

ISSA



Report on Shadow Banking

**Developments of Regulatory Changes and
their Impact on ISSA Members**

February 2014

Abstract

Drawing on recent regulatory changes relating to Shadow Banking a working group of ISSA members was formed to review these developments and their impact on ISSA members.

Target Audience

The target audience is custodian banks and market infrastructures.

Acknowledgements

This report is the result of efforts by a team of experts drawn from ISSA Operating Committee members and other ISSA participating member firms. All participants and third parties provided this committee with both valuable insight and market knowledge. The names of participating firms and the individual contributors are listed in Chapter 6. The ISSA Executive Board wishes to thank all supporters for their personal contributions as well as their firms for having enabled their participation.

Disclaimer

Neither ISSA nor the authors of this document warrant the accuracy or completeness of the information or analysis contained herein. Readers are encouraged to develop their own base of information and understanding.

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1. Executive Summary

«Shadow Banking» is a pejorative term first coined in 2007 to cover the many less regulated or unregulated financial entities and activities that might pose a threat to the financial system. At their November 2010 Seoul Summit the «Group of 20» (G20), a group of finance ministers and bank governors from 20 major economies, stated that the «remaining issues of the financial sector that warranted attention should be identified». The G-20 request, beyond its objective to ensure that all products, activities and market participants are effectively subject to appropriate oversight and regulation, is directly linked to the role that the Shadow Banking System might have played in the recent financial crisis and the associated contagion risks to the traditional banking. Whereas traditional relationship banking is based on the collection of deposits and onward lending to borrowers after the setting aside of reserves, Shadow Banking typically involves the making of loans that are then bundled into securities with the financing of such activity in the collateralized «Repo» market. While similar in nature to traditional banking with respect to maturity risk and credit transformation, it is subject to few or no specific regulatory provisions and reserve requirements and by its very nature is more susceptible to funding and contagion risk.

The G20 mandated the Financial Stability Board (FSB)* to address these banking-like risks which arise outside the traditional banking system, with a scope that ranged from identifying which entities and activities should be included in the Shadow Banking System and to what extent both should be further supervised and/or regulated.

** The FSB is a body established by the heads of state of the G20 to coordinate at an international level the work of national financial authorities and international standard setting bodies as well as to develop and promote the implementation of effective regulatory, supervisory and other financial policies. It is composed of the central banks and other authorities from the G20.*

According to the FSB, the Shadow Banking actors include:

- Hedge Funds
- Money Market Funds (MMFs)
- Securitized Investment Vehicles (SIVs)
- Finance Companies

And the activities core to Shadow Banking activities include:

- Securities Financing (Repo and Securities Lending)
- Securitization
- Financing by MMFs

These entities and activities are involved in liquidity and maturity transformation with short term funding on one side and provision of loans on a longer maturity on the other side.

The main concerns expressed by the FSB may be summarized as follows:

- The activity of Shadow Banks remains largely opaque and it is very difficult to collect some relevant data. Different approaches in the way to define the scope of these entities and activities from one jurisdiction to another are a further obstacle to a clear view on the size and risks inherent to Shadow Banks. The FSB reports that the size of Shadow Banking increased from \$60 trillion in 2011 to \$67 trillion in 2012. However there is no certainty on the exactitude of these figures as potentially all components of Shadow Banking are not correctly captured by existing estimations. As a result further transparency is a key priority for the FSB.

- Banks have narrowed the focus of their activities in response to new regulations such as the proposed Volcker Rule under Dodd Frank. Furthermore they have reduced their risk appetite in the face of higher capital requirements under Basel III and CDR IV/CCR in the European Union. Therefore the absorption of risk has partially shifted to the Shadow Banking System (such as Hedge Funds), which is much less impacted by market reforms driven by new regulations. As a consequence one key question raised by the FSB is the need to further regulate entities and activities of the Shadow Banking System, while taking into consideration existing rules (including those applicable to the banking system). Appropriate supervision of the Shadow Banking System is also at the core of the FSB's review.
- At the same time, the FSB acknowledges that Shadow Banks may play a positive role in the provision of liquidity and financing of the economy, especially to compensate for activities which were previously provided by the banking system. In this respect, the FSB's objective is also to have a proportionate approach that will preserve the smooth functioning of the whole system.

Many industry commentators have expressed concerns that the regulatory reforms, which focus on banks, are solving yesterday's problems and that the next financial crisis will start in Shadow Banking. At the same time many of the market reforms impact all market players, including Shadow Banks and only time will tell whether the introduction of direct regulation of Shadow Banks is the right approach to reinforce the stability of the whole financial system.

Drawing on the concerns relating to these recent regulatory changes, a working group of ISSA members was formed to review these developments and their impact on ISSA members. The findings of this working group are summarized in the prevailing report.

The report provides an overview of the main activities in Shadow Banking as defined by the FSB and an in-depth review of the two areas of greatest impact to the ISSA community, which are

- Securities Lending and Repo and
- MMFs.

In addition, the report is focused on regulatory developments in Europe and the US. While developments in other geographies are not covered ISSA would expect them to be greatly influenced by the developments noted in this report.

Progress in these two focus areas has in general been slower and more difficult than for regulatory changes targeted at banks.

- Proposals for the reform of securities financing (Repos and Securities Lending) were issued by the FSB only in August 2013 and they leave large discretion to national and regional regulators on how reforms should be implemented. On one issue (haircuts for securities financing transactions) the proposals were subject to a comment period that expired in November 2013.
- MMF reforms, especially in the US, have been problematic and contentious. In August 2012 the Securities and Exchange Commission (SEC) abandoned proposed reforms since three SEC Commissioners objected to them but in June 2013 issued new proposals for which the comment period has recently expired. These latest proposals are also contentious with the Investment Company Institute amongst others commenting that such reforms risk driving investors away from MMFs while their implementation would be both an administrative burden and very costly.

These reforms will affect the ISSA constituency:

- The proposed changes for MMFs will directly impact custodian banks that sponsor and/or function as fund administrators/accountants for MMFs - since they impact valuation principles (e.g. market value versus amortized cost valuation, Floating

- net asset value or Stable net asset value subject to protections such as redemption gates and liquidity fees).
- Many if not all custodians administer in-house Securities Lending programs and process Repo activity for their clients and so will be affected by disclosure requirements and other provisions.

2. General Description of Shadow Banking Initiatives

2.1 Introduction

During the Seoul Summit in November 2010, the G-20 required that «remaining issues of the financial sector that warranted attention should be identified». The objective of this requirement is to ensure that all products, activities and market participants are subject to appropriate oversight and regulation, which is currently not the case.

Shadow Banking is the generic term retained to cover all these unregulated or less regulated areas even if this title has been highly criticised by the industry due to its negative connotation. The FSB was mandated at international level to work on this new regulatory stream in order to address bank-like risks to financial stability emerging outside the regular banking system while not inhibiting sustainable non-bank financing models that do not pose such risks.

This report provides an overview of what has been done at this stage on this new regulatory stream, at the international level by the FSB but also on the European side by the European Commission and in the US by several authorities.

2.2 Work at the FSB Level

2.2.1 FSB General Approach

In October 2011, the FSB published its initial report «Shadow Banking – Strengthening Oversight and Regulation» which set out initial recommendations with a work plan to further develop them in the course of 2012. This report was endorsed by the G-20 at the Cannes Summit in November 2011.

The FSB identified five workstreams that were launched to develop the above policy recommendations:

- Interactions between Banks and Shadow Banking («mitigate the spill-over effect of the regular banking system and the shadow banking system»)
- Money Market Funds («reduce the susceptibility of MMFs to runs»)
- Securitization («assess and align the incentives associated with securitization to prevent a repeat of the creation of excessive leverage in the financial system»)
- Securities Lending and Repos («dampen risks and pro-cyclical incentives associated with secured financing contracts such as Repos and Securities Lending that may exacerbate funding strains in times of runs»)
- Other Shadow Banking entities («assess and mitigate risks posed by other shadow banking entities»).

The FSB also gave a definition of the Shadow Banking System which it described as «credit intermediation involving entities and activities (fully or partially) outside the regular banking system». The intent of this initiative is to address risks resulting from leverage and maturity transformation that can take place at an entity level or can also form part of a complex chain of transactions. According to the FSB, these risks can materialise as follows:

- «runs» that generate contagion risk and thus amplify systemic risk in the whole system
- Pro-cyclicality on credit supply and asset price variations (in both sense depending on the market level of confidence).

In addition the FSB indicated that a right balance between oversight and regulation of the Shadow Banking System should be found in order to have a resilient environment, while preserving Shadow Banking activities that are material to the system and that provide huge sources of financing. Indeed the FSB proposed to have a proportionate, complete, comprehensive and flexible approach to accommodate market evolution.

2.2.2 Description of each Workstream at International Level

MMFs

The FSB requested that the International Organization of Securities Commissions (IOSCO) undertake a review of potential regulatory reforms of MMFs, as - following their performance during the 2007-2008 financial crisis - their potential to spread or even amplify a crisis was highlighted, and regulators were alerted to their systemic relevance. In April 2012 IOSCO released a consultative report that provided a preliminary analysis of the systemic importance of MMFs and their key vulnerabilities (including susceptibility to runs) and sought market input in a consultation period that ended in June 2012.

In October 2012 IOSCO issued 15 policy recommendations, reviewed later in this report (Chapter 4.2), which mainly covered the general regulatory framework, valuation, liquidity management, MMFs that offer a Stable Net Asset Value (NAV), use of credit ratings disclosure to investors and MMFs' practices in relation to Repos. The key recommendation is the requirement that Stable NAV MMFs should be converted into Floating NAV MMFs where workable or that safeguards are introduced for Stable NAV MMFs where such conversion is not workable. The FSB endorsed the IOSCO recommendations as an effective framework for strengthening the resilience of MMFs to risks in a comprehensive manner.

Securitization

IOSCO, mandated by the FSB to work on this part in coordination with the Basel Committee on Banking Supervision (BCBS), published its findings for consultation in June 2012. The report proposed three possible policy actions to align the incentives associated with securitization and to support confidence in sustainable securitization markets while avoiding impediments to cross-border activity in those markets:

- Enhancing monitoring of the implementation of retention requirements and its impacts on the market
- Improving disclosure by issuers (stress testing, scenario analysis) and
- Encouraging standardisation of securitization products.

IOSCO published its final report on 16 November 2012. Key recommendations are about convergence for implementation of risk retention requirements and the development of standardised templates for asset level disclosure on the basis of work already achieved by the industry.

Securities Lending and Repos

In April 2012, the FSB dedicated working group on this stream published its interim report which provided an overview of these markets, described their location in the Shadow Banking System and discussed the financial stability issues arising from practices in these markets. In this respect, 13 policy recommendations were proposed around three main areas:

- Increase of transparency
- Minimum standards for haircut practices and
- Rules on assets posted as collateral for these transactions (cash and securities).

The potential wider use of CCPs was also reviewed.

The FSB supported these recommendations that were issued for public consultation on 18 November 2012. The consultation period ended on 14 January 2013. On 29 August 2013

the FSB issued its final report on the Shadow Banking risks associated with Securities Lending and Repo with eleven recommendations covering regulatory reporting and market transparency, regulation of securities financing and policy recommendations on the structural aspects of securities financing. The eleven recommendations are reviewed later in this report (Chapter 3.1.3).

Other Shadow Banking Entities

A dedicated working group on this stream was set up to detect the sources of Shadow Banking risks in the non-bank financial space to assess the risks posed from a financial stability perspective and to apply appropriate policy measures to mitigate those risks. The focus of this stream was to assess the risks posed by non-bank financial entities other than MMFs to include credit investment funds, exchange traded funds (ETFs), credit hedge funds, private equity funds, securities broker-dealers, securitization entities, credit insurers/financial guarantors, finance companies and trust companies.

Through the analysis conducted, the working group observed a high degree of heterogeneity and diversity of business models and risk profiles across the various sectors as well as within the same entity space. On this basis, the working group decided to approach this part through an economic function based perspective rather than solely through an entity based perspective. The objective is also to be able to capture new structures or innovations that conduct the same economic function.

The FSB endorsed the policy framework and the policy toolkits proposed by the working group. They were issued for public consultation on 18 November 2012. In August 2013 the FSB issued their final report which presented a menu of policy tools which national authorities could use to mitigate the risks posed by non-bank financial entities in a fashion compatible with the characteristics of their market. The policy tool menu was organized around specific risks:

- **Management of collective investment vehicles with features that make them less susceptible to runs**
Redemption gates, suspension of redemptions, and imposition of redemption fees or other redemption restrictions
- **Tools to manage liquidity risk**
Limits on investment in illiquid assets, liquidity buffers, limits on asset concentrations, limits on leverage and restrictions on maturity of portfolio assets
- **Loan provision that is dependent on short term financing**
Impose bank prudential regulatory regimes on deposit-taking non-bank loan providers, capital requirements, liquidity buffers, leverage limits, limits on large exposures and restrictions on types of liabilities
- **Intermediation of market activities that is dependent on short-term financing or on secured funding of client assets**
Impose prudential regulatory regimes equivalent to those for banks, liquidity requirements, capital requirements and restrictions on use of client assets
- **Facilitation of credit creation**
Capital requirements, restrictions on scale and scope of business, liquidity buffers, enhanced risk management practices to capture tail events and mandatory risk-sharing between the insurer/guarantor and insured/guaranteed (i.e. deductible, co-insurance)
- **Securitization-based credit intermediation and funding of financial entities**
Restrictions on maturity/liquidity transformation, restrictions on eligible collateral and restrictions on exposures to, or funding from, banks/other financial entities.

Interactions between Shadow Banking Entities and the Banking Sector

This workstream was mainly a prudential one which is under the BCBS responsibility. In July 2012 the BCBS reported to the FSB on measures already identified to strengthen the resilience of the banking sector against some risks posed by the Shadow Banking System (notably increased capital requirements related to securitization vehicles and to unregulated financial institutions as well as disclosure requirements related to securitization) and set out its plan to develop detailed policy recommendations on this workstream. Key areas that the BCBS proposes to address are the scope of consolidation for prudential regulatory purposes, a large exposure regime that takes into account the risks arising from the Shadow Banking System and a more internationally consistent and risk sensitive capital treatment for banks' investments in funds. The FSB endorsed the BCBS recommendations in October 2012. These proposals were to be submitted to public consultation in 2013.

Proposals are being developed by the BCBS:

- To ensure that all banks' activities, including interaction with the Shadow Banking system, are appropriately captured in prudential regimes
- To limit banks' large exposures to single counterparties (including to Shadow Banking entities) and
- To introduce risk-sensitive capital requirements for banks' investments in the equity of funds.

The BCBS will finalize its proposed supervisory framework for banks' large exposures and its proposed capital treatment for banks' investments in the equity of funds by the end of 2013. It will review the capital treatment of back-up lines to funds as necessary in 2014. The work on the scope of prudential consolidation will also be completed in 2014.

2.3 Work at the European Level

In 2012, the European Commission also consulted on Shadow Banking with the publication of a Consultation Green Paper in March 2012. Questions raised by the European Commission were very similar to those addressed by the FSB and mainly focused on the following aspects:

- General definition of Shadow Banking and activities/entities to be covered
- Risks and benefits related to Shadow Banking
- Challenges for supervisory and regulatory authorities
- Existing regulatory measures applicable to Shadow Banking in the EU

In July 2012, the European Commission released another consultation named «UCITS VI» that covered some aspects of Shadow Banking (notably MMFs and Securities Lending/ Repos operations) but also various items such as the depositary passport and enhancement of long-term investments.

In September 2013, taking into account the various responses to the consultation, the European Commission issued a communication, which describes the intention of the European legislator vis a vis the Shadow Banking Sector, the actions already taken and the future initiatives to be expected.

The Commission highlights in this communication the measures already taken to deal with the risks related to Shadow Banking such as the rules governing hedge fund activity (AIFM Directive) and reinforcing the relationship between banks and unregulated actors (the provisions related to securitization exposures in the revised Capital Requirements Legislation).

The Commission intends to launch additional legislative actions:

- Regulation on MMFs (proposal published on 4 September 2013)
- Initiative to increase transparency of the Shadow Banking Sector and collect data

- Legislation to clarify securities law and the risks associated with securities financing transactions (principally Securities Lending and Repurchase transactions), in order to facilitate in particular to identify property rights (who owns what?), monitor risk concentration and identify counterparties (who is exposed to who?).
- A framework for interactions with banks. The Commission wants to address the high level of interconnectedness between the Shadow Banking System and the rest of the financial sector, particularly the banking system, which may constitute a major source of contagion risk. The Commission could propose to address those risks by tightening the prudential rules applied to banks in their operations with unregulated financial entities.
- Additional work is also planned on the supervision arrangements of Shadow Banking entities/activities in order to ensure that specific risks are adequately addressed. Certain areas such as the set-up of resolution tools for non-bank financial institutions require further analysis and will be clarified later.

2.4 Work at the United States Level

In the United States, while the Dodd Frank Act focused on further regulating banks, it also stipulated that the Federal Reserve would have powers to regulate all systemically important institutions whether or not they were banks and also introduced registration requirements for the advisors to hedge funds. The Act further mandated changes to certain market practices, most notably the requirement for the bulk of over-the-counter derivatives to be traded on exchange, which impacts both banks and Shadow Banks alike.

As detailed later in this report (Chapter 4.3), the regulators are in the process of introducing reforms affecting the \$2.6 trillion of MMF industry aimed at reducing the liquidity risk present when investors elect to rapidly withdraw funds in the face of adverse market developments and/or rumors or risk situations. US regulators have been active in shaping the recommendations of the FSB with respect to Securities Lending and Repo and ISSA anticipates adoption of regulations in the US to largely mirror the FSB recommendations on the subject.

The Federal Reserve Bank of New York has issued no recent specific Shadow Banking requirements, but its December 2013 edition of «Economic Policy Review» includes an article titled Shadow Banking, at <http://www.ny.frb.org/research/epr/2013/0713adri.pdf> . Its authors note that increased capital and liquidity standards for depository institutions and insurance companies are likely to heighten the returns to Shadow Banking activity, and that Shadow Banking, in some form or another, is therefore expected to be an important part of the financial system for the foreseeable future. There appears therefore to be a significant institutional acceptance by the Fed of the inevitability of Shadow Banking, and that (hopefully) the correct regulatory route is to control rather than attempt to stifle.

2.5 Conclusions

Further Shadow Banking developments can be expected in 2014. New reports are expected from the FSB, notably on Securities Lending and Repos (for recommendations on minimum haircuts) and on interactions between the Shadow Banking System and banks and from BCBS with respect to the interaction between Shadow Banking entities and the banking sector.

Shadow Banking is also on the agenda of the European Commission and the US authorities for 2014. The highest priority at the European level seems to be a text proposal for MMFs and the SEC was expected to publish its rules on MMF as well in 2013. However other

topics may also be subject to regulatory evolutions in one way or another. In parallel, other regulatory initiatives may have some indirect impacts on Shadow Banking topics, as for instance the Volcker rule in the US or Banking Laws in Europe.

3. Initiatives affecting Securities Lending and Repos Transactions

3.1 FSB Documents

Securities Lending / Repos operations are one of the five workstreams identified by the FSB as part of the Shadow Banking system. In this respect the FSB has already released a number of documents:

3.1.1 Interim Report on Securities Lending and Repos - 27 April 2012

This report provided an overview of the markets, description of the Securities Lending and Repos markets' location in the Shadow Banking System and discussed the financial stability issues arising from practices in these markets. Main topics addressed in the report covered the following aspects:

- Key drivers of the Securities Lending and Repo market
- Location within the Shadow Banking System (in terms of leverage and maturity transformation)
- Overview of existing regulations for Securities Lending and Repos (requirements for banks/broker-dealers and for investors)
- Financial stability issues
- Lack of transparency
- Pro-cyclicality of system leverage / interconnectedness
- Issues associated with collateral re-use
- Potential risks arising from fire-sale of collateral assets
- Potential risks arising from agent lender practices
- Shadow Banking through cash collateral reinvestment
- Insufficient rigor in collateral valuation and management practices

3.1.2 FSB Consultative Document on Policy Recommendations to Address Shadow Banking Risks in Securities Lending and Repos - 18 November 2012

The report was submitted to public consultation by 14 January 2013 and set out 13 recommendations to enhance transparency, strengthen regulation of securities financing transactions and improve market structure.

3.1.3 Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos - 29 August 2013

Following the above consultative period, during which over 50 respondents submitted comments, the FSB issued eleven recommendations that covered three areas:

- Improvements in regulatory reporting and market transparency
- Regulation of securities financing (minimum standards for methodologies used by market participants in calculating «haircut» [margins] that limit the amount of financing that can be provided against a given security and minimum standards on cash collateral reinvestment) and
- Policy recommendations on the structural aspects of securities financing such as central clearing.

These recommendations were:

1. Authorities should collect granular data on securities Lending and Repo exposures amongst large international financial institutions with high urgency. As far as

possible this should lever existing international initiatives such as the FSB Data Gaps Initiative.

2. Trade level (flow) data and regular snapshots of outstanding balances should be collected. National authorities should decide how to collect this data but it might be obtained via CSDs, CCPs or Trade Repositories as well as regulatory reporting.
3. The national/regional data for both Repos and Securities Lending should be aggregated by the FSB to provide global trends (market size, composition, haircuts, tenors).
4. The Enhanced Disclosure Task Force (EDTF) should work to improve disclosure for financial institutions' Securities Lending, Repo and wider collateral management activities.

Here the FSB recommends that fund managers, relying on information from lending agents (custody banks), provide end-investors such information as

- Concentration data (top 10 borrowers)
 - A break-down of collateral types held and maturity profile and
 - Details of return splits (agent and end-investor) across all custodians.
5. Authorities should review reporting requirements for fund managers to end-investors against the FSB's proposal and consider whether any gaps need to be addressed.

With respect to implementation, minimum standards addressing liquidity, maturity transformation, concentration and credit risks should be applied

6. Regulatory authorities for non-bank entities engaged in Securities Lending should implement minimum standards for cash collateral reinvestment to limit liquidity risks.

The FSB believes that extra safeguards are needed on the re-hypothecation of client assets and while re-hypothecation may be used to finance client long positions, client assets should not be used to finance the intermediary's own account activities.

7. Authorities should ensure regulations governing re-hypothecation address the following principles:
 - Financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so clients can understand their exposures in the event of the failure of the intermediary
 - In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own account activities of the intermediary and
 - Only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets.
8. An expert group on client asset protection should examine possible harmonization of client asset rules with respect to re-hypothecation.
9. Authorities should adopt minimum regulatory standards for collateral valuation and management for all Securities Lending and Repo market participants.

The FSB believes that the use of CCPs for inter-dealer transactions has advantages since CCPs generally have robust collateral and default management processes. But it believes that the case for their use in the dealer-customer Repo market is less compelling (e.g. since institutions generally are «one way» in the Repo market there is less opportunity to gain from CCP netting) and contains moral hazard since market participants have less incentive to manage collateral risk and it places the CCP as the main source of financing for the dealers.

10. Authorities should evaluate the costs and benefits of introducing CCPs for inter-dealer Repos in markets where CCPs do not exist - and where such CCPs do exist - consider the pros and cons of extending participation to important funding providers in the Repo market.

The FSB recommends the examination of bankruptcy laws and their impact on Repo and Securities Lending. It notes that under US bankruptcy laws Repos are exempt

from «automatic stay» which entitles the holder to liquidate positions without any further approvals. This can have adverse effects especially when illiquid collateral is liquidated in a «fire sale».

11. Changes to bankruptcy law treatment of Repo Resolution Authorities (RRAs) should not be prioritized for further work at this stage due to significant difficulties in implementation.

The FSB also issued proposed recommendations on minimum haircut standards for non-centrally cleared securities financing transactions and in particular proposed numerical haircut floors. It was seeking additional comments on these proposals by 28 November 2013. Haircuts should cover with a high degree of confidence the potential declines of collateral values during liquidation and look at such risk factors as market risk, portfolio concentrations, illiquidity of the collateral portfolio and the non-correlated price and spread risk between lent and collateral portfolio assets. The minimum haircut floors recommended vary from 0.5% to 7.5% depending on the collateral type, maturity and issuer. For example, the FSB recommends a minimum of 2% haircut for debt issued by corporate and other issuers with a maturity greater than 5 years.

3.2 Main Potential Impacts Resulting from FSB Recommendations

The FSB proposals require the collection of very granular data by regulators that should position them to identify risk concentrations. The imposition of minimum haircut standards sets a floor to the collateral that safeguards financing transactions. However, the Repo market structure by its very nature is vulnerable to funding freezes in periods of market turmoil and contagion effects between participants. The FSB noted that the use of CCPs is generally beneficial in the dealer-to-dealer market, where it is already well established. It does not endorse, however, the extension of CCPs to the dealer-to-investor market where despite certain advantages (centrally managed risk by infrastructures established for that purpose) the FSB has concerns regarding the increased concentration of risk in CCPs and that the moral hazard-policing of exposures to broker-dealers by investors may fall away as they rely solely on CCPs, which as a result become a much larger potential point of failure.

The FSB further requires the collection of granular data by regulators to monitor the financing market. It leaves the method of collection open to national and regional regulators but notes that agents, CSDs and CCPs can be helpful if they supply their data and the use of Trade Repositories should also be considered. The absence of a global requirement to use Trade Repositories for the collection of data, combined with the absence of a standard for data will make the general use of Trade Repositories problematic since any usage will likely be only national/regional.

4. Initiatives Affecting Money Market Funds (MMFs)

4.1 Background

In Europe, a Stable or Constant Net Asset Value (CNAV) MMF is a fund that, unlike other investment funds, seeks to maintain a Stable €1.00 per share when investors redeem or purchase shares. The net value of the assets held by an MMF can, however, fluctuate, and the market value of a share may therefore not always be exactly €1.00. To avoid a fluctuating share value, a CNAV MMF uses amortized costs to value its assets. CNAV funds typically price their shares to two decimal places. Such penny rounded shares are only sensitive to movements in the funds' NAV of 0.5% or more. Because it is rare for the NAV of an MMF to move by this much, the share price of a CNAV fund tends to remain constant - hence the description of the fund as tending to have a Constant NAV. CNAV funds that fail to maintain a constant price are described as having «broken the buck». This has happened only rarely in recent times, notably in late 2008. (Drawn from European Commission - MEMO/ 13/764 04/09/2013 and from International Money Markets Funds Association article, Travis Barker, 2012).

In the US, MMFs are mutual funds registered under the Investment Company Act of 1940 (the «1940 Act») and are used by retail and institutional investors for both cash management and investment purposes. MMFs invest in various money market fund instruments, such as commercial paper, government debt, and US Treasury bills, which provide short-term yields and liquidity, and have a Stable NAV of \$1.00, thus providing investors with a safer alternative to equity investments.

In addition, MMFs also provide short term funding to businesses in need, who issue short-term instruments, thus serving as a catalyst to economic growth. As of March 2013, the US MMF industry had about \$2.6 trillion in assets under management («AUM»), compared to \$3.8 trillion at the end of 2008.

While regulated similar to US mutual funds, MMFs are subject to Rule 2a-7 under the 1940 Act, which allows them to use different methods for valuing and pricing their shares. Under Rule 2a-7, MMFs use the amortized cost method or the penny rounding method to round their shares. These methods allow MMFs to maintain the Stable NAV of \$1.00 even though the fair market value of the shares may vary by as much as 0.5%, per share, above or below \$1.00.

While considered to be safe investment vehicles, MMFs do have vulnerabilities, as evidenced by the run on the Reserve Primary Fund in September 2008. After the fund announced it was going to break the buck due to losses on Lehman Brothers debt instruments the fund had purchased, investors, in fear of losing their money, tried to redeem. This fear spread throughout the MMF industry and led investors in other MMFs to redeem their investments as well. Following the breaking of the buck by the Reserve Primary Fund, outflows from MMFs continued to pile up. As a result, MMFs weren't investing in short-term instruments, which led to further stress in the financial markets. The risk of runs on MMFs was again evidenced in the summer of 2011 when significant redemptions from MMFs occurred due to concerns related to the European debt crisis and the US debt ceiling debate.

The runs on MMFs caused great concern among regulators both in the US and internationally and after the unprecedented intervention by the US Treasury and Federal Reserve to stabilize the short term markets and prevent runs on MMFs, calls for reforms quickly began. In June 2009, the US Department of the Treasury issued a report, titled «Financial

Regulatory Reform: A New Foundation», proposing regulatory reforms that would enhance oversight of the financial markets, protect consumers and prevent a crisis, similar to the 2008 crisis, from occurring again. One of its recommendations was for the SEC to strengthen regulations surrounding MMFs and for the President's Working Group on Financial Markets (PWG)* to prepare a report assessing whether changes were necessary to reduce the risk of runs on MMFs.

*The PWG was established by Presidential order with the mandate to promote financial stability and is comprised of the Secretary to the Treasury who serves as Chairman, the Chairman of the Federal Reserve System, the Chairman of the Securities and Exchange Commission (SEC) and the Chairman of the Commodities and Futures Trading Commission (CFTC).

4.2 The IOSCO Recommendations

Following their November 2011 recommendations on Shadow Banking, the FSB asked the International Organization of Securities Commissions (IOSCO) to «undertake a review of potential reforms of MMFs that would mitigate their susceptibility to runs and other systemic risks and to develop policy recommendations». The FSB considers MMFs to be part of the Shadow Banking System. Although IOSCO found that MMFs did not cause the recent financial crisis their performance during the crisis «highlighted their potential to spread or even amplify a crisis».

On 9 October 2012, IOSCO published their report which outlines 15 recommendations and on 19 November 2012 the FSB endorsed the report. This followed a consultative IOSCO report that had been issued in April 2012. The SEC did not support the consultative or final reports but, as detailed below, nevertheless in June 2013 pursued actions designed to stem runs on MMFs. The most notable recommendation applied to jurisdictions, such as the US, that offer a Stable NAV, where regulators should either require a move to a Floating NAV or alternatively introduce safeguards (such as to include a 50 basis point NAV buffer, liquidity fees to slow down redemptions, and partial holdbacks of redemptions) that would reinforce a Stable NAV MMF's resilience and ability to face significant redemptions. There were many comment letters objecting to the consultative report and final report with Paul Schott Stevens of the ICI protesting that IOSCO drew a misinformed conclusion that MMFs with a constant NAV are more susceptible to runs than funds with Floating NAVs.

IOSCO grouped their recommendations under seven themes:

- General Recommendations:
 - MMFs should be explicitly defined in Collective Investment Scheme (CIS) regulation.
 - Specific limitations should apply to the types of assets in which MMFs may invest and the risks they take.
 - Regulators should closely monitor the development and use of other vehicles similar to MMFs (e.g. collective investment schemes or other types of securities).
- Valuation Recommendations:
 - When valuing securities held, MMFs should comply with the general principle of fair value and the amortized cost method should only be used in limited circumstances.
 - MMF valuation practices should be reviewed by a third party as part of their periodic review of fund accounts.

- Liquidity Management Recommendations:
 - MMFs should establish sound policies and procedures to know their investors.
 - MMFs should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales.
 - MMFs should conduct periodic stress tests concerning the assets or liabilities of the funds.
 - MMFs should have tools in place to deal with exceptional market conditions and substantial redemption pressures (tools might include temporary suspensions, gates or redemptions in kind).
- Recommendations regarding MMFs that offer a Stable NAV:
 - MMFs that offer a Stable NAV should be subject to measures designed to reduce the specific risks (run risk and first mover advantage) associated with their Stable NAV feature and to internalize the costs arising from these risks.
 - Regulators should require, where workable, a conversion to Floating/Variable NAV.
 - Alternatively, safeguards should be introduced to reinforce a Stable NAV MMFs' resilience and ability to face redemptions (suggestions include a 50 basis point NAV buffer, liquidity fees to slow down redemptions and partial holdbacks of redemptions).
- Recommendations regarding the use of ratings:
 - MMF regulation should strengthen the obligations of responsible entities (MMFs) regarding internal credit risk assessment practices and avoid any mechanistic reliance on external ratings.
 - Credit rating agency (CRA) supervisors should seek to ensure CRAs make more explicit their current rating methodologies for money market funds.
- Recommendations regarding disclosure to investors:
 - MMF documentation should include a specific disclosure, drawing investors' attention to the absence of a capital guarantee and the possibility of principle loss.
 - MMF's disclosure to investors should include all necessary information regarding the fund's practices in relation to valuation and the applicable procedures in times of stress.
- Recommendations regarding MMFs practices in relation to Repos:
 - When necessary, regulators should develop guidelines (including settlement, counterparty risks, and collateral management) strengthening the framework applicable to the use of Repos by MMFs, taking into account the outcome of current work on Repo markets.

4.3 Initiatives in the US

4.3.1 Introduction

After much debate and political pressure, in June 2013, the SEC released its latest MMFs Reform proposal addressing concerns that MMFs were structurally vulnerable and susceptible to runs.

Over the course of the past few years, there has been much discussion and politicking related to whether further reforms to MMFs are necessary. There are some who fear that MMFs, specifically runs on MMFs, which occurred during the 2008 financial crisis, threaten the financial stability of the US. On the other hand, there are others who strongly believe that MMFs are safe and already heavily regulated, thus, do not pose a threat to the finan-

cial stability of the US and that further reforms would destroy the industry. The debate surrounding MMFs Reform has been ongoing for years.

4.3.2 January 2010 SEC Reforms

In January 2010, the SEC adopted rules that would make MMFs safer and less likely to break the buck («2010 Reforms»). The 2010 Reforms included, among other things, the following requirements:

- **Improved Liquidity**
Creates daily and weekly liquidity requirements for MMFs. The new rules also place restrictions on the purchase of illiquid securities by MMFs.
- **Higher Credit Quality**
Reduces from 5% to 3% an MMF's ability to invest its assets in lower quality (Second Tier) securities, restricts an MMF from investing 0.5 % of its assets in Second Tier securities by a single issuer and restricts an MMF from buying such securities that mature in more than 45 days (previous limit was 397 days).
- **Shorter Maturity Limits**
Shortens the «weighted average life» maturity of an MMF's portfolio to 120 days and reduces the «weighted average maturity» of an MMF's portfolio to 60 days from 90 days.
- **«Know Your Investor» Procedures**
Requires MMFs to create procedures identifying investors whose redemption requests may create risks, allowing MMFs to anticipate large redemption requests.
- **Periodic Stress Tests**
Requires MMFs to conduct stress tests to determine if a fund can maintain a Stable NAV in the event of interest rate changes, high redemption requests etc.
- **Monthly Disclosures**
Requires MMFs to post their portfolio holdings to their website on a monthly basis.
- **Monthly Reporting**
Requires MMFs to report to the SEC detailed portfolio schedules on a monthly basis, which shall include an MMF's shadow NAV.
- **Suspension of Redemptions**
Permits an MMF's board of directors to suspend redemptions if the fund is about to break the buck and decides to liquidate the fund.

4.3.3 President's Working Group on Financial Markets (PWG) October 2010 report

In October 2010, the PWG followed suit and released a report addressing the risks to financial stability posed by MMFs' susceptibility to runs. The PWG report stated that while the 2010 Reforms made MMFs more resilient and less risky, they alone could not prevent a run on MMFs, and suggested that more reforms were necessary to address the structural vulnerabilities of MMFs. The PWG report included a number of options that could potentially mitigate the systemic risks posed by MMFs and suggested that the Financial Security Oversight Council (FSOC)* examine each of them.

*The FSOC was created under the Dodd-Frank Act to identify risks to the financial stability of the US, promote market discipline and to respond to emerging threats to the stability of the US financial system.

The options included in the PWG report were as follows:

- Floating net asset values
- Private emergency liquidity facilities for MMFs
- Mandatory redemptions in kind
- Insurance for MMFs

- A two-tier system of MMFs with enhanced protection for Stable NAV funds
- A two-tier system of MMFs with Stable NAV MMFs reserved for retail investors
- Regulating Stable NAV MMFs as special purpose banks
- Enhanced constraints on unregulated MMF substitutes

At this point, the debating and politicking had begun, and in November 2010, the SEC issued a formal request for public comment on the reforms described in the PWG report. In May 2011, the SEC hosted a roundtable on MMFs and systemic risk. Following the roundtable, the SEC met with various industry representatives to discuss multiple reform options and continued to collect public comment. The SEC then narrowed the reform options and prepared a proposal for the SEC Commissioners to approve. Despite all this, in August 2012, former SEC Chairman Schapiro announced that the SEC would not proceed with a proposed rulemaking, as SEC Commissioners were not all in agreement with such a move. In September 2012, the Chairperson of the FSOC, then US Treasury Secretary Geithner, sent a letter to the FSOC members urging them to take action which they did in November 2012 as detailed below.

4.3.4 FSOC's Authority and Recommendations

To carry out its responsibilities, the FSOC has the authority to issue recommendations to financial regulatory agencies, such as the Federal Reserve Board and the SEC, to apply more stringent requirements to activities conducted by bank holding companies and non-bank financial companies after concluding that such activities could create or increase the risk of significant liquidity, credit or other problems. In making this decision, the FSOC reviews the conduct, scope, nature, size, scale, concentration or interconnectedness of the financial activity or practice.

Using its authority under the Dodd-Frank Act, the FSOC proceeded with issuing a proposal threatening to make the determination that MMFs posed systemic risks to the US financial markets, thus subjecting them to more stringent regulations. In addition, the FSOC included in its proposal three MMF reform alternatives for the SEC to consider and implement.

The November 2012 recommendations present the following three options:

1. Floating Net Asset Value

Under this first option, MMFs would be required to float their NAV by requiring MMFs to use mark-to-market valuation versus amortized cost and/or penny rounding. As a result, MMF shares would not be fixed at \$1.00 and would reflect the actual value of the MMF portfolio, similar to other mutual funds. It is believed this requirement would have eliminated the shock associated with breaking the buck and prevented investors from redeeming when faced with small losses. This requirement would also have removed the advantage of moving quickly to exit an MMF and eliminated the notion that MMFs are risk.

2. Stable NAV with NAV Buffer and «Minimum Balance at Risk»

The second option would have required MMFs to have a NAV buffer of up to 1% to absorb fluctuations in the value of the fund's portfolio. This option would also have allowed MMFs to maintain a Stable NAV. This option also carries a requirement that 3% of a shareholder's highest account value in excess of \$100'000 during the previous 30 days, referred to as a Minimum Balance at Risk (MBR), be redeemable on a delayed basis (30 days). It is believed that this requirement would have dissuaded investors from redeeming their investment during times of stress in the financial markets, provide protection to those who remain in the fund and allow the fund to absorb changes in the fund's portfolio value.

3. Stable NAV with NAV Buffer and other Measures

The third option is similar to option 2 in that it would have allowed MMFs to have a Stable NAV and requires them to have a NAV buffer. There would not have been an MBR requirement with this option. With respect to the NAV buffer, this option would

have required a larger risk-based NAV buffer of 3%. The FSOC believed that the 3% buffer, coupled with other requirements, such as stricter diversification requirements, increased liquidity levels, enhanced disclosure, would have made a fund more secure and less vulnerable to runs, and allowed it to better absorb losses.

Eventually, the FSOC decided to forego issuing a final recommendation to the SEC because of its belief that the SEC is the proper regulatory authority to issue and oversee reforms related to the MMF industry. If the FSOC had gone ahead with issuing a final recommendation, the SEC would have had to either accept the FSOC's recommendations or provide good reason why it did not and then run the risk of having MMFs deemed systemically significant. Nonetheless, the FSOC's proposal was effective in that it forced the SEC's hand in finally proposing further reforms, which it did in June 2013.

4.3.5 Proposed SEC Reforms 5 June 2013

The SEC, under a new chairman, Mary Jo White, issued its MMF reform proposal. At almost 700 pages, it is very long and detailed and poses many questions for which it seeks comment. While the proposal discusses a number of reforms, its essential part focuses on two sets of alternatives, the Floating NAV Alternative and the Liquidity Fees and Redemption Gates Alternative.

Under the Floating NAV Alternative, prime institutional money market funds would be obliged to have a Floating NAV which would require funds to value assets based on market factors rather than at amortized cost. Therefore, daily share prices will fluctuate along with changes to the market value of a fund's portfolio securities and the concept of a Stable NAV of \$1.00 a share would be abandoned. Exempt from the Floating NAV requirement would be government and retail MMFs. Government MMFs would be defined as any MMF that holds at least 80% of its assets in cash, government securities, or repurchase agreements collateralized with government securities. Retail MMFs would be defined as an MMF that limits each shareholder's redemptions to no more than \$1 million per business day. The SEC noted that it focused on institutional prime funds since it was this category of MMFs that had difficulty in 2008 when the Lehman collapse caused the Reserve Primary Fund to break the buck.

Under the Liquidity Fees and Redemption Gates Alternative, MMFs would continue to have a Stable NAV, but would be able to use liquidity fees in times of stress. This alternative would require MMFs to impose up to a 2% liquidity fee on all redemptions, if the fund's weekly liquid assets fell below 15% of its total assets at the end of any business day. Once the fund's liquid assets fell below that 15% threshold, a «redemption gate» or a temporary suspension of redemptions, could be imposed. The gate would need to be lifted within 30 days or sooner and could not be in effect for more than 30 days in any 90 day period. The fund would also need to promptly and publicly disclose instances when its liquid assets fell below that 15% threshold as well as its intent on imposing any liquidity fee or gate, among other things. Government MMFs would be exempt from the fees and gates requirement but would be able to voluntarily opt into it. It is believed this would make redeeming less attractive and benefit those shareholders who remain in the MMF by covering liquidation costs.

The SEC also proposed a number of other reforms, including disclosure and reporting requirements with the intent of improving the transparency of MMF operations and risks. The disclosure requirements would ask MMFs to post certain information on their websites, including, among other things:

- Daily updates on the level of daily and weekly liquid assets
- Daily NAVs, redemption fees or gates in effect as well as monthly updates of all holdings.

Furthermore, MMFs would need to include specific disclosures to their registration statements specific to the reforms that are eventually adopted.

Under the proposed reporting requirements, MMFs would be required to promptly complete new Form N-CR disclosing certain events, including the imposition of a liquidity fee or gate. The proposed reporting requirements would also request additional information to be provided on Form N-M F P, such as Legal Entity Identifiers and securities purchase prices, among other things, to better assess the risks associated with MMFs, and would eliminate the 60-day delay and make information on the form publicly available upon filing. In addition, to monitor whether assets are being moved away from registered MMFs to liquidity funds, which are unregistered, the reporting requirements would also amend Form PF, which is the form used by advisers to report information related to any private fund they advise. The Form PF amendments would require large liquidity fund advisers, those managing \$1 billion or more in MMF and liquidity fund assets combined, to report on Form PF the same information as registered MMFs report on Form N-M F P.

4.3.6 Implications of Proposed SEC Reforms 5 June 2013

It is undeniable that further reforms to MMFs would have significant implications for both MMFs and the MMF industry. Implementing these reforms would have many challenges and subject the industry to technology and operational costs. In its release, the SEC discussed the potential tax implications for investors, as purchases and sales of MMFs using a Floating NAV could generate capital gains or losses, thus requiring additional tax reporting, especially for those investors that make frequent purchases. While the SEC stated that the US Treasury may work to alleviate some of these burdens, there is no guarantee that this will happen.

There are also numerous operational issues MMF sponsors need to consider. Specifically, fund accounting and transfer agency systems will need to be updated to accommodate the use of a Floating NAV. MMF sponsors will no longer be able to offer separate share classes for retail and institutional investors, thus requiring them to separate the share classes into separate funds, unless the sponsor decides to institute a \$1 million redemption limit for institutional share classes to fall under the retail MMF exemption or impose a Floating NAV on all share classes. In addition, sponsors will need to work with their intermediaries to make sure any liquidity fee is appropriately applied to beneficial owners in omnibus accounts. There is also the cost impact associated with implementing and complying with these reforms because these costs could eventually be passed onto investors.

Furthermore, there is the concern that these reforms would make MMFs less appealing to investors, thus decreasing the demand for them. There is also concern that implementing a Floating NAV would also lead investors away from MMFs as institutional investors may be unable to invest in MMFs that do not have a Stable NAV due to guidelines and policies they must adhere to. Due to statutory and regulatory requirements, states and local governments may also be prohibited from investing in MMFs that do not have a Stable NAV. The inability, and in some cases, the unwillingness to invest in such MMFs would decrease the assets of MMFs, which would have a trickle-down effect on the economy, as MMFs would not be able to invest to the same extent in the short-term securities of other businesses that need the funding. In addition, due to the operational costs associated with implementing these reforms, many sponsors may be unwilling to offer MMFs and leave the market. Also, intermediaries and service providers, who are integral to the operation of an MMF, may be unwilling to incur the additional costs associated with these reforms.

There is also fear that these reforms would create more systemic risk as investors would look to other investment products that may not be as regulated as MMFs. If investors turn away from MMFs and sponsors aren't willing to offer them due to the lack of demand, not to mention the costs, this could lead to increased demand for other investment products that may be riskier and pose more of a threat to the financial stability of the US. Further-

more, there would be less short-term financing for businesses and those who relied on MMFs for such financing, thus there would be a negative impact on the short-term credit markets, which could pose a risk to the financial stability of the US.

4.3.7 Conclusions Regarding Proposed SEC Reforms

As indicated above, the SEC's proposal is close to 700 pages posed with many questions. The SEC set a 90 day comment period, which has come and gone, and numerous objections and push-backs have been submitted. These comments, typified by those of the Investment Company Institute, contend that

- MMFs with a Floating NAV will not be attractive to many of the investor types such as US municipalities
- The fees and gates requirement would reduce liquidity and increase both costs and complexity and
- Other provisions such as the exemption of retail funds need further examination and should be based on the type of investor as characterized in social security numbers of investors rather than a withdrawal cap.

As the SEC continues its review of comments and deliberates as to which course of action it will take, there will certainly be a lot to consider. One last thing to keep in mind is that while the industry has not heard much from the FSOC with respect to the SEC's proposal, which does not exactly mirror the FSOC's proposed reforms, the FSOC could step back into the discussion if it feels the SEC's proposal is not enough and could propose additional recommendations for the SEC to implement.

4.4 Initiatives in the EU

4.4.1 Introduction

On 4 September 2013, the European Commission published a proposed regulation for MMFs. This legislative initiative followed a report and recommendations on MMFs issued on 18 February 2013 by the European Systemic Risk Board (ESRB), calling for the European Commission to act. This draft regulation is also the European response to the work done by the FSB on MMFs identified as Shadow Banking entities and to the recommendations of IOSCO.

4.4.2 Scope and objective

The objective of the European Commission is to improve the liquidity profile and stability of MMFs in order to avoid systemic risk contagion. The new rules proposed cover MMFs that are domiciled or sold in Europe whether they are UCITS (Undertakings for Collective Investments in Transferable Securities) or alternative investment funds. Those funds will have to comply with the specific provisions for MMFs in addition to their core regulation (either UCITS or AIFMD, the Alternative Investment Fund Managers Directive).

Three types of MMFs are identified in the draft regulation:

1. **Standards MMFs**

The portfolio of the fund must have a weighted average maturity of no more than 6 months and a weighted average life of no more than 12 months. These MMFs can only be valued according to a Variable NAV.

2. **Short Term Variable NAV MMFs**

The portfolio of the fund must have a weighted average maturity of no more than 60 days and a weighted average life of no more than 120 days. The fund is valued with a Variable NAV.

3. The Constant NAV (CNAV) Short Term MMFs

As a short term MMF the portfolio of the fund must have a weighted average maturity of no more than 60 days and a weighted average life of no more than 120 days. In addition CNAV MMFs will be required to establish and maintain at all times a cash capital buffer amounting to at least 3% of the total value of their assets held in a protected reserve account in the name of the CNAV MMF.

4.4.3 Main Provisions Proposed

Restriction in eligible Assets

MMFs shall only invest in the following categories of assets:

- Money market instruments including transferable securities negotiated on a regulated market or listed, provided that legal maturity at issuance or residual maturity is less than 397 days. These instruments can be securitizations subject to specific conditions. MMFs are not considered as money market instruments. Each MMF must internally assess each money market instrument and assign it a credit rating with six grades for instruments of non-defaulting issuers. The MMF will then only be permitted to invest in money market instruments assigned the first or second grade on its internal rating scale.
- Deposits with eligible credit institutions (on demand or less than 12 months maturity).
- Financial derivative instruments (only to hedge duration and exchange rate risks).
- Assets received as collateral under reverse repurchase agreements (with a maximum close out facility of two working days) shall themselves be eligible money market instruments, which are not securitizations, and not be sold or reinvested or pledged. However, such collateral must be included in the calculation of diversification and concentration limits.

Entering into Securities Lending, Borrowing or Repos shall not be allowed

Stricter Diversification and Maturity Rules

The Commission's proposal imposes stricter rules in terms of diversification requirements and the maturity of the assets held by the fund:

- At least 10% of daily maturing assets and 20% of weekly maturing assets
- 5% issuer limit for money market instruments (10% for standards MMFs)
- 5% limit on deposits with a single credit institution
- 10% aggregate limit in terms of issuer exposure (15% for standards MMFs)
- 10% aggregate limit in terms of securitization exposure
- 50% aggregate risk exposure to the same counterparty for OTC derivatives
- 20% aggregate amount of cash provided to the same counterparty in reverse Repo.

These restrictions are waived for sovereign issues of certain countries and public bodies subject to six issues/30% per issue limits.

Credit Rating Restriction

The draft regulation prohibits an MMF from soliciting or financing an external credit rating.

Valuation

MMFs should value their assets (other than CNAV MMFs) daily using mark-to-market whenever possible and otherwise mark-to-model. Only CNAV MMFs may value assets using the amortized cost method.

Redemption Monitoring and Liquidity Stress Testing

Managers of MMFs shall be required to monitor investors in order to «correctly anticipate the effect of concurrent redemptions by several investors» and shall also ensure that «redemption by an investor does not materially impact the liquidity profile of the MMF». Liquidity and the quality of assets in the MMF must also be assessed via stress tests on at

least an annual basis and measures taken to reinforce liquidity or asset quality where stress testing identifies any vulnerability of the MMF.

Prohibition of External Support in order to Stabilize the NAV

CNAV MMFs may only receive support through a specific NAV buffer (as dealt with below). All other MMFs shall be prohibited from receiving external support. The MMF's competent authority may, in exceptional circumstances (justified by systemic implications or adverse market conditions), allow an MMF (other than a CNAV MMF) to receive external support that is «intended for or in effect would result in guaranteeing the liquidity of the MMF or stabilising the NAV per unit or share».

Specific CNAV MMF Requirements

- CNAV MMFs will be required to establish and maintain at all times a capital buffer amounting to at least 3% of the total value of their assets. The NAV buffer shall be composed of cash and held in a protected reserve account in the name of the CNAV MMF. This reserve account shall be used solely for the benefit of the CNAV MMF and the instances when this account can be debited and credited are set out in detail in the Draft Regulation.
- The NAV buffer can only be used to compensate the difference between the constant NAV per unit or share and the «real» value of a unit or share.
- The NAV buffer should be replenished whenever it falls below 3%. The competent authority and ESMA (European Securities and Markets Authority) shall be immediately notified when the amount of the NAV buffer decreases by 10 basis points below the 3%.
- The recitals of the Draft Regulation also note that the competent authority should also have the power to convert a CNAV MMF into an MMF other than a CNAV MMF when it has justifiable reasons demonstrating the incapacity of the CNAV MMF to replenish the buffer within one month.
- The Draft Regulation allows a ramp-up period for existing CNAV MMFs in relation to the NAV buffer. Each CNAV MMF must provide in its constitutional document clear procedures for conversion to a non-CNAV MMF.

4.4.4 Main Impacts on the Industry

The proposal of the Commission is largely inspired by the IOSCO recommendations and by what has been proposed by the SEC in the US. However some provisions differ because the MMFs market in Europe has different characteristics than the one in the US. For example, in Europe a large part of MMFs are with Variable NAV and not Constant NAV contrary to the US.

Nevertheless, it is undeniable that this proposed reform to MMFs would have significant implications for both MMFs and the MMF industry. Implementing these reforms would have many challenges and subject the industry to technology and operational costs. For example, funding a NAV buffer would incur capital raising costs, including legal and accounting expenses. Similarly the requirement for asset managers to set up an internal rating of assets and no longer rely on external rating would also imply significant costs for the asset management company.

One of the key challenges of this reform is the stricter diversification requirement which may limit the ability of asset managers, especially given that the European bond market is more limited than the one in the US. All those constraints could make MMFs less appealing to investors, thus decreasing the demand for MMFs.

For custodians this reform will also imply new constraints but also potential opportunities. As depositary of the fund, the custodian will have to adapt and reinforce its oversight controls to monitor the various new ratios imposed on MMFs. This will imply additional cost and investment to upgrade the monitoring infrastructure. The prohibition for MMFs to enter into Securities Lending and Repos transactions may also have an impact on custodians' activities. This will also impact the industry as a whole as traditionally MMFs were

holding high quality fixed income assets, which most financial intermediaries will look for, given the various collateral requirements for derivatives clearing or liquidity buffers. Custodians can assist the asset manager community in complying with those new rules by providing independent valuation of assets, supporting the various additional reporting requirements as well as for example assisting in the monitoring of liquidity and redemptions of the funds.

4.4.5 Next Steps

The Commission issued its proposal in the form of a regulation which implies a direct application in the various Member States as soon as the text is being adopted without requiring national transposition. The Commission's ambition is to obtain final agreement by the end of 2014.

At the European Parliament level, a lot of work has already been performed. The rapporteur Said El Khadraoui published his draft report on 18 November 2013 with a broad support of the European Commission's proposal, notably on the mandatory 3% capital buffer for CNAV's. The rapporteur also introduced new provisions on external rating (the ban on use of external ratings was deleted) and on CNAV's with restriction for the distribution of CNAV's (CNAV's should not be offered to retail investors) and CNAV's should be transformed in Variable NAV's by the end of 2019.

The deadline for proposals of other amendments by the ECON (Economic and Monetary Affairs) Committee was on 10 December 2013. A total of 391 amendments were tabled with most of them on eligible assets (globally suggesting to enlarge the scope of eligible assets, including some securitization vehicles), diversification rules (for a wider alignment with the UCITS diversification rules) and on the capital buffer for CNAV's. On this particular one, the diversity of amendments reflects the current huge debate on CNAV's and the way they should be regulated in the European Union. More specifically, many amendments proposed to delete the cash buffer for CNAV's and to replace it by redemption and/or liquidity fees.

The vote of this text proposal by the ECON Committee is planned on 12 February 2014 and on 15 April 2014 in Plenary session. At the same time, the target to obtain a final agreement by the end of 2014 is most likely not to be achieved for two main reasons:

- First, the European elections in spring 2014 (resulting in the renewal of both the European Parliament and the European Commission), mean in practice that any major legislative work will be halted between February and September 2014.
- Second, the review of MMFs is part of the Greek Presidency's priorities for the second half of 2014 only and where there is enough capacity in this respect.

In addition it is worth mentioning that this proposal has created significant reactions both in the industry but also by a number of Member States. As a result it may be reasonably expected that consensus is hence far from being reached.

Despite potential delays, it is most likely that the European authorities will adopt some measures on the MMFs, at least to support the G-20 agenda and the FSB recommendations. It remains therefore important to monitor European initiatives on this front.

5. General Conclusions

To date regulatory reforms have focused on the regulation of banks to include capital requirements and practices that were considered central to the recent financial crisis. These market practice reforms, such as the move of OTC derivatives to an on-exchange model and the reporting of derivative exposures to regulators via Trade Repositories, impact all market participants. Time will tell whether the reforms envisaged for «Shadow Banks» and partially enacted at this stage (mainly about more transparency and increasing protection for investors) will be sufficient to make the Shadow Banking System less opaque or whether they should be more intrusive to control risks now shifted from regulated banks to hedge funds and other Shadow Banking actors.

The reforms detailed in this paper for MMFs and Securities Lending/Repo have a significant impact on custodians that sponsor or custody/administer MMFs and those that manage in-house Securities Lending programs or process Repo activity on behalf of their clients. The reforms need to be closely studied so that custodians can make required adjustments to accounting and disclosure policies and procedures. The jury is out as to whether proposed MMF reforms will impact client product appetite and whether other alternatives, to include bank deposits, will benefit.

6. Working Group Members

BNP Paribas Securites	Laurence Caron-Habib (Chair)	Paris
Citigroup	Bruce Treff	New York
Citigroup	Ionnis Tzouganatos	New York
DTCC / ISSA OC Chair	Neil Henderson	New York
Euroclear	Joe van de Velde	Brussels
HSBC	Wayne Burlingham	London
HSBC	Henry Raschen	London
ISSA	Urs Stähli	Zurich
SWIFT	Richard Young	Brussels