into securitization vehicles, including any exposure to asset backed commercial papers. This rule is not consistent with the actions taken by the ECB, the Commission itself and some jurisdictions seeking to revive the dis-intermediated financing of SMEs. These products are instruments of diversification that indirectly help to refinance the real economy.

Whilst certain types of ABCP did have problems during the crisis, the vast majority performed well because of the conservative way in which they were structured, in particular in terms of risk dispersion.

An indicator for the high regard in which a large proportion of the ABCP market was held was the fact that during the crisis the U.S. Fed accepted ABCP as non-recourse collateral for loans to banks which purchased it from MMFs. Against this background, we think that it would be more appropriate to limit ABCP to products that meet certain criteria in terms of their asset type, credit enhancement and liquidity support.

Prohibition of borrowing (Article 7.2 (f))

According to the Proposal, MMF shall be prohibited from borrowing cash. Instead, MMF should be allowed to borrow up to 10% of their assets, as long as these are temporary borrowings and not used for investment purposes. This possibility which applies to UCITS can be considered as a first line of action to allow MMFs to cope with larger-than-expected withdrawals. Prohibiting this possibility would go completely against the goal of enhancing financial strength of MMF.

Role for ESMA

We strongly believe that the Regulation should give ESMA the right to authorize other types of financial assets in the future to allow the Regulation to evolve with changing market conditions.

Article 9: Eligible deposits with credit institutions

The rule that deposits should be repayable on demand is too restrictive since time deposits may in general not be withdrawn at any time. This rule would prohibit MMF from investing in time deposits which runs counter to the stated objective of post-crisis bank regulation to extend the average maturity of banks' funding. It would force MMF towards overnight deposits with lower returns, which would increase the risk of negative returns for investors, given the currently very low interest rates. MMF would be abandoned as an important vehicle of short-term financing for states, financials and non-financials. This approach is also justified by the fact that liquidity requirements should be defined at the level of the fund as a whole, not through additional maturity requirements on specific instruments such as deposits.

Article 11: Eligible reverse repurchase agreements

The MMF shall only enter into reverse repurchase agreements provided that certain conditions are fulfilled.

The MMF shall have the right to terminate the agreement at any time upon notice of maximum 48 hours. This requirement is not workable. It will lead many MMF to stop entering into reverse repos as there will not be any counterparty accepting this requirement because of the liquidity risk. MMF would no longer be used as a source of liquidity in the market and an essential source of return for MMF would be eliminated. Furthermore, this restriction also runs counter to the stated objective of post-crisis bank regulation to extend the average maturity of banks' funding in case of banks as counter-parties.

The assets received by a MMF as part of a reverse repurchase agreement shall be only market instruments compliant with the Proposal. From our point of view collateral to be received by the MMF should not be exclusively MMI. Collateral is only a source of secondary recourse and in case of default will not be transferred to the fund portfolio, but immediately sold. The exchange of cash and cash equivalents makes no sense economically.

The collateral shall have a residual maturity not exceeding 397 days for MMF or 2 years for Extended MMF which is a real problem because the universe of eligible asset is considerably reduced. As an important risk-mitigating technique and cash management tool, reverse repos are a critical component of liquidity management, especially in light of the new portfolio liquidity requirements in the Proposal, and are acutely important for government MMF which cannot use bank deposits as an alternative hedging instrument.

It is certainly less risky for a MMF to have high quality collateral, of whatever maturity, than placing money unsecured. In the extreme circumstance of the repo counterparty failing to repay the cash, it is in the nature of the collateral to be able to be liquidated very readily – the intention would be not to continue running the fund by holding long maturity assets.

We believe that collateralized lending, and particularly lending backed by high quality government collateral, would give investors added comfort to continue to lend to banks for a longer period of time than lending on an unsecured basis.

The assets received by MMF as part of a reverse repurchase agreement shall be included for the purpose of calculating the limits on diversification and concentration. In this respect, we think that UCITS calculation rules should apply. More specifically, the collateral should not be commingled with the assets held in the portfolio for the diversification ratios calculation. Indeed, the diversification rules for the collateral should remain separate from the ratios applying to the assets held in portfolio.

Article 12: Diversification

The Proposal sets diversification rules exceeding the well-functioning investment limits of the UCITS Directive. The proposed tighter diversification rules will have unintended consequences for the financing of the economy in general and credit institutions in particular. Therefore, the Proposal should be in line with the provisions of the UCITS-D (5-10-40% and 20% for cash deposits).

The same applies in terms of OTC counterparty risk. There is no need to go beyond the rules of the UCITS Directive. An aggregated risk exposure not exceeding 5% results in high adjustment cost depending on market volatilities, especially for funds with high currency exposure. Permanent adjustments of forwards and counterparties would be the consequence.

Art. 13: Concentration

MMF may not hold more than 10% of the money market instruments issued by a single body. We deem this requirement quite problematic. A 10% limit seems basically acceptable, but the limit should instead be related to the total bond issuance of an issuer and not only to the MMI issuance. It is impossible to calculate the outstanding MMI of an issuer whereas the total bond issuance easily can be identified e.g. via Bloomberg.

Article 14: Credit quality of money market instruments

Structure of the internal rating system

In our view, MMF managers should employ a risk management process which enables them to monitor and assess the credit quality of the money market instruments they invest in, within a framework that should acknowledge long standing practices proven over time to be highly effective.

We have therefore serious reservations regarding (i) the proposed seven-grade rating system that should be established by each MMF manager and (ii) the proposal that ESMA should develop regulatory technical standards regarding the quantification of the default risk of an issuer: following such an approach would effectively commoditize the results of the internal procedures, potentially increasing concentrated market moves and systemic risks.

Many asset management companies have established their own issuer review processes that are used by all investment platforms within the same company. It would be quite costly to have a team of analysts - different from persons performing or responsible for the portfolio management - specifically dedicated to MMF or using various scoring models, for example the manager of a MMF replicates what CRAs are already doing, albeit with much more limited resources. The implementation of the proposed internal rating system would lead to high costs in terms of databases, tools, reporting, methodologies, staff, and internal organization, and therefore would reduce the investor's expected return.

Additionally, the governance requirement may unintentionally subject the regulator to potential liability if the Proposal's mandatory credit assessment process fails to adequately protect MMF and their investors from a credit default event.

If passed as currently drafted, we strongly consider that the Proposal would encourage many MMF managers to exit the business.

In summary, the proposed requirements are disproportionate to the asset class in which MMF are allowed to invest, as the default risk of money market instruments is close to zero. Consequently, we urge the Commission to allow managers of MMF to create their own internal rating system with the understanding that the manager would have to provide the design and operational details of the system, including the choice of rating criteria, the identification of the triggers of changes, the rating assignment process, the key data and methodology used to derive the internal rating, to allow competent authorities to evaluate the appropriateness of the system.

In addition, article 14.7 states that "all documents based on the assessment procedure" shall be made available to investors. We would argue that this information is the intellectual property of the fund provider. Investor access to this property would effectively amount to a loss of this intellectual property.

Downgrade by CRAs (Article 14.4 (c))

We agree that the use of credit rating agencies (CRAs) in the area of MMF should be reconsidered. Since the publication of the CESR/ESMA guidelines on MMF, our main concern had related to the requirement of a management company managing MMF having to check the short term credit ratings awarded by <u>each</u> recognized rating agency that has rated an instrument to determine if the instrument is of high quality. As there are already more than 30 CRAs registered with ESMA, we strongly believe that this is unworkable for compliance and economic reasons. At the very least, ESMA should clarify that the number of credit rating agencies to be considered should be determined by the fund's investment advisor in the best interest of the share/unit holders. We are therefore extremely concerned that on top of all the requirements set in Article 14, the Proposal requires that MMF managers continue monitoring the credit rating provided by all the CRAs that are registered with ESMA. We strongly believe that the number of CRAs to be considered should be determined by the MMF's investment manager in the best interest of the unit/shareholders.

Articles 16-17: Portfolio rules
The Proposals sets liquidity ratios for daily and weekly maturing assets. In this context it has to be pointed out that actual performance of daily and weekly maturing assets is at zero %. Therefore a 10% ratio of daily maturing assets will severely impact the attractiveness of MMF. The same applies to a 20% ratio of weekly maturing assets. The Proposal should at least clarify that the sum of daily and weekly maturing assets is 20% and not 30%.

Furthermore, it should be allowed to take into account the government bond exposure. This is a common procedure with the CRAs. The definition of “daily maturing assets” and “weekly maturing assets” as proposed would exclude longer government debt instruments. In our view, a fund manager should be allowed to include such instruments if it is determined that there is sufficient liquidity for them to be sold for cash within the appropriate time frame.

Article 18: MMF credit ratings
MMF or the manager of MMF shall not, directly or indirectly, solicit or finance a credit rating agency for rating the MMF. External ratings provide an external validation that the portfolio of the fund satisfies a series of criteria in order to qualify for the rating. That way these ratings may be important to some clients. It should also be noted that the proposal for *“CRD IV Regulation”* penalizes, in terms of risk weight, those collective investment undertakings (CIUs) that do not obtain a credit risk assessment from a nominated External Credit Assessment Institution. CIUs with this kind of assessment shall be assigned a risk weight according to a table, which in MMF cases would be 20% instead of 100%. The prohibition of external MMF ratings might also cause problems for investors who value third-party rating of MMF and/or have to rely on ratings contained in internal investment guidelines. Against this background, we recommend to allow MMF to obtain external ratings whenever it could be beneficial for them or their investors.

Article 19: Know your customer
The Proposal requires MMF to establish, implement and apply certain know your customer procedures. We agree that MMF should have in place sound procedures to be able to meet reasonably foreseeable liquidity demands of their clients, taking into account client concentration and client segments, industry sectors and instruments, and market liquidity positions. However, it should be noted that MMF managers who distribute their funds through external distributors are unable to have a breakdown of their customer base. In order to make the customer base available, information about investor cash needs, risk aversion, links and sophistication would require a personal contact between MMF managers and their investors. Due to the range of distribution channels used, this information could not be collected easily, except at great expense. This applies to exchange-traded MMF even more. Furthermore, an obligation to minimize the degree of concentration of investors is problematic since fund units are also available on secondary markets. Even if the asset manager has influence on who invests in a MMF, it is unclear how to avoid certain concentrations without an interrogation of each individual investor. In our view, the Proposal should require that MMF managers provide the operational details of the procedures put in place to know their customers in a manner that allows competent authorities to evaluate the appropriateness of the procedures.

Article 20: Stress testing

The Proposal requires sound stress testing scenarios for each MMF and certain actions plans for different possible scenarios. We think the requirements on liquidity stress-testing in general should be consistent with the provisions of the AIFM Directive, and specific scenarios for MMF might be useful since liquidity profiles differ compared to other fund types. However, the proposed requirement of “action plans” is too extensive. It seems inadequate to implement action plans for each individual fund considering all potential scenarios. In this context it should be clarified (para. 1 (e)) which time period is meant by the definition “worst historical data” and whether this definition refers to certain asset classes.

Article 21: Valuation of MMF’s assets

MMF (VNAV type) should be allowed to use the amortisation method for the money market instruments and transferable securities with a residual maturity of less than 3 months for the following reasons:

- MMF tend to hold money market instruments to maturity. Consequently, whereas equity and fixed income markets provide a wealth of mark-to-market prices, money market instruments do not as there is very little resale of money market instruments in the short-term debt market.

- For many securities, mark-to-market pricing is an approximation and so the cost involved in requiring mark-to-market pricing, even for securities very close to maturity, would not be justified. This concern is valid for all MMF.

- Amortised cost accounting is an accurate method of approximating the market value of high quality debt instruments with a relatively short maturity (generally up to three months).

- In case of term deposits and commercial paper, MMF managers tend to obtain daily prices by discounting at short-term interest rate and <u>initial</u> credit spread. If they need to update the credit spread daily, this would be cumbersome because they are not readily available and prone to estimation errors and variety of assumptions.

We therefore believe that all MMF should be allowed to use amortized cost accounting to calculate the value of money market instruments with a residual maturity of less than three months. The proposal to value the assets of MMF that are not of a CNAV type at “the more prudent side of bid or offer” would unfairly favor new subscribers to the fund as it would artificially depress the NAV. It would be better to allow the use of “mid-market” pricing under normal market conditions. In other words, bid pricing should only be used in stressed market conditions when the redeemer (or subscriber) were effectively expected to meet the additional burden in order to ensure equal treatment with other fund subscribers or for specific types of MMF with a specific type of clients.

Articles 25-26: NAV buffer

The Proposal requires each CNAV MMF to establish and maintain a NAV buffer of at least 3% of the total value of the MMF´s assets. Although German fund managers basically provide VNAVs, we generally think that the rationale for bank-like capital requirements simply does not apply to funds respectively to MMF. Furthermore, it should be taken into account that the US regulator obviously has identified different and workable solutions to address market movements, e.g. liquidity fees and gates. In terms of having a level playing field between US- and EU-CNAV, comparable rules in the EU should prevail.

Article 27: External support

The Proposal allows external support for VNAV MMF under exceptional conditions. In this context the obligation to immediately inform investors about external support should be dropped since the purpose of external support would be foiled by making investors insecure (para. 5).

Article 29: Reporting obligations

The Proposal requires certain reporting obligations (para. 2-3) for each MMF. We think reporting obligations should be limited to an adequate level. Disproportionate reporting obligations add to the increasing costs for MMF and therefore reduce the attractiveness of MMF for investors, minimize the supply of MMF and jeopardize the important function as source of short term financing. At least the requirements of para. 2 (f) should be deleted since the asset manager basically has no detailed information on individual investors (numbers, volumes, risk aversion).

Article 36: Transitional provisions

From an operational point of view, we are extremely skeptical that the operational requirements of the changes required could realistically be managed within the proposed time frame (6 months).