ASIC

Australian Securities & Investments Commission

REPORT 324

Money market funds

December 2012

About this report

This report summarises the findings of our review of money market funds in Australia, conducted in the 2011–12 financial year. The aim of our review was to examine money market funds and their risks, and to determine whether regulatory intervention is appropriate in Australia.

We also consider the relevance of the International Organization of Security Commissions’ (IOSCO) policy recommendations for money market funds, which were released in October 2012.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Contents

Executive summary

Money market fund industry

1 This report presents the findings of our review of money market funds in Australia, conducted in the 2011–12 financial year.

2 'Money market fund' is not a defined term in the Australian market. For the purpose of this report, we have defined them as unlisted managed investment schemes with investment objectives of capital preservation and yield generation. They achieve these objectives by investing in a diversified portfolio of high-quality, low-duration money market instruments.

3 Money market funds have grown substantially over several decades in overseas markets. One implication of the growth of money market funds is the increased role they play in the short-term funding markets. Consequently, the health of money market funds is important not only to their investors, but also to a large number of businesses and governments that finance their operations through short-term funding markets. A disconnect between money market funds and short term funding markets can lead to reduced business activity and pose risks to economic growth.

4 There has been increasing interest, in both the United States and Europe, in money market funds and the role they play in the financial system. This has prompted reviews of the regulation of money market funds within those jurisdictions. New laws governing the promotion and operation of money market funds are being considered in the United States, and similar initiatives are being implemented in Europe. In addition, the International Organization of Securities Commissions (IOSCO) has undertaken work on money market funds: see Section A.

5 There had been no systemic review of money market funds in Australia of similar nature. In response to developments overseas and the consequent interest from international regulatory agencies, we decided to conduct a review of money market funds to determine whether there was a need to revise the regulatory requirements applicable to such funds in Australia.

Objectives of our review

6 The aim of our review was to examine money market funds and their risks, and to determine whether regulatory intervention in the money market fund sector is appropriate in Australia.

7 We sought to establish a clear picture and better understand the characteristics and risks of money market funds generally, and how they applied to Australia.

8 With this information, we then considered whether regulatory intervention might be appropriate, given the measures introduced in overseas markets (especially the IOSCO recommendations[1]). Regulatory intervention may include appropriate product labelling, guidance or legislative changes.

Our findings

9 Our analysis of the Australian money market funds industry, using the data obtained through our review, revealed that money market funds in Australia do not share many of the characteristics that are prevalent in overseas money market funds.

10 In particular, we found that money market funds are not significant to the short-term funding market in Australia and play an inconsequential role in providing liquidity to this market.

11 We also found that money market funds' exposure to the perceived risks, such as susceptibility to runs is low in Australia. These risks are mitigated by:

(a) money market funds exhibiting short maturity profiles and low levels of volatility, with the possible exception of a few 'enhanced' money market funds that exhibited longer maturity profiles compared to other money market funds;

(b) the absence of any significant mismatch between liquidity and redemption terms, with the majority of money market funds being able to divest their holdings relatively efficiently to meet redemption requests;

(c) the limited exposure of retail and wholesale investors to money market funds;

(d) the lack of a visible misalignment between product branding and disclosure and the product characteristics, with the possible exception of a few enhanced money market funds;

(e) the dominance of variable net asset value (NAV) money market funds and the use of the marked-to-market valuation method;

(f) responsible entities' ability to freeze redemption requests under provisions of the *Corporations Act 2001* (Corporations Act);

(g) there being no requirement for money market funds in Australia to hold credit-rated assets only. Money market funds in Australia, however, choose to hold nearly all of their assets in 'A' and above credit-rated assets as part of prudent credit risk management processes; and

[1] Board of IOSCO, *Policy recommendations for money market funds* (IOSCOPD392), final report, IOSCO, 9 October 2012.

(h) money market funds having limited exposure to repurchase agreements and associated risks.

Methodology

12 We reviewed the concerns raised in overseas markets about money market funds and the regulatory responses made to date in those markets: see Section A.

13 We also reviewed the current regulatory framework for money market funds in Australia, to better understand the Australian industry: see Section B.

14 We selected 500 funds registered with ASIC for an industry review; the funds we selected were those that could be broadly classified as money market funds and fixed income funds. We carried out quantitative and qualitative analysis of the 500 funds, focusing primarily on product branding and investment holdings, to identify the key differences between money market funds and fixed income funds and to clarify the systemic importance of money market funds.

15 To capture industry data, we selected 30 money market funds and 20 fixed income funds operated by approximately 25 responsible entities for a risk-based review. We sent out a detailed survey focusing on key characteristics and risks of money market funds, such as liquidity, asset maturity, NAV structure, redemption terms, credit risk, and investment and investor profiles: see Section C.

16 We used the information obtained from our review to develop a risk matrix for money market funds in Australia. We assessed the industry data against the risk matrix in order to highlight any significant risks. We sought further information from six responsible entities before we finalised our assessment of the industry data against the risk matrix.

17 We also considered each IOSCO recommendation for the money market funds industry. We took into account the adequacy of current regulation and market practices when addressing the key risks identified by IOSCO and the relevance of each recommendation to Australian context: see Section D.

18 Finally, we used our risk assessment to consider whether or not regulatory intervention was warranted and to make the recommendations contained in this report: see Section E.

Recommendations and future action

19 Our analysis to date does not support regulatory intervention for money market funds.

20 We consider current regulation and market practice in Australia to be substantially aligned with the IOSCO recommendations.

21 We will liaise with industry bodies to encourage industry to adopt more standardised product branding, to better distinguish enhanced money market funds from the other money market funds.

22 ASIC has written to Treasury seeking amendments to the concept of liquid assets in the Corporations Act to provide more certainty about whether a scheme is liquid or not.

A Global money market fund industry

Key points

Money market funds play a significant role in the short-term funding markets globally. They hold a significant portion of the overall commercial papers, repurchase agreements, government short-term debt and other short-term money market instruments.

The global financial crisis highlighted the importance of the health of money market funds to short-term funding markets in general.

This has prompted a number of regulatory actions in the United States and Europe, and the development of internationally accepted standards by IOSCO.

Background

23 Money market funds are often defined as investment funds that have the objective of providing investors with daily liquidity while preserving capital through investment in a diversified portfolio of high-quality, low-duration fixed income instruments.

24 Many investors are attracted to money market funds because of their promised near-immediate liquidity and capital safety features.

25 Globally, both constant NAV and variable NAV money market funds are on offer to investors. Money market funds are allowed to use two separate accounting techniques to value their assets, depending on the fund structure and the jurisdiction. Constant NAV funds use the amortised cost method to value their assets to maintain their constant NAV structure, while variable NAV funds use the marked-to-market method to value some or most of their assets.

26 The money market fund industry is significant in size globally. It represented approximately US$4.7 trillion in assets under management in the first quarter of 2012, and around one fifth of the assets of collective investment schemes worldwide. The United States and Europe represent around 90% of the global money market fund industry. Money market funds hold significant portions of the overall commercial papers, repurchase agreements, government short-term debt and other short-term money market instruments.

27 Due to their significant scale, money market funds play an important role in capital markets, such as the short-term funding market, globally. In certain jurisdictions, money market funds engage in bank-like activities (credit

intermediation) and in maturity transformation for the short-term funding market. As a result, the health of money market funds is not only important to their investors, but also to a large number of businesses and state and local governments that finance current operations through the issuance of short term debt.

Regulation of money market funds after the global financial crisis

28 In September 2008, a run on some money market funds—in particular, in the United States—alerted regulators to the systemic relevance of money market funds. Although money market funds did not cause the global financial crisis, their performance during the financial turmoil highlighted their potential to spread or even amplify a crisis.

29 Both the United States and Europe have begun proactive reforms designed to significantly strengthen the regulatory requirements governing money market funds. For example, in 2010 the Securities and Exchange Commission in the United States introduced several investment conditions, regarding maturity and credit quality standards, and liquidity requirements for money market funds, to minimise key risks.

30 However, despite these reforms, concerns remain regarding the stability of the money market fund industry and the risks it may pose for the broader financial system. IOSCO set out the following key risks:

(a) the constant NAV structure gives an impression of safety, similar to a bank deposit, even though money market funds are subject to credit, interest rate and liquidity risk;

(b) the 'first mover advantage', where investors have an incentive to redeem from troubled money market funds at the first sign of market distress—investors who redeem shares early will redeem on the basis of the constant NAV, leaving the cost of any loss to be borne by the remaining shareholders;

(c) the discrepancy between the NAV published and the value of the assets, due to the use of amortised cost accounting valuation method;

(d) the implicit support provided by sponsors or, in extreme cases, governments, as there is evidence that money market funds have relied on sponsor support on numerous occasions but that such support is not guaranteed;

(e) the importance of credit ratings in money market fund regulations and to investors. Reliance on credit ratings may reduce managers' and investors' diligence in the selection of instruments or investments and may create ‘cliff’ effects or trigger a run. [2]

31 Consequently, IOSCO undertook a review of potential regulatory reforms for money market funds that would further mitigate their susceptibility to runs and other systemic risks, and to develop policy recommendations.

32 IOSCO published a consultation paper on money market funds on 27 April 2012.[3] The objective of the consultation paper was to share with market participants IOSCO’s preliminary analysis of the possible risks money market funds may pose to systemic stability, as well as possible policy options to address those risks. IOSCO’s review of potential regulatory reforms for money market funds included considerations such as:

(a) the role of money market funds in funding markets;

(b) different categories, characteristics and systemic risks posed by money market funds in various jurisdictions, and the particular regulatory arrangements that have influenced their role and risks;

(c) the role of money market funds in the global financial crisis and any lessons learned;

(d) regulatory initiatives underway and their possible consequences for funding flows; and

(e) the extent to which globally agreed principles and more detailed regulatory approaches are required and feasible.

33 Subsequent to the consultation, IOSCO released its policy recommendations on money market funds in October 2012: see Table 1. IOSCO notes that while their recommendations are designed to address the financial stability issues potentially raised by money market funds, regulators in each jurisdiction should first assess the role money market funds play in their markets and determine the appropriate policy responses. The size, features and systemic relevance of money market funds often differ significantly from country to country. Accordingly, the implementation of the recommendations may vary from jurisdiction to jurisdiction, depending on local conditions and circumstances, as well the specificities of the existing domestic legal and regulatory structures.

34 We consider current regulation and market practice in Australia is substantially aligned with the IOSCO recommendations: see Section D.

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[2] Board of IOSCO, *Policy recommendations for money market funds* (IOSCOPD392), final report, IOSCO, 9 October 2012.
[3] Technical Committee of IOSCO, *Money market fund systemic risk analysis and reform options* (IOSCOPD379), consultation paper, IOSCO, 27 April 2012.

Table 1: Summary of IOSCO's policy recommendations for regulation of money market funds

Recommendations		Details
General		
1	Money market funds should be explicitly defined in collective investment schemes regulation.	Money market funds may generally be defined as investment funds that seek to preserve capital and provide daily liquidity, while offering returns in line with money market rates. The definition should ensure that all collective investment schemes that present the characteristics of a money market fund are captured by the appropriate regulation even when they are not marketed as a money market fund.
2	Specific limitations should apply to the types of assets in which money market funds may invest and the risks they may take.	Money market funds should include restrictions on the types of asset that are permitted to be held (i.e. high-quality money market instruments and other low-duration fixed income instruments).
3	Regulators should closely monitor the development and use of other vehicles similar to money market funds (collective investment schemes or other types of securities).	This is to avoid confusion among investors as well as to limit the risk of regulatory arbitrage. When collective investment schemes are not money market funds, the reference in product documentation to terminology similar to 'money markets' or 'cash' should be avoided.
Valuation		
4	Money market funds should comply with the general principle of fair value when valuing the securities held in their portfolios. The amortised cost valuation method should only be used in limited circumstances.	Responsible entities should ensure that the assets of the collective investment scheme are valued accordingly to current market prices, provided that those prices are available, reliable and up-to-date.
5	Money market funds valuation practices should be viewed by a third party as part of their periodic review of the fund accounts.	Third parties should review the overall appropriateness of the procedures in place, especially the sourcing of prices for valuing assets.
Liquidity management		
6	Money market funds should establish sound policies and procedures to know their investors.	Money market funds should ensure that appropriate efforts are made to identify patterns in investors' cash needs, sophistication and risk aversion, as well as to assess the concentration of the investor base.
7	Money market funds should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales.	Jurisdictions should define a minimum level of liquid assets that the money market funds should hold (e.g. requirements in terms of daily liquid assets or weekly liquid assets).

Recommendations		Details
8	Money market funds should periodically conduct appropriate stress testing.	As part of prudent liquidity risk management, money market funds should periodically test their portfolios using certain hypothetical and/or historical events, such as a rise in the short-term interest rate, an increase in shareholder redemptions, a downgrade or a series of downgrades on portfolio securities, or a credit event.
9	Money market funds should have tools in place to deal with exceptional market conditions and substantial redemptions pressures.	Money market funds should use tools—such as temporary suspensions, gates and redemptions-in-kind—to manage a run on the fund.
NAV structures		
10	Money market funds that offer a constant NAV should be subject to measures designed to reduce the specific risks associated with their constant NAV structure and to internalise the costs arising from these risks. Regulators should require, where workable, a conversion to the variable NAV structure.	Constant NAV money market funds should convert to the variable NAV structure where such a move is workable. Where such a conversion is not workable, they should develop additional safeguards to reinforce their resilience to losses and their ability to satisfy significant redemption requests.
Credit ratings		
11	Money market fund regulation should strengthen the obligations of the responsible entities regarding internal credit risk assessment practices and avoiding any mechanistic reliance on external ratings.	The responsibility for the assessment of credit worthiness lies with the responsible entity and external ratings should be only one element to take into consideration when assessing the credit quality of an instrument.
12	Credit rating agencies supervisors should seek to ensure credit rating agencies make more explicit their current rating methodologies for money market funds.	Credit rating agencies should increase their efforts to educate investors about their rating methodologies and the differences, if any, between those methodologies.
Disclosure to investors		
13	Money market fund documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principle loss.	Money market fund disclosure documentation should explicitly state the possibility of principal loss.
14	Money market fund disclosure to investors should include all necessary information regarding the funds' practices in relation to valuation and the applicable procedures in times of stress.	Money market fund disclosure documentation should clearly explain to investors the procedures in place for the valuation of the instruments held in portfolios, as well as the procedures that may be used by the responsible entities in case of significant market stress or heavy redemption pressures.

Recommendations		Details
Repurchase agreements		
15	When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repurchase agreements by money market funds, taking into account the outcome of current work on repurchase agreements markets.	Due to the important role of money market funds in repurchase agreements markets, regulators should consider the risks in relation to repurchase agreements markets and, when necessary, develop guidelines governing the use of repurchase agreements and other similar techniques by money market funds. These guidelines should cover areas such as settlement, counterparty risk and collateral management.

Source: Board of IOSCO, *Policy recommendations for money market funds* (IOSCOPD392), final report, IOSCO, 9 October 2012.

B Australian regulatory framework

Key points

Australian money market funds are regulated in the same way as other managed investment schemes. In this section, we provide an overview of the regulatory framework applying to money market funds, including relevant provisions of the Corporations Act and Australian accounting standards.

Corporations Act

35 In Australia, money market funds are regulated in the same way as other managed investment schemes under the Corporations Act. The Act does not impose restrictions on what constitutes a money market fund, except that the name of the financial product must not be misleading or deceptive.

Liquid and illiquid funds

36 The Corporations Act defines when a fund is liquid or illiquid. Currently, to be regarded as liquid under the Corporations Act, 80% or more of fund assets must be liquid assets. Liquid assets include money in an account or on deposit with a bank, bank-accepted bills, marketable securities and other assets that the responsible entity can reasonably expect to be realised for market value within the period specified for meeting redemption requests in the fund's constitution.

37 Under the Corporations Act, only liquid funds may offer at-call redemption in accordance with the requirements of the fund's constitution. Illiquid funds may only offer redemption by making withdrawal offers to members in accordance with requirements of the Corporations Act and the fund's constitution. The Corporations Act requires any offer to specify the period of the offer, the assets that will be used to satisfy any withdrawal requests, the amount of money expected to be available and the method for dealing with withdrawal requests.

38 The responsible entity of a fund is responsible for determining whether a fund is liquid or not. The majority of money market funds in Australia operate as liquid funds. The responsible entity is also obligated to act with care and diligence and in the best interest of members. The Corporations Act does not impose specific obligations on the responsible entity for liquidity risk management.

Disclosure

39 The Corporations Act requires that the assets of the fund must be consistent with what is disclosed to investors, to ensure that disclosure is not misleading. It does not impose restrictions on the type of assets a money market fund may invest in.

40 The Corporations Act sets requirements for the content of product disclosure documents. These requirements include, but are not limited to, information about any significant:

(a) benefits to which a holder of the financial product may be entitled;

(b) risks associated with holding the financial product; and

(c) characteristics or features of the financial product.

41 The Corporations Act does not impose specific obligations to disclose information about the performance of a fund to prospective investors. However, retail investors are given an annual statement that must set out in Australian dollars the amount returned on the investor's investment, as well as management costs. For funds with more than 100 retail investors, the responsible entity has an obligation to disclose to members information that would have a material impact on the price of interests in the fund and is not publicly available. In Australia, as a common industry practice, many responsible entities of money market funds provide monthly updates to investors about fund performance and top investment holdings in addition to meeting their regulatory disclosure obligation.

42 We have published disclosure principles in Regulatory Guide 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (RG 168), to help product issuers in preparing a Product Disclosure Statement (PDS). These principles focus on disclosure and suggest it should:

(a) be timely, relevant and complete;

(b) promote product understanding and product comparison;

(c) highlight important information; and

(d) take into account consumers' needs.

43 We conduct selective compliance reviews of PDSs periodically, to determine whether they comply with the PDS requirements. According to RG 168, when assessing whether a PDS appears to be misleading or deceptive, we pay particular attention to:

(a) statements about future matters such as forecasts (they should have reasonable grounds);

(b) statements about past performance;

(c) statements of opinion (they should be formed honestly and reasonably);

(d) the likely overall impression of the PDS;

(e) the use of illustrations or examples to highlight an aspect of the disclosure being provided;

(f) the use of disclaimers;

(g) ambiguous statements;

(h) whether statements draw inaccurate, unfair or inappropriate comparisons;

(i) the currency of information; and

(j) how information is set out and the prominence given to particular pieces of information.

44 We may also review information and disclosure about any significant benefits and risks associated with holding the financial product.

Australian accounting standards

45 The Australian accounting standards, issued by the Australian Accounting Standards Board, contain requirements for valuations. The requirements for preparing financial statements are governed by Australian Accounting Standard AASB 139 *Financial instruments: Recognition and measurement*.

46 Under AASB 139, financial instruments may be classified into the following four types:

(a) held at fair value through profit or loss (including financial assets held for trading);

(b) available for sale;

(c) held for maturity; and

(d) loans and receivables.

47 The asset types set out in paragraphs 46(a)–46(b) must utilise the 'fair value' valuation method. The best evidence for fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity may establish fair value by using a valuation technique.

48 For the asset types set out in 46(c)–46(d), the Australian accounting standards either require or permit adoption of the amortised cost valuation method.

Our regulatory guidance

49 There is no requirement that valuation for pricing purposes and accounting purposes be the same.

50 Regulatory Guide 134 *Managed investments: Constitutions* (RG 134) governs the operation of managed investments and requires valuation for pricing purposes to be conducted in an independently verifiable manner or in accordance with a reasonable documented policy that is consistent with ordinary commercial practice.

51 RG 134 is currently under review: see Consultation Paper 188 *Managed investments: Constitutions—Updates to RG 134* (CP 188).

C Findings of review: Australian industry

Key points

In this section, we provide the results of our review of the money market fund industry in Australia. We discuss the industry's:

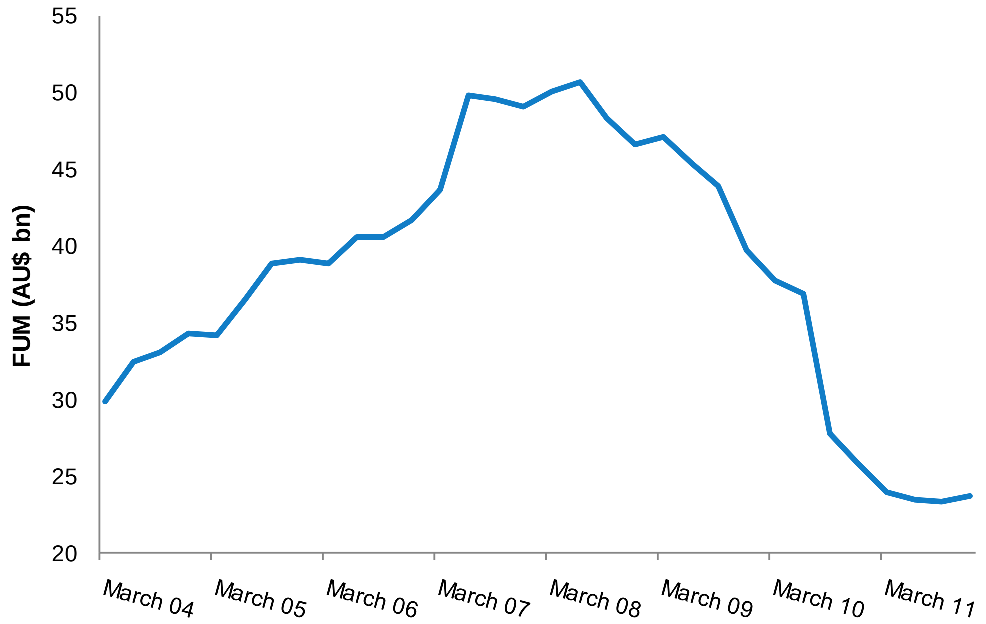
- size (paragraphs 52–53);
- investor profile (paragraph 54 and Figure 1);
- role in the short-term funding market (paragraph 55–57);
- types of investment (paragraphs 58–64);
- NAV structures (paragraphs 65–66)
- product branding and disclosure (paragraphs 67–70)
- maturity and liquidity profile (paragraphs 71–74);
- creditworthiness (paragraph 75);
- redemption terms (paragraphs 77–78); and
- experience in the global financial crisis (paragraphs 79–82).

Size of the industry

52 According to the Australian Bureau of Statistics, in June 2012 the managed funds industry had $1,886 billion funds under management (FUM) and money market funds had, on an unconsolidated basis, a total of $24.4 billion FUM. By these figures, money market funds account for 1.3% of the total managed funds industry in Australia. In March 2012, the global money market fund industry was estimated to be $4.7 trillion. On that basis, Australian money market funds are estimated to account for less than 1% of the global money market fund industry.

53 Funds allocated into money market funds increased leading up to the global financial crisis, peaking at AU$50.7 billion in June 2008. There has since been a decreasing trend of investment within money market funds, as shown in Figure 1.

Figure 1: FUM in Australian money market funds between 2004 and 2012

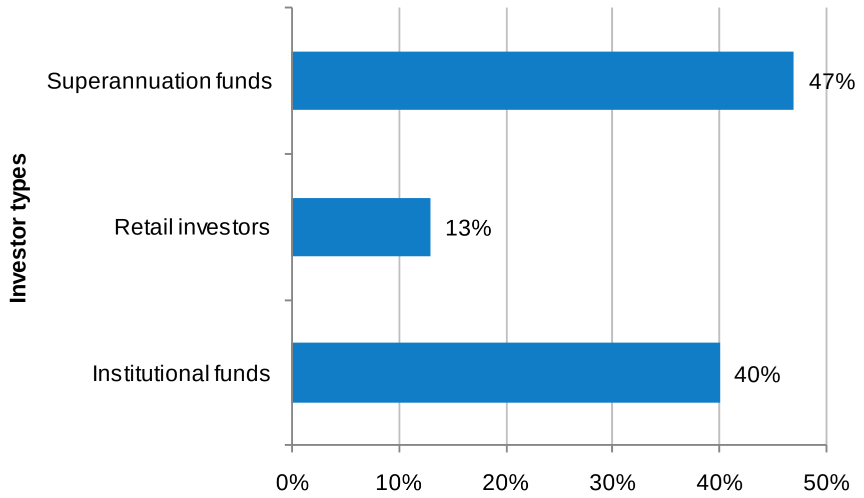


Source: Australian Bureau of Statistics, *Managed funds, Australia* (5655.0, September 2012).

Investor profile

54 Institutional and superannuation funds invested heavily into money market funds in comparison to retail investors. According to the results of our survey, institutional funds account for 40% and superannuation funds account for 47% of the total FUM invested in money market funds, while retail investors only account for 13% of the total FUM.

Figure 2: Investor profile of money market funds



Role within the short-term funding market

55 The short-term funding market plays an important role in the domestic financial system, both as a source of liquidity for the banking sector and as a pricing benchmark for a wide range of contractual obligations. Within the Australian market, the banking sector is the predominant issuer of short-term debt securities,[4] through the sale of certificates of deposit and bank-accepted bills.

56 The role of money market funds in the Australian short-term funding market is not significant in comparison to overseas markets. The Reserve Bank of Australia estimated the size of the short-term funding market to be around $250.6 billion on 30 June 2011.[5] While money market funds engage in some bank-like activities (credit intermediation), they typically do not engage in maturity transformation and are a small part of the financial system. It is estimated that money market funds represent no more than 9.5% of the short-term funding market and currently account for 0.5% of financial system assets in Australia.[6]

57 In addition, the role of money market funds within the short-term funding market has changed in recent times. Before the global financial crisis, many short-term debt issuers were slowly moving towards extending the maturity of their liabilities by issuing longer-term debt securities. The importance of money market funds has declined since the Australian Government introduced the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme) on deposits of up to $1 million (subsequently reduced to $250,000) in late 2008, one of many measures introduced to combat the effect of the crisis. The effect of that measure was reflected in a shift in the perception of some investors, who viewed deposits as a more stable source of funding than negotiable instruments. On the demand side, there was also a switch from short-term securities to deposits with similar maturity.

Types of investment

58 Money market funds are a subcategory of income funds[7] in Australia. There are distinct differences between money market funds and fixed income funds in terms of targeted return, risk profile and investment timeframe. The main

[4] Short term debt securities are those issued with less than 12 months to maturity.
[5] M Boge & I Wilson, 'The domestic market for short-term debt securities', *Bulletin*, Reserve Bank of Australia, September Quarter 2011.
[6] B Donovan & A Gorajek, 'Development in the structure of the Australian financial system', *Bulletin*, Reserve Bank of Australia, June Quarter 2011.
[7] Major categories of income funds include: 'cash' and 'cash enhanced'; 'mortgage' and 'mortgage aggressive'; 'bonds'; 'diversified credit'; 'multi-strategy income'; and 'high yield'.

investment objectives of money market funds are to provide a regular income stream with daily liquidity and a very low risk of capital loss. They often have the word ‘cash’ or ‘money market fund’ in their product branding. Most measure their performance against a bank bill index and/or the Reserve Bank of Australia cash rate. The recommended investment timeframe is often short, with most funds recommending an investment horizon of less than one year.

59 Most money market funds invest in high-quality liquid and short-term money market instruments and offer daily redemption. Money market funds typically invest in a combination of the asset types set out in Table 2.

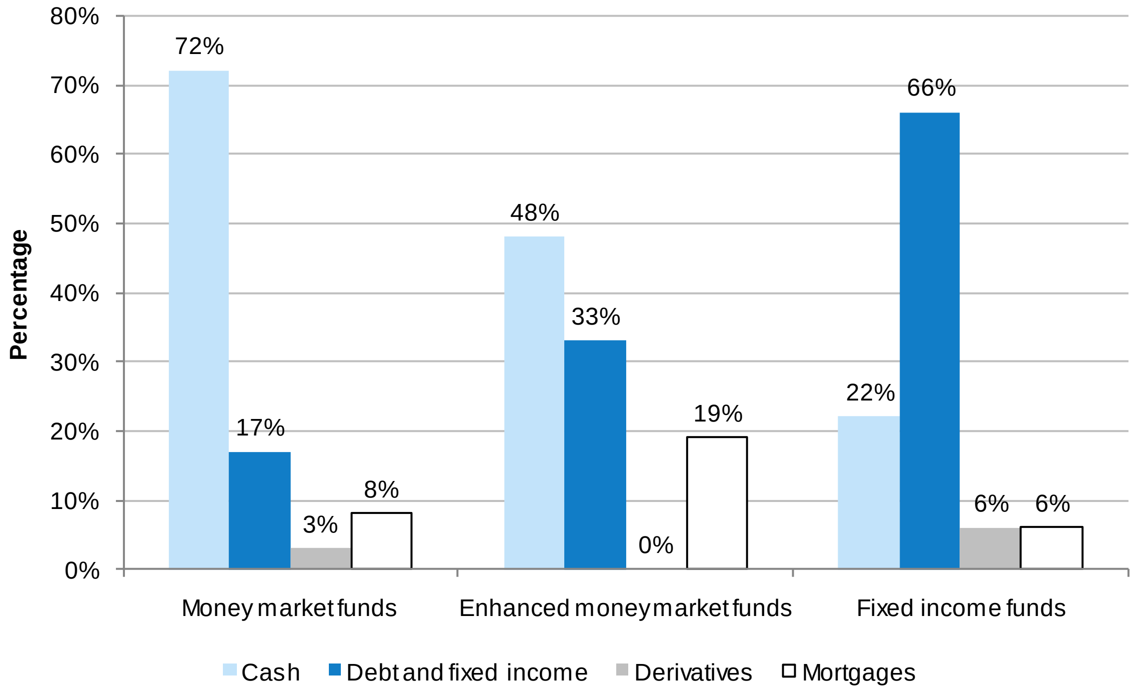
Table 2: Common asset types of money market funds

Asset type	Examples
Cash	Cash receivables, bank deposits, time/call deposits, negotiable certificates of deposit, discount notes, bank bills, non-Australian dollar denominated cash, cash equivalent securities and other money market securities
Debt and fixed income securities	Government and semi-government securities, bills of exchange, promissory notes, notes, asset-backed bonds, corporate floating or fixed rate debts, commercial paper, treasury bills, and asset backed securities
Mortgage	Mortgage securities, collateralised mortgage obligations and mortgage-backed securities
Derivatives	Repurchase agreements and foreign exchange contracts. Derivatives are primarily used for hedging purposes

60 Our survey results revealed, on average, 72% of the assets of money market funds were invested in cash instruments, with the remainder in assets such as mortgages and fixed incomes. The use of repurchase agreements is insignificant; the vast majority of funds (95%) have no exposure to repurchase agreements.

61 A subcategory of money market funds, called ‘enhanced’ money market funds, have on average 48% of their assets in cash and often more than 50% of their FUM in fixed income instruments and mortgages. According to our survey results, enhanced money market funds represent a small proportion of the overall money market funds industry.

Figure 3: Portfolio composition of money market funds, enhanced money market funds and fixed income funds



62 Fixed income funds were found to include diversified credit, income, high-yield and bond funds. They do not contain the words 'cash' or 'money market fund' in their product names. Fixed income fund investment strategies tend to be more aggressive than money market funds and their objectives are often to maximise total return and preserve credit quality. Fixed income fund assets broadly include portfolios of fixed interest and money market securities. The recommended investment timeframe is often longer, ranging from one to three years.

63 Fixed income funds invest significantly more in debt and fixed income instruments than money market funds. On average, fixed income funds invest 66% of their FUM in debt and fixed income assets. This is in line with our understanding and expectations of fixed income funds. The higher proportion of debt and fixed income assets is often associated with the recommended longer investment timeframe.

64 Our survey ascertained that there are significant differences between fixed income funds and money market funds in terms of the investment portfolio, with the exception of few enhanced money market funds. We will consider encouraging better differentiation between enhanced money market funds from the other money market funds: see paragraphs 135–136.

NAV structures

65 Our survey results indicate approximately 95% of money market funds in Australia are variable NAV funds. An examination of the constitutions and PDSs for registered money market funds revealed that the majority of funds quote a variable NAV and use the marked-to-market valuation method where possible (i.e. where quoted prices in an active market are available). A small group of money market funds presently quote a daily $1.00 unit price for the ease of fund operation. However, they are permitted by their constitutions to adjust unit prices to reflect the market value of the assets. All these funds have disclosed in their relevant disclosure documents that they are not offering a capital guaranteed product and carry the possibility of capital losses.

66 The remaining 5% of surveyed money market funds use the at-cost valuation method, according to their constitutions. These funds primarily hold bank deposits only. The at-cost valuation method is considered to be appropriate under these circumstances. It is distinctly different from the amortised cost method, as it values assets on a historical cost basis and does not allow for adjustments.

Product branding and disclosure

67 Our survey showed that most money market funds are being clearly marketed to investors through product branding and disclosure.

68 A review of several money market fund and fixed income fund PDSs revealed most funds provide investors with clear disclosure about investment holdings in terms of asset classes, in addition to detailed disclosure about investment risks (with some exceptions: see paragraph 69 on enhanced money market funds). There does not appear to be visible misalignment between product branding and disclosure and the product characteristics.

69 However, our analysis revealed a number of enhanced money market funds have investment mandates similar to bond or diversified funds, with a higher risk profile than other money market funds. Money market funds tend to invest in term deposits, treasury bills, bankers acceptances and ‘11 am cash’, whereas enhanced money market funds also invest in loan obligations, mortgage-backed securities and bank issues with various subordinations. These enhanced money market funds seek to bridge the gaps between money market funds and fixed income funds by offering higher returns (by taking on additional risk) and exhibit longer maturity with less liquidity.

70 The product branding and PDSs of enhanced money market funds often contain the words ‘cash’ or ‘money market fund’. These funds could be confused with other money market funds by retail investors. We will consider

encouraging better differentiation between enhanced money market funds from other money market funds: see paragraphs 135–136.

Liquidity and maturity

71 A portfolio weighted towards securities with longer maturities often imposes greater interest rate, credit and liquidity risks. Weighted average life and dollar-weighted average maturity are time measures (usually calculated in days for money market funds) used to test the extent of a money market fund's exposure to interest rate, credit and liquidity risks.

72 According to our survey results, money market funds (excluding enhanced money market funds) exhibit an average weighted average life of 123 days and an average dollar-weighted average maturity of 57 days. They are also highly liquid. Twenty four (100%) of the money market funds we surveyed indicated they could divest 80% of their portfolio within 10 business days: see Table 3 and Table 4.

73 The survey results show that money market funds have a maturity significantly shorter and significantly more liquid than fixed income funds.

74 According to our survey results, a few enhanced money market funds exhibited a higher weighted average life (629 days) but a lower dollar-weighted average maturity (36 days). Some adopted the alternative maturity matrix of 'modified duration', which is not directly comparable with weighted average life and dollar-weighted average maturity. They are less liquid than other money market funds. Five (83.3%) of the enhanced money market funds we surveyed indicated they could divest 80% of their portfolio within 10 business days. The one fund that was unable to achieve that can divest 74% of their portfolio on average within 10 business days: see Table 3 and Table 4.

Table 3: Liquidity of money market funds, enhanced money market funds and fixed income funds

	Money market funds		Enhanced money market funds		Fixed income funds	
	No. of schemes	**Proportion**	**No. of schemes**	**Proportion**	**No. of schemes**	**Proportion**
Day 1: 100% divestment	7	29.2%	0	0%	1	5.6%
Day 5: 100% divestment	12	45.8%	1	16.7%	4	22.2%
Day 10: 100% divestment	18	62.5%	2	33.3%	7	38.9%
>80% divestment	24	100.0%	5	83.3%	12	66.7%
Total	**24**	**100.0%**	**6**	**100.0%**	**18**	**100.0%**

Note: Because the percentages in the 'Proportion' columns of this table are cumulative, they do not add up to 100%.

Table 4: Maturity of money market funds, enhanced money market funds and fixed income funds

Maturity matrices (days)	Money market funds	Enhanced money market funds	Fixed income funds
Weighted average life	123	629	1419
Dollar-weighted average maturity	57	36	1449
Modified duration	28	N/A	719

Creditworthiness

75 Money market funds are not subject to any Australian regulation that stipulates or imposes requirements for the proportion of their assets in credit-rated instruments or other assets.

76 Nearly all surveyed money market funds hold credit-rated assets and the majority of them hold 80% or more in assets rated 'A' and above by credit rating agencies.

Redemption terms

77 Our survey results revealed 70% of money market funds met redemption requests within one day of the request in the past 12 months of operation. Enhanced money market funds and smaller funds tended to require a longer time period to meet redemption requests. However, all redemption requests were met within five days of the request. Most constitutions allow for longer redemption periods. These redemption periods are significantly shorter than fixed income funds we surveyed.

78 Responsible entities of money market funds in Australia have discretion to suspend redemptions during times of volatility, if it is in the best interest of the fund investors. This has the advantage of halting a run caused by fear of loss from investors and operates as a mechanism to help preserve the capital of investors.

Global financial crisis

79 Australia experienced some disruptions to its short-term funding markets as a result of the global financial crisis. However, money market funds played a negligible role in the crisis in Australia.

80 The Guarantee Scheme, introduced by the Australian Government on 12 October 2008, was designed to promote stability in the Australian financial system by supporting confidence and assisting eligible authorised deposit-taking institutions to continue to access funding at a time of considerable turbulence. The Guarantee Scheme did not extend to money market funds or mortgage schemes.

81 While mortgage schemes suffered heavy redemptions, most money market funds weathered the crisis reasonably well. Money market funds may have experienced an increase in redemption requests, but they were able to meet these requests in a timely fashion without disruption to the fund or underlying funding markets because of high levels of liquid assets. We note that Australian money market funds at the time were not heavily exposed to US short-term debts.

82 Since the crisis, the size of the money market funds industry has declined significantly, partly as a result of an increasing preference for bank deposits over money market funds by investors.

D Findings of review: IOSCO risk analysis

Key points

In this section we consider the key systemic risk factors prevalent in money market funds globally, the IOSCO recommendations to address these risk factors and their overall relevance in the Australian market.

We conclude that money market funds in Australia do not share many of the potential systemic risks that are prevalent in overseas money market funds. In Australia, money market funds do not play a significant role to the short-term funding market and their susceptibility to runs is lower, because of:

- the prevalence of variable NAV structures;
- the use of the marked-to-market valuation method;
- the right of responsible entities to suspend redemptions;
- maturity profiles and low interest rate risks that produce healthy access to liquidity;
- the lack of any significant mismatch between liquidity and redemption features;
- general low credit risk levels with minimal exposure to repurchase agreements markets, and
- reasonably consistent product branding and appropriate disclosure.

We consider that current regulation and market practices in Australia are substantially aligned with the IOSCO recommendations.

Importance in the short-term funding market

83 Money market funds play a large role in the capital and short-term funding markets overseas, due to the size of the money market funds industry. As a consequence, the health of money market funds is important not only to their investors, but also to a large number of businesses and state and local governments that finance current operations through the issuance of short-term debt. Due to the intrinsic link between money market funds and the short-term funding market, confidence shocks in money market funds can quickly have a broader macroeconomic impact.

84 Australia, in comparison to overseas markets, has a much smaller money market fund industry (a total of $24.5 billion FUM): see paragraphs 52 and 56. The lack of scale means that money market funds' role in providing liquidity to the Australian short-term funding market, estimated to be around $250.6 billion, is significantly smaller. While money market funds do engage in some bank-like activities (credit intermediation), they typically do not engage in

maturity transformation and are too small to pose a systemic risk to the short term funding market and the Australian financial system.

Susceptibility to runs

85 In general, money market funds can be susceptible to runs when there is a perception the fund might suffer a loss and unit holders have an incentive to redeem their units before others do. The constant NAV structure, the use of the amortised cost valuation method and the risk profile of typical investors, among other things, amplify the risk of susceptibility to runs for money market funds.

86 Other features, such as the absence of capital preservation mechanisms like the right to suspend redemptions, poor credit risk levels, maturity and interest rate risk, large exposure to repurchase agreements, and a mismatch between liquidity and redemption features will also negatively affect a money market funds' ability to handle a run on redemptions.

87 In our review of the Australian market, we have also taken into account the IOSCO recommendations. Table 5 sets out the recommendations and references to our assessment of each.

Table 5: IOSCO recommendations and our assessment

Recommendations		Our assessment
General		
1	Money market funds should be explicitly defined in collective investment schemes regulation.	See paragraphs 126–130
2	Specific limitations should apply to the types of assets in which money market funds may invest and the risks they may take.	See paragraphs 100–104
3	Regulators should closely monitor the development and use of other vehicles similar to money market funds (collective investment schemes or other types of securities).	See paragraphs 126–130
Valuation		
4	Money market funds should comply with the general principle of fair value when valuing the securities held in their portfolios. The amortised cost valuation method should only be used in limited circumstances.	See paragraphs 88–94
5	Money market funds valuation practices should be viewed by a third party as part of their periodic review of the fund accounts.	See paragraphs 88–94

Recommendations		Our assessment
Liquidity management		
6	Money market funds should establish sound policies and procedures to know their investors.	See paragraphs 105–114
7	Money market funds should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales.	See paragraphs 105–114
8	Money market funds should periodically conduct appropriate stress testing.	See paragraphs 105–114
9	Money market funds should have tools in place to deal with exceptional market conditions and substantial redemptions pressures.	See paragraphs 95–99
NAV structures		
10	Money market funds that offer a constant NAV should be subject to measures designed to reduce the specific risks associated with their constant NAV structure and to internalise the costs arising from these risks. Regulators should require, where workable, a conversion to the variable NAV structure.	See paragraphs 88–94
Credit ratings		
11	Money market fund regulation should strengthen the obligations of the responsible entities regarding internal credit risk assessment practices and avoiding any mechanistic reliance on external ratings.	See paragraphs 115–120
12	Credit rating agencies supervisors should seek to ensure credit rating agencies make more explicit their current rating methodologies for money market funds.	See paragraphs 115–120
Disclosure to investors		
13	Money market fund documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principle loss.	See paragraphs 126–130
14	Money market fund disclosure to investors should include all necessary information regarding the funds' practices in relation to valuation and the applicable procedures in times of stress.	See paragraphs 126–130
Repurchase agreements		
15	When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repurchase agreements by money market funds, taking into account the outcome of current work on repurchase agreements markets.	See paragraphs 121–125

Constant NAV structure and the use of the amortised cost valuation method

88 The constant NAV structure and the use of the amortised cost valuation method have contributed in some overseas jurisdictions to instability in money market funds, by giving investors a false expectation that these funds are a

risk-free cash equivalent investment with interest that are redeemable for the same amount paid for them. The potential for a significant run occurs when a fund fails to live up to those expectations. Before the crisis, the expectation of safety fostered by the constant NAV structure was not supported in any way by guarantees, formal capital buffers or insurance to prevent NAV declines.

89 Consequently, during times of volatility, the amortised cost valuation may deviate significantly from market value and then lead to money market fund issuers being unable to support the constant NAV structure.

90 Variable NAV money market funds dominate in Australia. The variable NAV structure is supported by the use of the marked-to-market valuation method and the regulatory requirement that valuation for pricing purposes be conducted in an independently verifiable manner: see paragraphs 39–46.

91 Money market funds in Australia are not sold as capital guaranteed products and do disclose that they carry the possibility of capital losses. The marked-to-market valuation method provides market transparency on the risk that there may be occasions where units are redeemed at a price below the current quoted NAV.

92 Fund managers are under less pressure to liquidate assets in a declining market, as variable NAV and the use of the marked-to-market valuation method increases money market funds' ability to handle runs. These features allow adjustment of the NAV of a fund to reflect actual risks and market value.

93 IOSCO made three recommendations for possible tools to increase the stability of money market funds and reduce their vulnerability to runs during volatile times. IOSCO recommended money market funds adopt a variable NAV structure where possible (Recommendation 10), utilise fair value when valuing securities (Recommendation 4) and that valuation practices should be reviewed by a third party (Recommendation 5): see Table 1.

94 In Australia, the predominance of variable NAV structures and the marked-to market-valuation method, together with the requirement for valuation methodology to be independently verifiable, indicates that current regulation and market practice is consistent with these IOSCO recommendations.

Absence of right to suspend redemption

95 The absence of a right to suspend redemptions when a run occurs exacerbates the vulnerability of money market funds in volatile markets. If investors fear they may suffer a loss if they do not redeem, there may be a wave of redemptions that the investment manager is unable to halt.

96 While investors may redeem their investments in money market funds on demand under most circumstances in Australia, the requirements in the

Corporations Act concerning whether a fund is liquid or illiquid (see paragraph 36) provides an embedded mechanism for responsible entities to freeze redemption requests to preserve investor capital in circumstances such as a run, market volatility or tightening credit market conditions. The responsible entity can effectively operate the fund as illiquid rather than liquid until the fund or the market stabilises. Additionally, most fund constitutions provide a responsible entity with the discretion to suspend redemption when the responsible entity considers it in the best interest of members to do so.

97 These mechanisms reduce the need for responsible entities to divest fund investments in a declining market and allow for the orderly transition of assets to maximise the return of investor capital. By reducing the need to divest at the first sign of heightened risk or investor redemption demand, it also reduces the likelihood of further runs and increased volatility in the short-term funding market.

98 IOSCO recommends money market funds have tools such as temporary suspensions, gates and redemption-in-kind options (Recommendation 9) to help money market funds better manage liquidity, especially during volatile times: see Table 1.

99 In Australia, the redemption suspension tools provided through current regulation and market practice is consistent with this IOSCO recommendation.

Maturity and interest rate risk

100 Maturity limits are often used to reduce the liquidity risk profile of a fund and limit the exposure of money market funds to certain risks, such as sudden interest rate movements. Instruments with longer periods remaining until maturity generally exhibit a higher level of volatility. This increases funds' susceptibility to runs and provides less assurance that a money market fund will continue to be able to maintain a constant NAV structure.

101 Most money market funds in Australia have a low weighted average life and dollar-weighted average maturity, while some enhanced money market funds exhibit a longer weighted average life maturity profile. Enhanced money market funds represent a very small proportion of the overall money market funds industry in Australia: see paragraph 74 and Table 3–Table 4.

102 The prevalence of variable NAV money market funds in Australia reduces the impact of maturity and interest rate risk as the unit price reflects market value. Also, due to the insignificant role of money market funds in the short-term funding markets, any increase in maturity and interest rate risk in money market funds is unlikely to have a significant impact on the wellbeing of the short-term funding market.

103 IOSCO recommends that specific limitations should apply to the types of assets in which money market funds may invest and risks they may take, including the restrictions on maturity measures such as weighted average life and dollar-weighted average maturity (Recommendation 2), to reduce the liquidity risk profile of a fund: see Table 1.

104 In Australia, the current regulation and the market practice (of low weighted average life and dollar-weighted average maturity of money market funds) are substantially aligned with the IOSCO recommendations regarding asset allocation and maturity. However, ASIC will liaise with the relevant industry bodies to encourage industry to only use the term 'money market fund' or similar in its product branding when the funds have a low weighted average life and dollar-weighted average maturity.

Mismatch between liquidity and redemption profile

105 A mismatch between liquidity and the redemption profile (a direct reflection of the characteristics of a money market fund's investor base) also heightens the likelihood of a run. This mismatch further exacerbates the liquidity risks faced by money market funds in volatile and depressed markets.

106 Wholesale investors, including institutional and superannuation funds, are considered to be more informed than retail investors. Past experience from the crisis in the overseas markets shows that redemption pressure mostly arose from institutional investors, which represent the larger part of money market funds' investor base.

107 Institutional investors' overall exposure to money market funds is small in Australia. For example, according to Australian Bureau of Statistics, the total FUM of unconsolidated superannuation funds was $1,349 billion at June 2012. It is estimated that 0.8% of total investments by unconsolidated superannuation funds were invested in money market funds.

108 Retail investors' exposure to money market funds is limited in Australia: see paragraph 54. Money market funds do not appear to be used as an alternative to bank deposits but rather as a tool in a diversified investment strategy. While money market funds do often include in their investment objectives capital preservation and yield generation, they are generally not marketed as a capital guaranteed product.

109 Our review revealed a high proportion, approximately 72%, of money market funds' assets were invested in cash instruments, with the remainder in assets such as mortgages and fixed incomes. All the money market funds (excluding the enhanced money market funds) we surveyed can divest their holdings relatively efficiently; they can divest 80% of their portfolio within 10 business days, and offer daily redemptions to investors. In fact, 70% of money market funds surveyed meet redemption requests within one day and the remainder

meet them within two days. These terms are supported by highly liquid asset holdings by money market funds. These liquidity parameters are regularly tested by money market funds.

110 A small group of enhanced money market funds hold a lesser proportion in cash instruments and are less liquid. Consequently, they require longer periods to meet redemption requests. Due to the small number and size of enhanced money market funds, active regulatory intervention is unwarranted at this stage. We will consider liaising with industry bodies to encourage better differentiation between enhanced money market funds from the more traditional money market funds: see paragraphs 135–136.

111 The Corporations Act requires fund disclosure to not be misleading. We have provided disclosure principles as guidance to meet the disclosure requirements under the Corporations Act: see RG 168. Our review of PDSs indicated that product branding and disclosure is consistent with asset allocation and redemption approaches: see paragraphs 40–43.

112 In Australia, only liquid funds may offer at-call redemption. To be regarded as liquid under the Corporations Act, 80% or more of fund assets must be liquid assets: see Section B. ASIC has proposed amendments to the Corporations Act to further tighten the concept of liquid assets. Tightening of the concept of liquid assets will further align Australian regulatory practice with the IOSCO recommendations: see paragraphs 138–141.

113 Adequate management of liquidity risks is essential to bridging any gap between the liquidity of the underlying assets and redemption profiles of the investors. To address this liquidity gap, IOSCO recommends that money market funds establish sound policies and procedures to know their investors (Recommendation 6), hold a minimum amount of liquid assets (Recommendation 7), and periodically conduct appropriate stress testing (Recommendation 8): see Table 1.

114 In Australia, the current disclosure regulations and market practice (of holding high levels of liquid assets in money market funds) are substantially aligned with the IOSCO recommendations. Additionally, the overall risk management framework of responsible entities (including topics such as stress testing) is the subject of a separate ASIC review that, along with the tightening of the definition of liquid assets, will further enhance the high levels of liquidity and Australia's alignment with the IOSCO recommendations.

Credit risk

115 The credit risk of the underlying assets play a crucial role in determining the risk profile of a fund and may have significant impact on its liquidity capability. Credit rating downgrades associated with less creditworthy assets can cause significant market turbulence, with the credit risk resulting in

heavily depressed market asset valuations and contributing to the seizing up of the short-term funding markets.

116 Stringent regulations are in place overseas to reduce the risk profile of funds, especially their liquidity risk. In some jurisdictions, the downgrading of a credit rating to certain instruments in itself may increase a fund's susceptibility to runs, due to the requirement to hold certain levels of credit-rated instruments and the need to divest when the instruments no longer meet the credit rating requirements. The need to maintain a constant NAV structure in conjunction with the sheer size of money market funds in overseas markets heightens the importance of appropriate management of credit risks.

117 Our survey revealed that Australian money market funds hold nearly all of their assets in credit-rated assets, and a significant proportion of those assets have a credit rating of 'A' or above to manage their credit risk: see paragraph 75. However, they are not subject to any Australian regulation that stipulates or imposes requirements on money market funds concerning the proportion of their assets in credit-rated instruments or other assets, thus removing the risk associated with credit rating downgrade.

118 The prevalence of variable NAV money market funds in Australia also reduces the risk that a credit rating downgrade will result in a run, because market transparency exists where unit pricing reflects market value. Also, due to their small role in the short-term funding markets, increase in credit risks in money market funds (especially those associated with a credit rating downgrade) is unlikely to have an impact on the wellbeing of the short-term funding market.

119 IOSCO made two recommendations to build robustness around the use of credit ratings and credit rating agencies in managing the money market funds' credit risk and reducing its negative impact on the wellbeing of short term funding markets. They include strengthening internal credit risk assessment and reducing reliance on external ratings (Recommendation 11) and credit rating agencies making explicit their current rating methodologies for money market funds (Recommendation 12).

120 We support the IOSCO recommendations; however, we consider the current market practice in Australia to be substantially aligned with these IOSCO recommendations. Money market funds represent a low proportion of the market and hold low levels of credit instruments overall (and those held are highly rated).

Use of repurchase agreements

121 Money market funds are important lenders in the repurchase agreements markets, and repurchase agreements transactions constitute an important part of money market funds portfolio in overseas markets.

122 The repurchase agreements markets are currently under review by various international bodies, with focus on key risk areas such as settlement, counterparty risks and collateral management.

123 In Australia, the use of repurchase agreements by money market funds is very small, with the majority of money market funds having no exposure to repurchase agreements at all.

124 IOSCO recommends that regulators develop guidelines strengthening the framework applicable to the use of repurchase agreements by money market funds when necessary (Recommendation 15): see Table 1.

125 We support the IOSCO recommendations; however, we consider regulatory intervention not warranted at this time, given the insignificant exposure of money market funds in Australia to repurchase agreements.

Proper product branding and disclosure

126 Proper product branding and disclosure is crucial to managing investor expectations. For example, a constant NAV money market fund fosters an expectation of safety of capital, overlooking the fact that underlying investments are still subject to credit, interest rate and liquidity risks without formal capital buffers or insurance to prevent NAV declines.

127 There are distinct differences between money market funds and other types of income funds in Australia: see paragraphs 58–63. Our analysis revealed there is no visible misalignment between product branding and disclosure and the product characteristics, with the possible exception of a few enhanced money market funds.

128 Variable NAV money market funds dominate in Australia: see paragraph 90. Money market funds are not being sold as capital guaranteed product and do disclosure that they carry the possibility of capital losses (often in the section on significant risks in the fund disclosure documents).

129 IOSCO made four recommendations to address concerns about product branding and disclosure. For product branding, IOSCO recommends money market funds be explicitly defined (Recommendation 1) and use of terminology similar to 'money market' or 'cash' be avoided for funds that are not classified as money market funds (Recommendation 3). For disclosure, IOSCO recommends that disclosure documents should draw investors' attention to the possibility of principal loss (Recommendation 13) and the funds' practices in relation to valuation (Recommendation 14).

130 We support the IOSCO recommendations; however, we consider there is minimal current misalignment between product branding and asset allocation in Australia. Use of terms such as 'cash' and 'money market' by funds in Australia is limited to money market funds, and PDSs appropriately detail the

risk of principal loss and the valuation methodology used. Current regulation and market practice appear adequate in light of our review of money market funds in Australia. In addition, we propose to encourage industry to adopt more standardised product branding, to distinguish enhanced money market funds from other money market funds.

Industry comments

131 In our industry consultation, we sought participants' observations on the overseas developments. We were specifically interested in whether the Australian market may benefit from similar initiatives.

132 Generally, the responses do not support further regulation of money market funds in Australia. Key reasons given were that:

(a) the causes for further regulation in United States and Europe do not exist in Australia—for example, unlike in the United States where a significant number of investors in money market funds are retail, investors in money market funds in Australia are primarily wholesale;

(b) the existing regulation under the management investment scheme regime is sufficient;

(c) there would be a significant increase in costs; and

(d) there is likely to be slow growth in money market funds in the near future, as a result of anticipated reduction in term deposit rates and risk aversion to equities by investors

E Recommendation and future action

Key points

Our analysis does not support specific regulatory intervention for money market funds at this time.

We will consider liaising with industry bodies to encourage the standardisation of industry practice in relation to product branding.

ASIC has proposed amendments to the definition of liquid assets under the Corporations Act.

IOSCO recommendations

133 Our analysis does not support specific regulatory intervention for money market funds at this time.

134 We considered each IOSCO recommendation for the money market funds industry. We consider the current regulation and market practice in Australia is substantially aligned with the IOSCO recommendations and adequate in addressing the key risks identified by IOSCO.

Standardise industry practice

135 We will liaise with industry bodies to encourage industry to standardise product branding to better distinguish enhanced money market funds from other money market funds. Generally, we consider that it would be preferable if the term ‘money market fund’ or similar were used only by funds that have a low weighted average life and dollar-weighted average maturity.

136 Relevant industry bodies should consider illustrating the distinction between money market funds and so-called enhanced money market funds, and highlighting risks that are specific to enhanced money market funds. Industry bodies might also consider whether there is value in adopting a naming convention that avoids describing a fund as a money market fund (whether ‘enhanced’ or not) where it does not meet the standard described in paragraph 135.

137 Regulatory intervention could be subsequently considered if industry standards to address transparent branding for enhanced money market funds do not develop within a reasonable time.

Definition of liquid assets

138 We have written to Treasury seeking amendments to the concept of liquid assets in the Corporations Act, to provide more certainty about whether a scheme is liquid or not.

139 We proposed that liquid assets include cash, term deposits, bank bills of three months or less, and other assets realisable for market value within 10 days. This last component replaces the current requirement that assets be realisable within the period specified in the constitution for meeting redemption requests.

140 If this amendment is implemented, it will inform product design and risk management practices for liquid products. Greater clarity regarding liquid assets should significantly reduce the risk of schemes converting from liquid to illiquid and funds being frozen for significant periods of time.

141 The proposed narrower definition of liquid assets may also address some of the issues concerning enhanced money market funds. It is possible that schemes with so-called ‘enhanced money market fund strategies’ may not be able to meet this new concept of liquid assets and operate as liquid, at-call money market funds.

Key terms

Term	Meaning in this document
AASB 139 (for example)	An Australian accounting standard (in this example numbered 139)
amortised cost valuation method	An accounting technique that values the assets at their purchase price, and then subtracts the premium or adds back the discount in a linear fashion over the lift of the assets. The assets are then valued at par with their maturity
Australian accounting standards	Standards issued by the Australian Accounting Standards Board pursuant to s334 of the Corporations Act
ASIC	Australian Securities and Investments Commission
collective investment scheme	A type of investment scheme that involves collecting money from different investors and then combining all the money collected to fund investments. Terminology varies with country but collective investment vehicles are often referred to as 'mutual funds', 'investment funds', 'managed funds' or 'managed investment schemes' in Australia
constant NAV structure	A fund has a constant NAV structure when it quotes a fixed dollar price for application and redemption purposes
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
dollar-weighted average of maturity	A measure of asset liquidity and maturity. It calculates the average amount of time until all the assets in a portfolio mature
enhanced money market fund	An unlisted managed investment scheme that primarily invests in a diversified portfolio of high-quality, low-duration money market and fixed income instruments
fixed income fund	An unlisted managed investment scheme that primarily invests in a diversified portfolio of fixed income instruments
FUM	Funds under management
Guarantee Scheme	Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding
IOSCO	International Organization of Securities Commissions
IOSCO recommendations	The 15 recommendations contained in IOSCO's final report, *Policy recommendations for money market funds*: see Table 1

Term	Meaning in this document
marked-to-market valuation method	An accounting technique that values the assets at the price that could be obtained if the assets were sold (i.e. market price)
money market fund	An unlisted managed investment scheme, with investment objectives of capital preservation and yield generation, that primarily invests in a diversified portfolio of high-quality, low-duration money market instruments
NAV	Net asset value
PDS	Product Disclosure Statement
Product Disclosure Statement	A document that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act Note: See s761A for the exact definition.
repurchase agreements	The sale of securities together with an agreement for the seller to buy back the securities at a later date
RG 134 (for example)	An ASIC regulatory guide (in this example, numbered 134)
SEC	Securities and Exchange Commission
short-term funding market	A financial market for assets involved in short-term borrowing, lending, buying and selling, with original maturities of one year or less.
variable NAV	A fund has a variable NAV structure when it quotes a variable dollar price for application and redemption purposes
weighted average life	A measure of asset liquidity and maturity. It calculates the average amount of time for which each dollar of principal on a loan remains outstanding.

Related information

Headnotes

amortised cost valuation method, constant NAV structure, dollar-weighted average maturity, enhanced money market funds, fixed income funds, IOSCO, liquidity, marked-to-market valuation method, maturity, money market funds, redemptions, repurchase agreements, short-term funding market, variable NAV structure, weighted average life

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RG 134 *Managed investments: Constitutions*

RG 168 *Disclosure: Product Disclosure Statements (and other disclosure obligations)*

Legislation

Corporations Act

Consultation papers and reports

CP 188 *Managed investments: Constitution—Updates to RG 134*

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B Donovan & A Gorajek, 'Development in the structure of the Australian financial system', *Bulletin*, Reserve Bank of Australia, June Quarter 2011

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