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AMF

AMF Position No. 2011-13
The classification of collective investment schemes as cash equivalents

References: Article 222-3 of the AMF General Regulation

AFG, AFTE and AF2I have updated the previous analytical memo dated March 2006 pertaining to the classification of collective investment schemes as "cash equivalents", following CESR's recommendation 10-049 of 19 May 2010, "CESR's Guidelines on a common definition of European money market funds" and the new classification of money market funds stipulated by the AMF in its Instruction 2005-02 of 25 January 2005, as amended on 3 May 2011, which transposes the European provisions.

This approach proposes an update of the practical criteria that financial management professionals usually apply and introduces some new benchmarks, in view of CESR's new classifications for collective investment schemes to be applied in 2011.

It should be remembered that an investment must meet four criteria[1] to be deemed a "cash equivalent":

- Criterion 1: it must be a short-term investment;
- Criterion 2: it must be a highly liquid investment;
- Criterion 3: it must be readily convertible into a known amount of cash;
- Criterion 4: it must be subject to an insignificant risk of changes in value.

AFG, AFTE and AF2I put forward an analytical approach that relies on the classification of collective investment schemes into two categories:

- collective investment schemes that the AMF has classified as "money market" or "short-term money market" that are **automatically assumed to fulfil the four criteria making them eligible for classification as "cash equivalents", for practical purposes**, since they meet the analytical criteria stipulated in the proposed analytical approach;
- collective investment schemes other than "money market funds" and "short-term money market funds" **that are not assumed to be eligible and that must be examined on a case-by-case basis to ensure that they fulfil all four criteria making them eligible for classification as "cash equivalents"**, meaning that they are "short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value".

Position:

Based on a jointly drafted document by AFG, AFTE and AF2I, the AMF stipulates that:

- for the two categories of collective investment schemes that are assumed to be eligible ("money market funds" and "short-term money market funds"), **a periodic performance review is critical to confirm that the risk of changes in the value of these instruments is insignificant, especially in times of crisis or market tensions**; for other types of collective investment schemes, **the analysis of the four eligibility criteria must be updated**, with special care to ensure that the risk of changes in value is insignificant (particularly with regard to past volatility and projected sensitivity) and that daily or weekly net asset values are available for the previous period, regardless of market circumstances; failure to meet any of these four criteria rules out any classification as "cash or cash equivalents";

[1] See IAS 7.7.

- Constant net asset value money market funds[2], which are mentioned in the CESR's new classification, “short-term money market funds”, have a constant net asset value by design and distribute all revenue and net capital gains to their investors in order to keep the value of share or unit constant; **these funds cannot be considered as “cash equivalents” unless:**

1. **the funds show that they are subject to an insignificant risk of changes in value and the prospectus mentions an explicit capital guarantee granted by a credit institution or another institution subject to prudential rules and supervision, <u>and if</u>**
2. **the funds show on a case-by-case basis that they comply with the three other eligibility criteria[3] for classification as “cash equivalents”, since the fourth criteria has already been fulfilled.**

The net asset value of these collective investment schemes may not accurately reflect the value of their assets, which could lead to problems when the scheme needs to sell securities at market value to cover redemptions. This means that, if the market value of the underlying assets decreases and the undertaking faces massive redemptions, it may not provide full transparency to its investors concerning the conversion value that they are likely to obtain. Furthermore, such undertakings are vulnerable to sudden drops in value without any warning, if their linear valuation model breaches acceptable limits.

With due consideration of the two additional stipulations made above, the AMF deems that the analytical approach put forward by AFG, AFTE and AF2I constitutes a reasonable basis for classification of collective investment schemes as “cash equivalents” on a balance sheet.

The joint document by AFG, AFTE and AF2I is appended below. This document **supersedes** the AFG-AFTE position of 8 March 2006.

[2] CNAV (*Constant Net Asset Value*).
[3] The other three criteria are:

- Criterion 1: it must be a short-term investment;
- Criterion 2: it must be a highly liquid investment;
- Criterion 3: it must be readily convertible into a known amount of cash.

Analytical approach to the classification of collective investment schemes as cash equivalents

Background

This memo proposes an analytical approach to the classification of collective investment schemes as “cash equivalents” in response to the needs expressed by industry professionals.

This approach is also an update of the earlier analytical memo dated March 2006 and follows CESR’s recommendation 10-049 of 19 May 2010, “CESR’s Guidelines on a common definition of European money market funds”, and the new classification of money market funds stipulated by the AMF in its Instruction 2005-02 of 25 January 2005, as amended on 3 May 2011, pertaining to the full prospectus of collective investment schemes authorised by the AMF, with the exception of futures and options funds, venture capital funds, innovation funds, employee profit-sharing funds and employee share ownership plans (see Annex 1 for the relevant passage).

This approach includes the practical criteria that financial management professionals usually apply and now introduces some new benchmarks, in view of the new CESR classifications for collective investment schemes to be applied in 2011.

According to the definition in the Official Journal of the European Union dated 13 October 2003 - L 261/34, “Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value”.

Four criteria[4] need to be fulfilled for an investment to be deemed a “cash equivalent”:

- Criterion 1: it must be a **short-term** investment;
- Criterion 2: it must be a **highly liquid** investment;
- Criterion 3: it must be **readily convertible into a known amount of cash**;
- Criterion 4: it must be **subject to an insignificant risk of changes in value**.

[4] See IAS 7.7.

Analytical approach

An analysis of whether collective investment schemes fulfil the four criteria making them eligible for classification as “cash equivalents” can be based on the information in their prospectuses (classification, benchmark index, investment strategy, recommended investment period, subscription and redemption order execution procedures, etc.) as well as the historical net asset value data.

There are two distinct categories of collective investment schemes:

- collective investment schemes that the AMF has classified as “money market” or “short-term money market” that are automatically assumed to fulfil the four criteria making them eligible for classification as “cash equivalents”, for practical purposes, since they meet the criteria stipulated in the proposed analytical approach;

- collective investment schemes other than “money market funds” and “short-term money market funds” that are not assumed to be eligible and must be examined on a case-by-case basis to ensure that they fulfil all four criteria making them eligible for classification as “cash equivalents”, meaning that they are “short-term, highly liquid investments that can readily be converted into a known amount of cash and which are subject to an insignificant risk of changes in value”.

This approach concerns all collective investment schemes, regardless of the base currency.

I – Collective investment schemes presumed to fulfil the criteria

These are collective investment schemes set up under French law and authorised by the Autorité des Marchés Financiers (AMF), governed by all of the prudential rules applying to such entities and classified as “money market funds” and “short-term money market funds”, along with foreign UCITS money market funds and/or funds authorised for sale in France or another country and classified as such by the regulatory authority of the country in question.

Their compliance with the criteria set out above means that such collective investment schemes are in a position to fulfil all the eligibility requirements for classification as “cash equivalents”, and, for practical purposes, they are presumed to be eligible:

Eligibility criteria	Evaluation criteria	Source documents
Short-term investment	- The AMF classifies the collective investment scheme as a “money market fund” or a “short-term money market fund”; - The benchmark index for the collective investment scheme is a money market index (EONIA, 3-month EURIBOR, etc.); - The recommended investment period[5] is usually 3 months or less. This period could be up to 6 months if all of the other criteria are fulfilled.	KID or Prospectus
Highly-liquid investment	- The collective investment scheme shares/units can be subscribed or redeemed every day; - The collective investment scheme's assets are valued for each net asset value in accordance with the AMF Instructions. They can be sold at any time without affecting the net asset value.	KID or Prospectus
Readily convertible into a known amount of cash	- In view of the liquidity criterion and the money market benchmark used, the likely redemption amount is known.	KID or Prospectus and Reporting
Insignificant risk of changes in value	- By definition, “money market funds” and “short-term money market funds” post regular movements and track their benchmark index; - The WAM is less than 6 months; - The link to money market benchmarks rules out any disruption directly linked to changes on the long-term interest rate markets, equity markets or currency markets; - Such funds must show historical data proving the regularity of their movements and their performance.	KID or Prospectus and Reporting and financial databases

Since 1 July 2011, the classification of money market funds must consider the maximum residual maturity of securities in the portfolio, the weighted average maturity (WAM) and the weighted average life (WAL).

[5] The holding period recommended by the manager to attain the performance target, which may be the benchmark, plus a margin. This period is in no way like a notice period or a lock-in period.

The table below sets out the rules for distinguishing between "money market funds" and "short-term money market funds":

	Short-term money market funds	**Money market funds**
Maximum residual maturity	397 days	2 years, provided the time remaining until the next interest rate reset date is no more than 397 days
Weighted average maturity (WAM)	60 days	6 months
Weighted average life (WAL)	120 days	12 months

In addition, some quantitative criteria could be used to measure the risk of changes in value:

Example: The annualised historical volatility of a fund, as calculated by renowned financial databases, is less than or equal to the volatility of the benchmark index, plus 0.25%, for example.

II – Other collective investment schemes

There is no presumption that other collective investment schemes are eligible for classification as cash equivalents. Case-by-case analysis is required to determine whether a collective investment scheme is eligible for classification as a "cash equivalent" and if it fulfils all four of the following criteria:

- Criterion 1: it must be a **short-term** investment;
- Criterion 2: it must be a **highly liquid** investment;
- Criterion 3: it must be **readily convertible into a known amount of cash**;
- Criterion 4: it must be **subject to an insignificant risk of changes in value**.

The table below sets out of list of factors that rule out eligibility for classification as a "cash equivalent" that must be considered when analysing collective investment schemes on a case-by-case basis. For practical purposes, any collective investment scheme, other than a money market fund, that finds itself in one or more of the situations described below cannot fulfil the eligibility criteria for classification as a cash equivalent under any circumstances:

Criteria	Factors ruling out classification as cash equivalents	Source documents
"Short-term investment"	- The benchmark index is not a money market index (EONIA, 3-month or 6-month EURIBOR, etc.) - The recommended investment period is more than 12 months.	KID or Prospectus, Reporting, financial information providers
"Highly-liquid investment"	- Daily or weekly net asset values are not available, which means that shares or units cannot be subscribed or redeemed each day or each week. - Notice requirements or redemption penalties that rule out the possibility of redemption during the recommended investment period. - The cash available at any given time is not adequate to honour redemptions. - The final maturity of any position exceeds 36 months*.	KID or Prospectus
"Readily convertible into a known amount of cash"	- The historical volatility is not consistent with that of a money market index. For example, a collective investment scheme where the maximum acceptable volatility deviates by more than 0.50% from that of the capitalised EONIA index.	KID or Prospectus, reporting, databases

"Insignificant risk of changes in value"	- The investable universe includes any amount of:
	  - risky investment in securities that are not money market instruments or short-term interest rate securities, or securities with speculative grade ratings from any renowned rating agency (Moody's, Fitch or S&P) or that the management company deems to be speculative grade, if no rating is available,
	  - securitisation products, or products where the issuer retains options.
	- The structure of a collective investment scheme can lead to significant counterparty risk if the counterparty goes bankrupt and/or if the collateral does not comply with the liquidity and short-term investment criteria for money market instruments.
	- The WAM is negative or greater than 6 months*.
		KID or Prospectus, Reporting and databases

Criteria	Factors ruling out classification as cash equivalents	Source documents
	- The WAL is greater than 18 months*.	

* The definitions of final maturity and the procedures for calculating the WAL and the WAM are the ones set out in *CESR's Guidelines on a common definition of European money market funds*, 19 May 2010.

APPENDIX 1:

INSTRUCTION No. 2005-02 OF 25 JANUARY 2005 as amended on 3 May 2011, ON THE FULL PROSPECTUS OF COLLECTIVE INVESTMENT SCHEMES AUTHORISED BY THE AMF, WITH THE EXCEPTION OF FUTURES AND OPTIONS FUNDS, VENTURE CAPITAL FUNDS, INNOVATION FUNDS, EMPLOYEE PROFIT-SHARING FUNDS AND EMPLOYEE SHARE OWNERSHIP PLANS
For the purposes of Articles 411-1 to 413-21 of the AMF General Regulation

(EXTRACT)

CLASSIFICATION OF COLLECTIVE INVESTMENT SCHEMES (Extract)

Article 28b – “Short-term money market funds” and “money market funds”

This article is based on CESR's Guidelines on a common definition of European money market funds, dated 19 May 2010.

I. General provisions:

1. These provisions apply to collective investment schemes set up under French law and classified as “euro money market funds” or “international money market funds”, regardless of whether they comply with Directive 85/611/EEC.

2. Any collective investment scheme marketed or labelled as a money market fund shall adopt these provisions.

3. A money market fund shall clearly indicate in its full prospectus whether it is a “short-term money market fund” or a “money market fund”.

4. A money market fund shall provide appropriate information about its risk/reward profile so that investors can identify specific risks stemming from the fund's investment strategy.

II. A “short-term money market fund” must:

1. Have the primary investment objective of maintaining the principal of the fund and aim to provide a return in line with money market rates.
2. Invest in money market instruments that comply with the criteria for money market instruments as set out in Directive 2009/65/EEC, or deposits with credit institutions.

3. Ensure the money market instruments it invests in are of high quality, as determined by the management company. In making its determination, the fund or the management company must take into account a range of factors including, but not limited to:

a) The credit quality of the instrument;
b) The nature of the asset class represented by the instrument;
c) For structured financial instruments, the operational and counterparty risk inherent within the structured financial transaction;
d) The liquidity profile.

4. For the purposes of point 3.*a)*, consider a money market instrument not to be of high quality unless it has been awarded one of the two highest available short-term credit ratings[6] by each recognised credit rating agency that has rated the instrument. If the instrument is not rated, the fund (or the management company) must determine that it is of an equivalent quality by an internal rating process.

[6] For example, securities with ratings lower than A2, P2 or F2 cannot be deemed to be securities with high credit quality.

5. Limit investment in securities to those with a residual maturity until the legal redemption date[7] of less than or equal to 397 days. The residual maturity means the period remaining before the legal redemption date.

6. Have a net asset value based on a daily valuation and provide daily subscription and redemption of shares/units.

7. Ensure that its portfolio has a weighted average maturity (WAM) calculated according to the procedures defined in CESR's Guidelines of 19 May 2010 under the heading "definitions" of no more than 60 days.

8. Ensure that its portfolio has a weighted average life (WAL) calculated according to the procedures defined in CESR's Guidelines of 19 May 2010 under the heading "definitions" of no more than 120 days.

9. When calculating the WAL for securities, including structured financial instruments, base the maturity calculation on the residual maturity until the legal redemption date of the instruments.

However, when a financial instrument embeds a put option, the exercise date of the put option may be used instead of the legal residual maturity only if the following conditions are fulfilled at all times:

- The option can be freely exercised by the fund at its exercise date;
- The strike price of the option remains close to the expected value of the instrument at the next exercise date; and
- The investment strategy implies that there is a high probability that the option will be exercised at the next exercise date.

10. Take into account, for both the WAL and WAM calculations, the impact of financial derivative instruments, deposits and efficient portfolio management techniques (in accordance with the criteria defined in Article R. 214-12-IV of the Monetary and Financial Code).

11. Not take direct or indirect exposure to equity or commodities, including via derivatives; and only use derivatives in line with the money market investment strategy of the fund. Derivatives that give exposure to foreign exchange may be used only for hedging purposes. Investment in non-base currency securities is allowed provided the currency exposure is fully hedged. (For example, a fund denominated in EUR cannot hold investments denominated in USD that are not hedged against EUR/USD exchange risk. However, a fund denominated in USD can hold investments denominated in USD that are not hedged against EUR/USD exchange risk.

12. Limit its investment in other collective investment schemes to those that comply with the definition of a "short-term money market fund".

13. Have either a constant or a fluctuating net asset value.

III. A "money market fund" must:

1. Comply with points 1, 2, 3, 4, 6, 9, 10 and 11 of Article 28b II.

Furthermore, a "money market fund":

2. May, as an exception to the requirement in point 4 of Article 28b II., hold money market instruments issued or guaranteed by a central, regional or local authority or central bank of a Member State, the European Central Bank, the European Union or the European Investment Bank with Investment Grade ratings.

1. For example, securities with ratings lower than A2, P2 or F2 cannot be deemed to be securities with high credit quality.

[7] The legal redemption date is the maturity set out contractually in the issue documents of the financial instrument concerned.

2. The legal redemption date is the maturity set out contractually in the issue documents of the financial instrument concerned.

3. Must have a fluctuating net asset value;

4. Must limit its investment to securities with a residual maturity of no more than 2 years, provided the time remaining until the next interest rate reset date is no more than 397 days. Floating rate securities should reset to a money market rate or index;

5. Must ensure that its portfolio has a weighted average maturity (WAM) calculated according to the procedures defined under the heading “definitions” in CESR's Guidelines of 19 May 2010 of no more than 6 months.

6. Must ensure that its portfolio has a weighted average life (WAL) calculated as the average final maturity of the financial instruments according to the procedures defined under the heading “definitions” in CESR's Guidelines of 19 May 2010 of no more than 12 months.

7. Must limit its investment in other collective investment schemes to those that comply with the definitions of a “money market fund” or a “short-term money market fund”.

IV. Transitional provisions:

1. These provisions will enter into force on the same date as the entry into force of the transposition of Directive 2009-65/EC, on 1 July 2011.

2. Money market funds created after 1 July 2011 will have to comply with these provisions immediately.

3. Money market funds in existence at 1 July 2011 must comply with Article 28b of this Instruction for new investment made on or after that date. However, in respect of investments acquired before 1 July 2011, such funds have six months to comply with the provisions.

APPENDIX 2

DEFINITIONS

Weighted Average Life (WAL) and Weighted Average Maturity (WAM)

The procedures set out in under the heading "definitions" in CESR's Guidelines of 19 May 2010[8] shall be followed.

COMMITTEE OF EUROPEAN SECURITIES REGULATORS
CESR's Guidelines on a common definition of European money market funds

(EXTRACT)

Weighted Average Maturity: WAM is a measure of the average length of time to maturity of all of the underlying securities in the fund weighted to reflect the relative holdings in each instrument, assuming that the maturity of a floating rate instrument is the time remaining until the next interest rate reset to the money market rate, rather than the time remaining before the principal value of the security must be repaid. In practice, WAM is used to measure the sensitivity of a money market fund to changing money market interest rates.

Weighted Average Life: WAL is the weighted average of the remaining life (maturity) of each security held in a fund, meaning the time until the principal is repaid in full (disregarding interest and not discounting). Contrary to what is done in the calculation of the WAM, the calculation of the WAL for floating rate securities and structured financial instruments does not permit the use of interest rate reset dates and instead only uses a security's stated final maturity. WAL is used to measure the credit risk, as the longer the reimbursement of principal is postponed, the higher is the credit risk. WAL is also used to limit the liquidity risk.

[8] Ref.: CESR/10-049 *CESR's Guidelines on a common definition of European money market funds*