



# IMMFA

INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

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## QUALIFYING MONEY MARKET FUNDS

**A MiFID2 guide for investment firms placing and administrating client money**

(Version 1)

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## QUALIFYING MONEY MARKET FUNDS:

### MiFID2 guide for investment firms placing and administrating client money

(Version 1)

#### EXECUTIVE SUMMARY

This leaflet acts as a guide for Financial Conduct Authority authorised firms when considering using Qualifying Money Market Funds for client money.

Recent rule changes from the FCA are causing firms to revisit options for client money. Key considerations for firms are:

- the requirement to obtain explicit consent from investors before placing client money in a QMMF;
- assessment of the fund as a QMMF against the updated FCA definition;
- operational challenges, such as splitting client money pools.

#### INTRODUCTION

The Financial Conduct Authority (“FCA”) Client Asset Sourcebook (“CASS”) gives UK based MiFID investment firms the ability to place client money in Qualifying Money Market Funds (“QMMF”). This leaflet provides a guide to the regime for that activity. It is a non-exhaustive guide, and firms should therefore satisfy themselves that they meet all the requirements for client money in a QMMF. We strongly recommend confirming the position with your compliance officer and CASS auditor.

Placing client money has become increasingly difficult for many authorised firms as the introduction of new capital rules for banks make it expensive for them to accept short term deposits. Quarter ends have proved particularly challenging and there is anecdotal evidence that firms have had to consider placing client money with lower-rated institutions at these times. Firms are understood to be keen to find other repositories for client money in order to ease capacity concerns, and money market funds provide one such possibility. Coincidentally the FCA, in the UK, has recently revised its rules on the use of QMMF for client money purposes. The new rules come into effect on 3 January 2018. The leaflet reflects the changed regime.

## BACKGROUND

In November 2007 MiFID<sup>1</sup>, a broad-scope European (single market) Directive, came into force. Amongst many other provisions, it established minimum standards across the EU, for the first time, for protecting client money in the event of the insolvency or bankruptcy of an authorised financial services firm. Also for the first time, the Directive permitted firms to place client money into QMMF, as an alternative to depositing client money in a bank.

Because MiFID is a Directive, each EU Member State has to implement the provisions in to domestic law and regulation. The UK accordingly changed its pre-existing client money rules to encompass the use of QMMF. At that point, firms faced no difficulty in depositing client money with banks and most did not therefore investigate the use of QMMF in any great detail. The UK implementation in respect of QMMF created substantial additional work for them. Few firms wished to take this on.

The use of QMMF for client money therefore largely remained in abeyance until the recent rules implementing MiFID2<sup>2</sup> (a Directive that revised MiFID). In the current environment many financial services firms are experiencing difficulties with placing client money on deposit at banks, owing to the introduction of new bank capital rules under Basel III. Following engagement with the FCA during its consultation on the UK implementation of MiFID2, the status of and requirements for firms placing client money in a QMMF were clarified. Changes were also made to the definition of QMMF, to align it with MiFID2. The rule changes come into effect on 3 January 2018, as part of MiFID2 implementation.

The recent changes make the placement of client money in a QMMF a fully viable option for UK based MiFID investment firms with client money responsibilities.

It is worth noting that whilst MiFID has been approaching final implementation, regulatory reform has also been under way for money market funds. Although the new European money market fund Regulation<sup>3</sup> (the “MMF Regulation”) has little impact on the MiFID QMMF client money rules, we have nonetheless for clarity reflected the position before and after its implementation in the analysis of the QMMF definition. A chart, at Appendix 1, displays the relationship between existing European money market fund products and new money market fund products that will come into being during 2018. Further information on the money fund reforms may be found on our website and are summarised in a pamphlet written for investors: <https://www.immfa.org/about-mmfs/investor-help.html>

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<sup>1</sup> Markets in Financial Instruments Directive 2004/39/EC

<sup>2</sup> Markets in Financial Instruments (amending) Directive 2014/65/EC

<sup>3</sup> Regulation on money market funds (EU) 2017/1131

## HOW DO THE REVISED CLIENT MONEY RULES WORK?

In their second Policy Statement on MiFID<sup>4</sup> implementation, the FCA clarified two important points:

- The status of firms using QMMF for client money purposes.
- The new wording for the definition of *Qualifying Money Market Funds*

Both points are explained further below. Additionally there is a schedule identifying required communications with clients.

### Status of firms

For a MiFID investment firm, placing client money is an “ancillary” activity. This means that the activity is undertaken as a consequence of the firm’s main business (e.g. wealth management, investment management) and is not operated as a separate business.

However long before MiFID was in place, firms in the UK were given separate permissions for their authorised activities including one for the purposes of handling client money. When MiFID came in to effect, the UK continued with their existing permissions regime by way of implementing it. In relation to QMMF, this approach gave rise to uncertainty about precisely which rules applied to firms using QMMF for client money purposes. A particular concern was that the firms appeared to be subject to the full range of Conduct of Business rules (COBS) that would apply had a client’s holding in an investment fund arisen from an investment recommendation, rather than being a placement of client money. In the recent Policy Statement, FCA have clarified the position, as follows:

- When client cash is held by the firm, it is subject to CASS 7 rules.
- When client cash is placed in a QMMF, CASS 7.13.26R makes the firm’s holding of the units in the QMMF subject also to CASS 6. This is because the cash has been converted to an asset and the holding of the asset is subject to custody rules, including the record keeping for custody assets.
- The asset remains subject to CASS 6 until the units in the QMMF are redeemed. At that point the cash becomes subject to CASS 7 once more, so there is no gap in application of client money/asset protection.
- COBS applies only as relevant to the activity of handling client money. In practice, this refers principally to client reporting requirements set out in COBS.
- The QMMF units will also be subject to Client Money and Asset Reporting (“CMAR”) by the firm to the regulator. The units held in a QMMF should be reported as a line entry alongside information on bank deposits. The value of units held in a QMMF and of bank deposits will thus represent a firm’s total client money liability.

Holding client money in a QMMF is not therefore treated as an investment activity. Accordingly rules that would apply, had the QMMF holding arisen from an investment service provided to a

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<sup>4</sup> MiFID II Implementation – Policy Statement II PS17/14

client, do not apply when the QMMF holding is made for purposes of placing client money, under CASS 7. As an example, the rules on appropriateness and best execution would not apply.

Firms that hold client assets and client money will already be familiar with the CMAR reporting requirements. Most firms will also be familiar with the requirements of CASS 6, including having the necessary record keeping and client reporting arrangements in place. Holding units in QMMF for client money purposes will not change this, but rather will fit within it.

Firms that currently hold only cash under CASS 7 would need to become familiar with the requirements of CASS 6 and set up operations to deal with CASS 6 requirements before venturing to place client money in a QMMF. We recommend that firms confirm the requirements with their compliance officer and CASS auditor.

### Applying the definition of a “Qualifying Money Market Fund”

Qualifying Money Market Funds were first defined in MiFID, although money market funds as such have been available for decades. In 2010, and again in 2014, ESMA<sup>5</sup> (the European securities market regulators) published Guidelines on Money Market Funds<sup>6</sup> which effectively also gave guidance (by means of additional detail) on the MiFID QMMF definition. Further adjustment was made to the QMMF definition in MiFID2, and this was captured by the FCA, but without all the added guidance from ESMA. The definition which will be adopted from 3 January 2018 is set out in the table. Although a list of QMMF is not maintained by any regulatory authority, the wording of the definition sets out the key requirements, in particular in section (1) (a)-(c). It is worth noting that FCA have provided clarification on the wording in section (2) (b) on the “two highest short-term credit ratings by any agency...”.

To date, the reference points for establishing which money market funds are QMMF have been, in addition to MiFID, the ESMA Guidelines on money market funds, the ratings provided by regulated credit rating agencies and the IMMFA Code of Practice<sup>7</sup>. However once the new MMF Regulation comes fully into effect by 21 January 2019, it is expected to become the main regulatory reference point, outside MiFID, for establishing which funds meet the definition of a QMMF.

Currently all IMMFA funds are constant net asset value Short Term MMFs which in principle should meet the QMMF definition, although firms responsible for client money placement are obliged to make their own assessment of each fund in accordance with CASS rules. With effect from 1 January 2018, the potential universe of IMMFA funds will expand to cover all fund types in the MMF Regulation (see footnote 3). The table below analyses the QMMF definition by reference to the permitted MMF types in the new MMF Regulation and to the position of IMMFA funds from 1 January 2018, to align with the MiFID 2 deadline.

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<sup>5</sup> European Securities and Markets Authority, made up of Competent Authorities from all EU Member States

<sup>6</sup> ESMA (formerly CESR) guidelines on a Common Definition of European Money Market Funds, published 2010 and updated 2014

<sup>7</sup> IMMFA Code of Practice and supplement: <https://www.immfa.org/about-immfa/immfa-code.html>

<i>qualifying money market fund</i>	<i>Features of IMMFA MMF</i>
<p>(1) (in COLL, CASS 7 and BSOCS) a collective investment undertaking authorised under the UCITS Directive, or which is subject to supervision and, if applicable, authorised by an authority under the national law of the authorising Member State, and which satisfies the following conditions:</p>	<p><i>A list of IMMFA funds may be found in the IMMFA Money Fund Report: <a href="https://www.immfa.org/market-statistics/money-fund-report.html">https://www.immfa.org/market-statistics/money-fund-report.html</a></i></p> <p><i>IMMFA funds are (currently) all authorised as UCITS and are domiciled in an EU Member State.</i></p>
<p>(a) its primary investment objective must be to maintain the net asset value of the undertaking either constant at par (net of earnings), or at the value of the investors' initial capital plus earnings;</p>	<p><i>The primary objective of an IMMFA MMF, which appears in the IMMFA Code of Practice, is to preserve capital and provide daily liquidity. The output is a yield comparable with short term money market rates.</i></p> <p><i>In the new MMF Regulation the primary objective is reflected in the requirements for <b>Short Term MMF</b>. There are three fund types that can be Short Term MMF and the position on each is:</i></p> <ol style="list-style-type: none"> <li><i>1. Public Debt CNAV MMF/current Sovereign debt MMF) – eligible to be a QMMF - capital preservation a regulatory objective</i></li> <li><i>2. Low Volatility NAV MMF/current Prime MMF – eligible to be a QMMF - capital preservation an implicit regulatory objective</i></li> <li><i>3. Variable NAV MMF – could be eligible QMMF - capital preservation an option as primary objective, check Prospectus to confirm</i></li> </ol> <p><i><b>Standard MMF</b> are not eligible to be QMMFs as they do not meet WAM requirements below.</i></p> <p><i>See chart in Appendix I to compare current and new fund types.</i></p>
<p>(b) it must, with a view to achieving that primary investment objective, invest exclusively in high quality money market instruments with a maturity or residual maturity of no more than 397 days, or regular yield adjustments consistent with such a maturity, and with a weighted average maturity of no more than 60</p>	<p><i>IMMFA MMF that are Short Term MMF (now and in the future) may invest in a range of instruments that the manager assesses as high quality, including certificates of deposit, commercial paper, variable and floating rate notes, government bonds, treasury bills, Eurobonds, asset back securities an corporate bonds. Fixed rate instruments held in Short</i></p>

<p>days. It may also achieve this objective by investing on an ancillary basis in deposits with credit institutions;</p>	<p><i>Term MMF have a maximum maturity of one year and floating rate instruments have a maximum maturity of 397 days. The maximum permitted weighted average maturity (“WAM”) is 60 days.</i></p>
<p>(c) it must provide liquidity through same day or next day settlement.</p>	<p><i>IMMFA MMF offer same or next day settlement for redemption instructions received by the dealing deadline. Short Term MMFs under the new MMF Regulation should also meet this requirement of a QMMF, as they have been designed to allow same or next day settlement.</i></p>
<p>(2) For the purposes of (1)(b), a money market instrument may be considered to be of high quality if the AIFM or UCITS management company of the collective investment undertaking performs its own documented assessment of the credit quality of money market instruments that allows it to consider a money market instrument as high quality subject to the conditions below: (a) where one or more credit rating agencies registered and supervised by ESMA have provided a rating of the instrument, the AIFM’s or UCITS management company’s internal assessment must have regard to, inter alia, those credit ratings; and</p>	<p><i>IMMFA MMF are required to undertake a credit assessment of assets in order to ensure that assets selected are of high quality. This ensures compliance with the fund rating (where applicable) and the IMMFA Code of Practice.</i></p> <p><i>Under the new MMF Regulation, undertaking a credit assessment is a regulatory requirement for all MMF, designed to ensure that assets selected are of high quality. Some exemptions are made for government securities issued by EU Member States.</i></p>
<p>(b) while there can be no mechanistic reliance on such external ratings, a downgrade below the two highest short-term credit ratings by any agency registered and supervised by ESMA that has rated the instrument will lead the AIFM or UCITS management company to undertake a new assessment of the credit quality of the money market instrument to ensure it continues to be of high quality.</p>	<p><i>In an email dated 7 March 2016 addressed to IMMFA, the FCA clarified that the “two highest short-term credit ratings” mean A1 and A2, P1 and P2 or F1 and F2. They agree with ESMA guidance: “Where a rating agency divides its highest short-term rating into two categories e.g. A-1+ and A1, these two ratings should be considered as a single category.”</i></p>
<p>[Note: article 1(4) of, and recital 4 to, the MiFID Delegated Directive]</p>	

## Communicating with clients

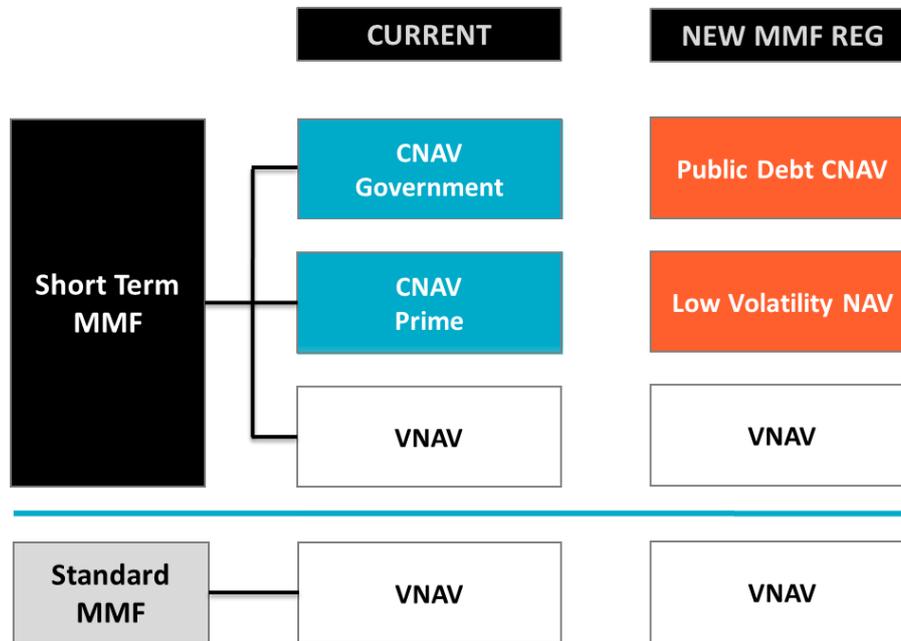
MiFID, and therefore the FCA client money rules, require firms to obtain consent and make certain disclosures to clients before placing client money in a QMMF. These are summarised in the table below. It should be noted that this is a non-exhaustive list and firms should take their own measures to ensure compliance with all the requirements of CASS rules.

**Firms will be repapering clients ahead of the January 2018 MiFID2 deadline and it is suggested that consents should be obtained then if QMMF may be used in future.**

Key FCA Handbook references	Requirement
<b>CASS 7.13.28R</b>	Client must give explicit consent to the placement of their money in a QMMF
<b>CASS 7.13.28R</b> + <b>CASS 7.13.29AG</b>	Firms must inform clients that “money placed with a QMMF will not be held in accordance with the requirements for holding client money”  This requirement may be met by following CASS 7.13.29AG, which states that the firm may inform the client “that the units or shares in the QMMF will be held as safe custody assets”
<b>CASS 9.4.1G</b>	Firms to which COBS 6.1 applies are reminded that, under COBS 6.1.7R, firms must provide clients with specific information about custody assets and client money
COBS 6.1.7R	See above – as mentioned, the rule requires firms to provide clients with specific information on safeguarding of custody assets and client money
<b>CASS 9.5.1G(1)</b>	Firms are reminded of the client information requirements that apply under COBS 16.4
COBS 16.4R	See above – the rule requires firms to provide clients with a statement at least annually of their client money and investment holdings

APPENDIX I

CHART SHOWING CURRENT MMFS AND NEW FUND TYPES UNDER MMF REGULATION



Further information on the money market fund reforms may be found on our website and are summarised in a pamphlet written for investors, available here: <https://www.immfa.org/about-mmfs/investor-help.html>