THE INVESTMENT ASSOCIATION

Felix Grenfell Bozek and Liam Browne
Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

8 March 2024
By email to: cp23-28@fca.org.uk

Dear Felix and Liam,

RE: FCA CP 23/28: Updating the Regime for Money Market Funds

The IA welcomes the opportunity to respond to the FCA's consultation on its proposed changes to the UK Money Market Funds (MMF) Regime. There are many reforms proposed in the consultation that we regard as beneficial, such as delinking, but some proposals, in particular, around the increase of minimum daily and weekly liquid asset requirements are not justified and could prove damaging. Our response to the consultation is attached to this letter.

In discussing the proposed reforms to the UK MMF regime, it is important to note that the majority of sterling MMFs that are marketed in the UK are domiciled in the EU, as is acknowledged in the consultation. We recognise that it is the FCA's prerogative to proceed with MMF reform proposals ahead of the EU. However, the divergence this creates presents challenges for both managers of MMFs and their investors. In particular, early clarity is needed on the future recognition of EU MMFs[1] under the Overseas Funds Regime. Under the current proposals, the recognition of EU UCITS MMFs under the Temporary Marketing Permissions Regime (TMPR) is due to expire at the end of 2026, whereas for EU AIF MMFs, the TMPR will remain until 2027. This difference in the expiry dates is a cause for uncertainty and concern for both managers and investors. To avoid any cliff-edge concerns, which could trigger unnecessary withdrawals from MMFs, the TMPR for EU UCITS MMFs should be extended to the end of 2027. We appreciate that the recognition of the EU MMF framework, and the applicable timelines for transition, are largely outside the FCA's responsibilities, but nonetheless it is important to highlight these concerns given their significance.

[1] Strictly speaking, the Temporary Marketing Permissions Regime also extends to EEA member states, but our understanding is that only MMFs established in EU member states, particularly in Ireland and Luxembourg, are actively marketed in the UK, so for simplicity we will refer to EU MMFs in this response.

The Investment Association

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Equally, the UK authorities need to be mindful that divergence also creates the risk that UK MMFs will be at a competitive disadvantage to EU MMFs, particularly while the TMPR is still in force. As far as possible, we would welcome the alignment for the transition period for UK and EU MMFs into the new requirements, so all MMF managers, whether they choose to domicile their MMFs in the EU or the UK, have a fair playing field.

We look forward to discussing these wider issues further with the FCA, the Bank of England and HMT, as well as the technical points raised in the consultation.

Yours sincerely

Peter Capper
Senior Adviser, International Fund Regulation

Response to consultation

FCA CP23/28: Updating the Regime for Money Market Funds

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.8 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 48% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

- The IA welcomes the FCA's decision to allow the existing MMF structures to continue, including its decision to retain the stable NAV feature of Public Debt CNAV and LVNAV MMFs, and to continue allowing intraday and same day settlement of redemptions from MMFs.
- We strongly support the proposal to remove the link between minimum liquidity thresholds and the imposition of liquidity management tools, noting that this has created the perception of a cliff-edge among MMF managers and investors, creating the potential for run risks.
- We do not support the proposed increase in minimum Daily Liquid Asset (DLA) and Weekly Liquid Asset (WLA) requirements. The higher minimum DLA and WLA significantly weaken the commercial attractiveness of MMFs and could exacerbate stresses in Short Term Funding Markets (STFMs) rather than resolve these. Existing minimum liquidity buffers have not been used, let alone found to be deficient, so the increases proposed are neither justified nor prudent.
- There are deficiencies in the market analysis provided in the consultation paper to support the increase in minimum DLA and WLA requirements, particularly in several assumptions used.
- The FCA's approach to reflecting the costs of selling assets in redemptions is reasonable, and we welcome the flexibility for MMF managers to choose from a range of anti-dilution liquidity management tools (LMTs) one that is most suitable for its product, and that the use of anti-dilution LMTs, and the imposition of LMTs, will remain at the discretion of the MMF Manager.
- We are comfortable with the proposal to enhance KYC requirements for all MMFs, though note that obtaining information on underlying investors from intermediaries remains challenging.
- We are also in agreement with proposals to enhance stress testing requirements for LVNAV MMFs, although more detail on these will be needed, and we suggest that the insights and experience of industry practitioners are taken into consideration when developing and designing the stress tests and scenarios used.
- There is a demonstrable use case for tokenised MMFs to be used as collateral, particularly in non-centrally cleared derivative transactions, although we do not discount the use of these for centrally cleared derivative transactions either. The IA has produced a paper, Money Market Funds and Tokenisation: Collateral Opportunities (March 2024), produced jointly with LiCuido, on this use case of tokenised MMFs, which will be presented to the Asset Management Task Force.

Response to Questions

Responses to specific questions raised in the consultation are provided below.

Chapter 2: The Wider Context

Q1: What, if anything, do you consider to be unintended consequences of this intervention?

While acknowledging that the FCA did not take forward most of the proposals that could cause significant damage to the UK MMF sector, the broader financial system and the broader economy, the IA perceives that certain proposals in the consultation paper could still have unintended, or at least undesirable consequences.

Higher Liquidity Buffers

The proposal to increase the minimum DLA and WLA requirements will have a several unintended consequences, including on STFMs. The available pool of sterling assets that meet this criteria is limited. Increasing the WLA requirements across all funds will lead to a significant increase in demand for daily and weekly assets. It is not clear that there will be sufficient supply available to meet this demand, especially at quarter and year ends, where our members report that bank repurchase facilities fall by around 80-90%.

The lack of supply to meet DLA and WLA requirements will increase prices, greatly reducing the yields available at these points. We estimate the effect of this proposal on MMF yields, particularly considering if the significant number of overseas MMFs marketed in the UK are required to comply with the same requirements, will likely exceed the estimates given in paragraph 80 (page 72) of the Costs and Benefits Analysis. This will affect the attractiveness of all MMF products to investors, but particularly standard VNAVs which typically offer higher yields through investment in longer dated assets, but on the understanding that these prioritise yield over immediate liquidity (or where immediate liquidity is provided, there may be a small cost for this). Investors seeking higher yield may instead choose to invest in short-dated bond funds (i.e. those that don't meet the definition of MMFs).

Competitiveness of UK MMFs

Proceeding to implement reforms to the UK MMF Regime ahead of any reforms to the EU MMF framework being consulted/implemented, places UK MMFs at a potential disadvantage vis-à-vis EU MMFs, particularly while the EU MMFs marketed in the UK can remain in the TMPR. Given the high connectedness between the EU and UK frameworks, and the dominance of the EU framework, we recommend that the FCA takes a pragmatic approach to the timing of the implementation of its reforms and seeks, as far as possible, to align with the EU MMF Regulation reform proposal expected during the next Commission.

Chapter 3: Increasing Available Liquidity

Q2: Do you agree with our proposal to 'delink' stable NAV MMFs' liquidity buffers? Please give your reasons.

We support the proposal to remove the link between stable NAV MMF liquidity buffers and a requirement to consider the deployment of liquidity management tools. As has been widely documented, while the current MMF framework only requires the Board of the MMF/its manager to consider if these tools should be deployed, not to actually deploy these, the threshold is now seen as a floor rather than a source of liquidity available to meet unexpected redemptions. Explicitly removing the link will remove an explicit and known point at which a manager might impose a liquidity management tool. This increases the likelihood that MMF investors are less likely to associate a fund's assets fall below the minimum buffer levels.

We consider that the removal of delinking effectively makes the buffer more useable as an emergency liquidity reserve. This will allow managers to set buffers over the regulatory minimum that they expect to be required under normal or even moderately stressed scenarios.

Q3: Do you agree that we should revoke FG22/3, but retain its guidance on managers returning the fund to the relevant regulatory minimums as Handbook guidance in MMFS?

Yes – the guidance in FG22/3 was helpful, clarifying that there was no regulatory expectation that liquidity management tools should be imposed if regulatory minimum levels were breached. The guidance that managers should seek to return funds to their regulatory minimum levels is helpful, as this cements the purpose of the minimum buffers as a resource to meet unexpected liquidity demands, not a to meet unexpected liquidity demands, not a floor with negative consequences for the MMF and investors if these are breached. We therefore support retaining this as Handbook Guidance in MMFS.

Q4: Do you have any overall comments on our policy position on other options to increase the usability of MMF liquidity resources?

The IA agrees that changes are not needed to how liquidity buffers are calculated and supports the decision of the FCA not to propose that regulators dynamically change requirements in a stress. As the FCA notes, dynamic thresholds could have significant downsides, such as increasing supply pressures in very short-dated assets and exacerbating sales of longer dated assets (i.e. those that are not daily or weekly maturing assets) in challenging market conditions. A regulatory announcement on a change in liquidity requirements could also negatively influence investor behaviour.

Q5: Do you agree with the proposed increases in minimum daily and weekly liquidity to 15% and 50% of assets respectively for all UK MMF types? Please explain your reasoning.

We do not agree with the FCA's proposals to increase the minimum daily (DLA) and weekly liquidity (WLA) requirements for all MMFs, regardless of type, to 15% and 50% respectively. There are several reasons for disagreeing with this proposal:

The case for increasing the existing minimum liquidity thresholds has not been made. It is our view that to justify an increase in minimum liquidity thresholds, the following should have occurred:

1. During a stressed market episode, a MMF was forced to draw on its minimum liquidity buffer; and
2. The minimum liquidity buffer proved insufficient to meet the outflows.

Since the implementation of the existing minimum liquidity buffer requirements introduced as part of the EU MMF Regulation, there have been several occasions of market stress where MMFs came under pressure, most notably in March 2020 and September 2022. Yet at no time during these stress events was any MMF even forced to draw on its minimum liquidity buffers, let alone test whether these were adequate.

The proposed increased thresholds do not differentiate between MMF types, despite material differences in the characteristics of different MMFs. We do not believe the case has been made to increase weekly liquidity buffers for any MMF type. That said, the increase in WLA from 15% to 50% for VNAV MMFs is especially egregious, particularly for standard VNAV MMFs. A VNAV MMF is not committed to maintaining a stable price, and therefore a deviation from expected value following a sale has less impact on the MMF. This is particularly the case for standard VNAV MMFs, where investors have chosen funds that are intended to provide an uplift in yield through some exposure to longer dated assets. The increase in WLA undermines this objective and purpose.

Significant increases in minimum WLA requirements will increase market demand pressures on overnight and weekly assets. The supply of sterling weekly assets is already constrained, particularly around quarter and year ends. Our members report that banks can reduce their capacity by as much as 80-90% at these key junctures. A significant increase in WLA requirements will put added pressures on these markets, creating price distortions and reducing yields. We explore this more in our response to Q30.

Managers do not rely on liquidity held in their minimum liquidity buffers to meet redemptions under normal or stressed market conditions. They maintain buffers of daily and weekly assets over and above minimum thresholds, in order to meet redemptions without having to draw on their minimum buffers, which themselves are standalone regulatory requirements. There is no indication that this is likely to change after delinking – feedback from our members who manage MMFs suggest that they will want to continue holding buffers over and above minimum DLA and WLA levels.

The fact that some managers are holding WLA and DLA levels close to the proposed new minimum thresholds does not signal a limited impact on MMF portfolios and potential yields. Rather, managers are likely to hold much higher levels of DLA and WLA. As well as placing strains on the markets for daily and weekly assets, and reducing yields, this will also result in MMFs holding less in assets with longer maturities, such as commercial paper (CP) and certificates of deposit (CD), which typically have maturities around 1-3 months. MMFs will have less capacity to purchase primary issuance of these papers, or purchase these on secondary markets, removing an important source of bank funding and liquidity in these markets.

It is not evident that investor perceptions on minimum liquidity buffers will change materially following delinking. We very much welcome delinking, which will mean that the minimum DLA and WLA requirements will no longer be a defined trigger point for the implementation of liquidity management tools. But it should not be assumed that investors will no longer have any concerns regarding the minimum liquidity buffers, or monitor liquidity levels. Feedback from our members suggest that these will continue to be scrutinised, and MMF managers will still be expected by investors to hold liquidity over the minimum liquidity buffer requirements. This will contribute to MMF managers raising levels of DLA and WLA assets noted above.

Overall, we are concerned that the increases proposed to minimum DLA and WLA thresholds will significantly weaken the commercial attractiveness of MMFs and could exacerbate market stresses rather than resolve these. Given that to date, the minimum liquidity buffers have not been used, let alone found to be deficient, the increases proposed are neither justified nor prudent. This is particularly the case for the dramatic increases proposed for standard VNAV MMFs.

Q6: Do you agree with our assessment of the market impact? Are there other factors we should consider?

We do not agree with the assessment of the market impact. In our view, several assumptions are made in the market impact analysis and the subsequent assessment which do not reflect market practice.

The assessment assumes that MMFs will not sell, or be able to sell, any assets to meet redemptions. This is not the case – although MMFs typically hold assets to maturity, asset sales are possible. Although the level of secondary trading in STFMs is low, the assets are not inherently illiquid – typically they can be traded and settled the same day, if a buyer can be found. Banks will normally be willing to buy back their paper in the event a MMF needs to sell.

The analysis assumes that MMFs will only hold CP and CD. Certain MMFs can hold other assets, such as covered short-dated bonds and SSA assets which can be sold much easier than CP and CD in stressed market conditions.

The analysis does not differentiate between types and characteristics of MMFs. An LVNAV MMF will generally meet redemptions from DLA and may want to avoid selling non-DLA asset as this could risk a deviation of the Fund's mark to market NAV from its transactional stable value, but this consideration is less of a factor for VNAV MMFs, particularly standard VNAV MMFs. In any case, an LVNAV MMF if necessary, can move to a Variable NAV. A further differentiation is settlement – UK authorised standard VNAVs do not usually offer same day settlement, giving them more time to find buyers to meet asset sales.

Furthermore, the market analysis does not consider the introduction of anti-dilution liquidity management tools, and the ability of all MMF managers to deploy these. Should a MMF manager only be able to sell an asset at a discount in order to meet redemptions, the manager will be able via anti-dilution LMTs to pass the cost directly to redeeming investors, limiting any impact on the MMF or the remaining investors.

Q7: Do you agree with the resulting balance between daily and weekly liquidity requirements? How does the balance between these elements impact resilience?

MMF managers often elect to hold a significant proportion of their WLA in daily assets, especially overnight reverse-repos, much above what is required in the thresholds. That said, we do not support a change to minimum DLA requirements – these are already calibrated to provide an emergency supply of liquidity, which is what buffers are intended for.

Q8: Do you agree that the stable NAV MMF WLA derogation (to include highly liquid government debt as WLA up to a limit of 17.5 % of total assets) should be extended to VNAVs? Do you have views on what public sector debt should be permitted in this derogation, and what the appropriate level should be?

We agree with this proposal – we see no reason for this derogation to only be extended to stable NAV MMFs. We are also of the view that the 17.5% upper limit on highly liquid government debt should be removed. This can be a valuable source of liquidity and diversify the WLA pool. Over the last decade, the availability of highly liquid government debt has been too thin for MMFs to have substantial holdings in these. For this reason, we do not support a minimum government debt requirement. However, we do not think there is a case for limiting the proportion of these assets that could be held and count for WLA purposes, were issuance of such assets to increase in the future.

Q9: Do you agree that the WLA derogation allowing VNAV MMFs to include money market instruments or units of other MMFs within their WLA up to a limit of 7.5 % of total assets should be removed?

We are aware that the proposed removal of the derogation will cause difficulties for some VNAV MMFs. The use of money market instruments or units of other MMFs has proved an efficient mechanism for VNAV MMFs to meet their minimum WLA requirements. The ability for MMFs to use these as part of their WLA are capped, limiting the reliance on other MMFs and non-government money market instruments. Notably, these can only be used as part of the WLA, not the DLA, giving time for the MMF to draw on the liquidity where needed. In respect of MMF units, risk of contagion is also limited through the KYC requirements that apply at the level of the investee MMF – these KYC requirements allow the manager of the MMF to track what proportion is held by other MMFs, identify and liaise with the managers of those MMFs their expected flows so any outflows can be managed.

Other diversification and concentration measures could be considered as policy option to mitigate contagion risks as an alternative to an outright removal of this derogation. The industry is open to discussing potential options with the FCA.

Q10: Do you agree with our proposed rules changes to strengthen and broaden the existing MMFR KYC requirements for managers of all MMFs?

Along with other industry groups, we identified that the KYC requirements had greatly assisted managers in understanding their investor bases, expect flows and factors that might lead to sudden redemptions by investors (eg margin calls). As such, we agree with the FCA's proposals to enhance the KYC requirements, recognising these can assist managers in ensuring MMFs have sufficient liquidity to meet expected redemptions in normal and stressed market conditions.

Where distribution is intermediated, obtaining KYC information on underlying investors can be more challenging for MMF managers, as intermediaries are not under the same obligation to provide KYC information to MMF managers, and are often reluctant to do so citing client confidentiality. The FCA should consider obligations on intermediaries to provide KYC information to MMF managers, where this relates to the requirements in MMFS.

Q11: What do you see as the advantages and disadvantages of a commercial borrowing facility for MMF liquidity during a stress? How likely would you be to use such a facility?

The IA supports the ban on external support, noting both that it prevents transmission of risks to the wider financial sector (e.g. by a sponsor assuming risks of a distressed MMF on its balance sheet), but also ensures a level-playing field between different types of MMF providers, some of which are standalone asset managers and some which belong to broader financial services groups. Similarly, a borrowing facility for MMF liquidity during stress could raise risks for both MMF investors and the wider financial system. As such, we do not believe MMFs should be permitted to enter into commercial borrowing arrangements on an overnight or longer basis.

This prohibition is not currently interpreted as applying to intraday overdrafts. The ability to use intraday overdrafts is key for MMFs offering intraday settlement, and bridges settlements against liquidation/maturity payments. As long as these overdrafts do not extend overnight, the risks arising from these are limited, essential for operational reasons and should continue to be out of scope of the prohibition on borrowing.

Chapter 4: Passing on the cost of liquidity

Q12: Do you have any comments on our overall policy approach to the issue of passing on the costs of liquidity to redeeming MMF investors?

We agree with the overall policy proposed by the FCA and note this is aligned with reforms in other jurisdictions. This approach achieves the balance of providing tools to manage any dilution risks that may occur without mandating a "one size fits all" approach. In particular, we welcome the approach to retaining the discretion on whether to use anti-dilution tools with the MMF manager, who has the closest and most immediate knowledge of the composition of the portfolio, the nature of the investor base and to inflows and outflows.

In principle, we support costs of liquidating assets to meet redemptions to be borne by the investors that are redeeming the investments from the perspective of treating customers fairly. This also reduces the potential for perceived first mover advantage, since it ensures investors will not benefit from a more favourable price if the redemptions result in reduced liquidity or asset sales. In practice, MMFs rarely incur costs of liquidity as MMF managers closely monitor flows and use overnight securities and maturing assets to meet investor redemptions. We therefore expect that anti-dilution tools will only be applied to MMFs in exceptional circumstances.

Q13: Do you agree with our proposed rules on requirements for liquidity management procedures and tools for UK MMFs?

We agree with the proposed rules. Offering a choice of tools that can be used to manage dilution allows managers to opt for a tool which is most suitable for the characteristics of that MMF. As noted, we also support the MMF manager being primarily responsible for deciding when anti-dilution or other liquidity management tools should be imposed.

Chapter 5: Addressing risks from Stable NAV MMFs

Q14: Do you agree with our proposed rules on the enhancing stress testing for stable NAV MMFs?

In principle we are comfortable supporting enhanced stress testing requirements for stable NAV MMFs. However, limited detail has been given by the FCA, and the industry would welcome more detail on the proposed enhancements to stress testing, particularly as the FCA looks to replace the stress testing guidelines published by ESMA annually.

We suggest that the FCA seeks to work with industry practitioner experts in designing the stress testing framework and building the scenarios to ensure that these are relevant and effective.

Q15: Do you agree with our proposed rules on the enhancing operational resilience for stable NAV MMFs?

We agree with these proposed rules. It is already accepted best practice for managers of stable NAV MMFs to have operational processes and investor communication strategies in place that can allow a change from a stable NAV to a variable NAV, in the event the 20bps collar is breached. Rules requiring these should provide confidence that a change in the NAV basis can be managed in the event of a price deviation from the 20bps collar.

Careful consideration needs to be given on investor communication. It is important that investors are notified of the change, but also that these are not worded in a way that triggers redemptions. In particular, the communication of the NAV change basis should not be conflated with the overall financial strength of the MMF, or its ability to meet redemption requests.

Q16: Do you have any comments on our overall policy approach to stable NAV operation in the UK MMF regime?

We are in agreement with the proposal for the LVNAV Manager to be required to notify its Board, the FCA and the depositary if the constant NAV deviates from the floating NAV by more than 15bps. Pre-notification that a stable NAV MMF is close to the collar limit seems prudent.

Getting close to, or exceeding the collar should not be seen as a regulatory event. The collar is related to the pricing of assets, and events that lead to the collar being exceeded are generally outside the control of the manager. Exceeding the collar means that the MMF must change its pricing basis from the stable price to a variable one. It does not necessarily signal an inability of the MMF to meet redemptions, nor that a regulatory breach has occurred. It is important this perception is clear to the broader market.

Chapter 7: Developments in relation to use of MMF units

Q17: In your view, what are the advantages and disadvantages of investors posting and accepting MMF units as collateral for non-centrally cleared derivatives?

The IA strongly supports initiatives to allow the posting and accepting of MMF units as collateral. Ideally, this use case could extend to centrally cleared derivatives, particularly for initial margin, as well as non-centrally cleared derivatives, although in the shorter term we see fewer barriers for this use case for non-centrally cleared derivatives.

The use of MMF units as collateral has the principle advantage that there is no need to redeem the MMF for the purposes of posting collateral. Although strictly financial instruments, units of MMFs, particularly short term MMFs, are usually treated as being cash equivalent or near cash for accounting purposes. These therefore represent a relatively secure and stable asset for the purposes of collateral. Posting the units as collateral, rather than withdrawing the cash from the MMF and posting that cash, reduces redemption pressures on the MMF. Redemption pressures arising from margin calls are less predictable than redemptions arising in other contexts, and are more likely to be procyclical, which can amplify market stress. Removing the need to redeem MMF units in order to post them as collateral removes this additional procyclical selling pressure.

The posting of units also offers potential operational efficiencies, both for the counterparty posting the collateral and the counterparty accepting the collateral. There is a single transaction for the counterparty posting the collateral, removing the need to redeem the MMF unit and then transferring the cash proceeds. The counterparty accepting the collateral also has no need to place the cash on deposit or in another MMF, as the collateral is already held in an MMF.

The disadvantages arise through the operational barriers of transferring and holding units in the MMF. The counterparty accepting the collateral may also need or want to impose a haircut on the collateral received, which would be avoided if cash was posted. This may make posting MMFs units less attractive when compared to posting cash.

Q18: What specific barriers are there, if any, to posting and accepting MMF units as collateral for non-centrally cleared derivatives?

For non-centrally cleared derivatives, we understand the principal barriers to the posting of MMF units as collateral are operational – although MMF units are transferable, the process for transferring these is onerous, requiring a stock transfer form (or a pre-arranged standing instruction) to be submitted to the MMF registrar. The turnaround for transfers of title to units is typically slow, as there is not an obligation on the manager to process these the same day as there is with sales and redemptions of units.

Some regulatory barriers also restrict the use of MMF units for use as initial margin in MMF transactions, such as the concentration limits applicable to UCITS in the UK Margin RTS. As noted by ISDA in its response, raising the current 15% concentration limit and removing the €10 million limit will allow MMFs to be more efficiently used.

The tokenisation of MMFs could remove many operational barriers. This would allow the immediate transfer of the tokenised units, without having to go through the registrar (and the consequent operational inefficiencies and delays), and with minimum inconvenience to the collateral provider and receiver. Our paper, Money Market Funds and Tokenisation: Collateral Opportunities (March 2024), produced jointly with LiCuido, sets out how tokenisation can overcome traditional barriers to using MMFs as collateral.

In discussions with counterparties, some concerns have been raised on the acceptance of MMF units/tokens as collateral, which would need to be overcome, including:

- The need for all parties to accede to an agreed tokenisation platform, including performing due diligence to ensure legal certainty over matters such as the treatment of the tokens, enforceability of insolvency, etc.
- The need to establish custodial arrangements to hold MMF units/tokens.
- The need to look through to the underlying assets of the MMF to establish eligibility of collateral and haircuts.
- The fact that MMFs can impose fees, gates or suspend dealing.

We think these barriers can be overcome through development of robust tokenisation platforms (of which some are already available) and better communication of the nature of MMFs. For example, delinking removes the red line whereby fees, gates or suspension are considered in the fall in DLA or WLA to below minimum threshold levels (and of course, historically no UK or EU sterling MMF has fallen below the minimum thresholds, let alone imposed LMTs). The need to look through could be addressed through recognition of the strict rules and asset thresholds applying to MMFs, especially short-term MMFs, and supported credit ratings from regulated Credit Ratings Agencies. Regulatory endorsement on the acceptability of MMF units would support this significantly.

Q19: What do you see as the advantages and disadvantages of tokenisation in overcoming the operational barriers for use of MMF units as collateral?

Please refer to our paper, Money Market Funds and Tokenisation: Collateral Opportunities (March 2024), produced jointly with LiCuido, which explores these in detail.

It is important that a distinction is made, both for regulatory purposes, between traditional securities, such as MMF units, that are being represented by tokens, and digital assets such as cryptocurrencies. Regulatory clarifications should be given to ensure that MMF units represented by tokens are not treated adversely compared to other MMF units, for example on EMIR and Basel III standards.

Q20: How could MMF tokenisation in general interact with the proposals to increase MMF resilience?

Delinking in particular will increase the acceptability of MMF tokens for the purposes of collateral, along with other measures such as enhanced stress testing and KYC. It is our view that increasing minimum DLA and WLA thresholds will be unlikely to make MMF tokens more acceptable – the focus for collateral is more likely to be on the quality of assets rather than the maturity.

We anticipate that tokens that represent an entitlement to high quality liquid assets, such as Treasury Bills, will be preferred by counterparties (though as noted, there is limited supply of these assets in the sterling markets).

Chapter 8: Smarter Regulatory Framework

Q21: Do you have any comments on the proposed drafting in MMFS? In light of the explanations given in Appendix 1, are there are any areas where you consider we may have inadvertently changed the policy?

In its 2019 UK Fund Regime Working Group report, we recommended the FCA consider moving investment fund regulation to a single sourcebook. We would therefore have preferred the FCA to have incorporated these rules as a new chapter in one of the existing rulebooks, rather than adding to the proliferation of fund sourcebooks.

We otherwise have no material comments on the proposed drafting in MMFS.

Q22: Do you have any feedback on our proposed drafting of MMFS with regard to the definition of 'commodities'?

We agree with aligning the definition of commodities with that also used in the UK MiFID/MiFIR, recognising and supporting the policy intent.

Q23: Do you agree that the Handbook should revert to original intention of EU MMFR Article 10?

It is our view that MMFS 3.3.1R should remain aligned with COLL 5.2.8R - we do not consider the original narrowing in the EU MMF Regulation to have been necessary.

Q24: Do you agree that these modifications do not make a material change to MMF rules?

We agree.

Q25: Do you agree that MMFs depositing cash with such public bodies should be regularised with explicit text in regulation?

We agree that MMFS should explicitly permit the depositing of cash overnight with the DMO and other such public bodies.

Q26: Do you agree that UK MMFs should be able to enter into reverse repurchase agreements that can be terminated by giving prior notice of no more than 5 days?

We agree with this proposed rule change, which will make it easier for MMFs to enter into reverse repurchase agreements.

Q27: Does the Handbook drafting setting out the requirements of UK MMFR Articles 17(7)(a)-(d) represent a material change from the UK MMFR?

We are comfortable that the drafting changes referred to in the question do not represent a material change from the UK MMFR.

We do note that the requirements in MMFS 2.8.5R and MMFS 3.2.6R, while being transferred from the existing UK MMFR, are likely to prove challenging if repurchase/reverse repurchase agreements are moved to central clearing, especially where these face off to the central clearing counterparty. This will increasingly be the case for US dollar transactions. We recommend the FCA introduce an exclusion from these requirements where the counterparty is a CCP.

Q28: Do you agree that these provisions are not relevant to the UK financial sector and can be deleted without affecting the operation of MMFs in the UK?

We agree the provisions on employee savings schemes and diversification exemptions for MMFs in states with small financial sectors are, while remaining relevant in other European markets, not relevant to the UK financial sector.

Q29: Do you agree with the overall approach to stress testing, reporting and supervisory requirements? Please set out the reasons for your answer.

We agree with the overall approaches set out by the FCA, although look forward to more detail being given on the stress testing in due course.

As regards reporting, we were disappointed when in 2020, the FCA opted to use the Qualtrics Survey Tool to receive MMF reports. This has limited functionality, and information has to be inputted manually. MMF reporting should be moved to RegData, where systems to systems reporting can be used.

Annex 1: Cost Benefit Analysis

Q30: Do you have any comments on our cost benefit analysis?

It is our view that the CBA underestimates the impact on MMF yields of increasing minimum DLA and WLA requirements. As we understand it, the CBA does not take into consideration the following:

- MMF Managers are likely to continue holding DLA and WLA levels that are significantly higher than minimum levels. DLA and WLA levels are therefore likely to be higher than accounted for by FCA.
- The CBA does not consider any potential impact on pricing of 1 week rates arising from an increase in demand. Issuance in this area is low, limiting opportunities to hold instruments that meet WLA definitions.
- The CBA only considers the impact of the 17 UK authorised MMFs increasing their DLA and WLA holdings. This does not consider that increased DLA and WLA requirements are likely to be mirrored by the much larger volume of EU domiciled sterling MMFs. This could feasibly arise through one or more of the following scenarios: i) EU MMFs are obliged to comply with UK MMF minimum liquidity thresholds as an additional requirement for recognition under the OFR, ii) UK reforms are mirrored within the EU, or iii) expectations from investors or credit rating agencies adjust so that EU sterling MMFs are expected to hold the same minimum liquidity thresholds as UK MMFs. This would further exacerbate demand on the limited UK MMFs.
- Finally, the CBA does not consider that availability/issuance of short term instruments varies throughout the calendar year. In particular, bank overnight and short term capacity can be very limited at key reporting periods at quarter ends, and particularly year ends as banks pare down their balance sheets. The demand pressures on the limited market capacity will only be exacerbated by the proposed increases in DLA and WLA thresholds for all MMF types, which will further drive down yields MMFs can obtain for their DLA and WLA during these periods.