March 8, 2024

Felix Grenfell Bozek and
Liam Browne
Financial Conduct Authority
12 Endeavour Square
London
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By email: cp23-28@fca.org.uk

Dear Mr. Bozek and Mr. Browne,

Response to FCA CP23/28: Updating the regime for Money Market Funds

The International Swaps and Derivatives Association, Inc. ("**ISDA**") appreciates the opportunity to submit these comments on the Financial Conduct Authority's ("**FCA**") Consultation Paper CP23/28: Updating the regime for Money Market Funds ("**MMFs**"). Our response focuses on Chapter 7 of the consultation.

We welcome the opportunity to provide our views on this important topic. As MMFs are not posted directly as collateral for variation margin ("**VM**") and initial margin ("**IM**") for operational and record keeping challenges, we focus our response in Q17 and Q18 on the use of MMFs as a reinvestment vehicle for cash as collateral. In response to Q19 and Q20, we note that tokenised MMFs would address the challenges with posting MMF as direct collateral.

Background

MMFs have long been used as a reinvestment vehicle for cash posted as VM in the North American markets and this trend is expanding to other jurisdictions, such as the UK and the EU. With the onset of the uncleared margin rules, implemented in the UK by the onshored EMIR and Binding Technical Standards (BTS) 2016/2251), there is a regulatory requirement to segregate IM. Therefore, if cash is posted as IM, pledgors are likely to transfer cash into a MMF as cash cannot be segregated from an operations perspective.

It is important to note that MMFs that are used as collateral and are eligible under the UK BTS 2016/2251 are those that are restricted to government-only or Treasury-only MMFs, also known as Public Debt Constant Net Asset Value ("**PDCNAV**"), not corporate or prime funds, also known as Low Volatility Net Asset Value ("**LVNAV**") funds. In recent times of market volatility, inflows to government-focused MMFs have been driven by flight to quality concerns. And, although such

MMFs that fit this criteria domiciled in third countries are allowed under the UK BTS, there is a very limited market of PDCNAV issues in EUR or GBP currencies.

It is essential that firms are allowed to post cash for VM or IM and to reinvest into a MMF as eligible collateral because:.

1) Firms may not have ready access to eligible non-cash collateral.

2) Firms may not have the operational infrastructure and/or the capacity to efficiently transform cash to eligible collateral.

3) Transformation outside the custodian can be costly for firms with less scale.

4) Holding securities specifically in anticipation of collateral calls creates a drag on performance and decreases investment performance for end investors.

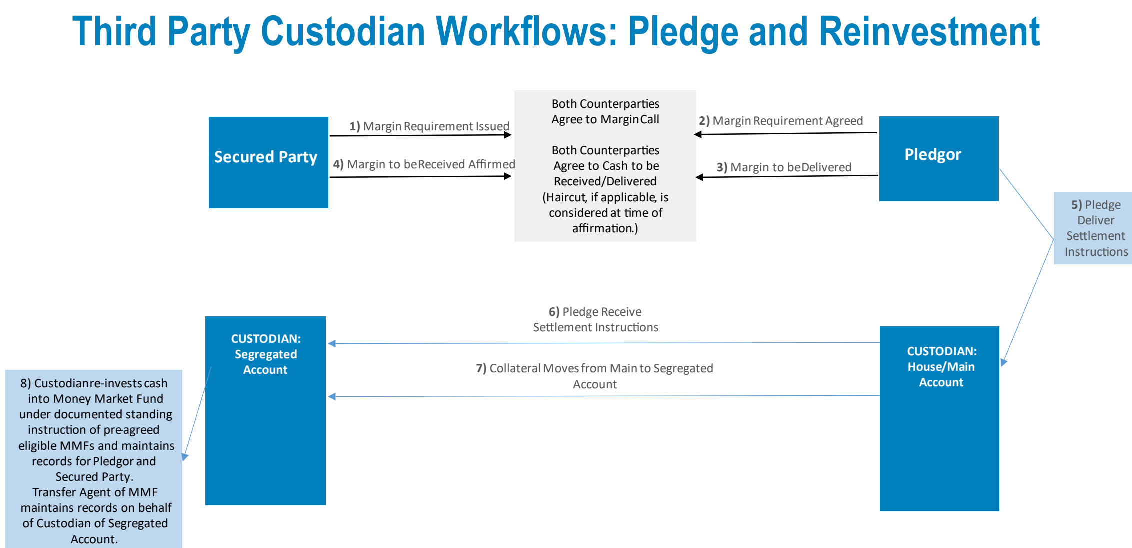
5) There are situations where transformation is not possible or practical prior to posting e.g. due to reinvestment/custodian cut-off times.

Specifically, the workflow for posting OTC derivatives collateral using a MMF is currently a multi-step process. Both parties must agree to eligible collateral to be posted and received. This is documented at the beginning of the relationship, using an eligible collateral schedule ("**ECS**"). When using cash and MMFs, both types of collateral must be listed in the ECS, including one or multiple MMFs that meet all regulatory requirements.

When a margin call is issued, the pledgor and secured party agree to the amount to be pledged, including the haircut to be associated with the MMF.

The pledgor sends cash to the custodian of the secured party, and the custodian then performs a daily sweep into the appropriate MMF, purchasing shares of the MMF as collateral pledged to the secured party.

Figure 1



According to ISDA's Margin Survey Year End 2022, 57.6% of all IM and VM received is in cash, and 68.9% of all IM and VM posted is cash.[1]

Responses to consultation questions

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

Currently, there are both advantages and disadvantages to posting cash and reinvesting to MMFs. First, the advantages are:

1) For investors that rely on cash as a source of collateral for VM, posting cash and reinvesting to MMFs provides a structure that can reduce custodian risk exposure, compared to posting cash. Further, investors that wish to use cash for IM collateral need to ensure their collateral can be segregated, and therefore reinvesting into another type of eligible collateral, such as government securities or MMFs are viable options.

[1] ISDA's Margin Survey Year End 2022

2) For firms that do not have government security trading desks, posting cash and then reinvesting into a MMF is an efficient method to deploy cash within tight margin call and settlement timeframes.

3) Posting cash and reinvesting to MMFs reduces the need to employ traders to manage cash purchases of securities to be used as securities, including the transaction and settlement costs. This can be a costly impact to end-investors' performance.

4) And lastly, custodian insolvency risk is reduced when posting cash and reinvesting into MMFs. If collateral is kept at the custodian in cash, it is consolidated on the custodian's balance sheet for supplemental leverage ratio calculations.

There are also disadvantages to using MMFs as collateral, such as:

1) Currently, there are inconsistent rules between the US, the UK and the EU regarding specific MMFs that are eligible. For example, the US does not currently allow MMFs that use repo or asset transfers compared to the UK and the EU.

2) Because MMF shares are not directly posted to counterparties as collateral, counterparties must have systems that can account for the cash to be initially posted and also the MMF reinvestment. Details include being able to calculate the haircut on MMFs to ensure the collateral valuation is correct from day to day.

3) Although one of the primary reasons to reinvest cash to a MMF is to reduce custodian risk, there is a chance that the custodian could file bankruptcy after the cash is posted and before the MMF sweep.

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

As described above, the workflow of posting cash and then reinvesting into MMFs can require meeting earlier timeframes for collateral settlement. Investors that choose to post cash and reinvest into MMFs carefully balance the benefits, costs, and risks compared to purchasing securities that can be posted directly, such as government securities.

We recommend reducing the barriers to using MMFs as IM by allowing the use of PDCNAV MMFs without a concentration limit. For other defined MMFs, the current 15% concentration limit should be raised and the Euro 10 million limit should be removed: as a practical matter it can equate to a concentration limit of below 5%, making MMFs too inefficient for use as initial margin

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

To ensure clarity, ISDA's response to this consultation is focused on MMFs that invest in government securities, where the unit holder register is recorded and managed using distributed ledger technology (DLT). MMFs represent a compelling use-case for tokenization because (i) the fund unit is already de-materialized and (ii) tokenization of fund units could replace the traditional subscription and redemption work-flow, making the process faster and more efficient. Given MMF units meeting certain criteria are permitted to be used as collateral for non-centrally cleared derivatives (see above response to Q17), the tokenization of MMF units could provide further operational efficiencies to market participants:

- Within the traditional subscription and redemption process for MMFs, transaction settlement typically occurs on T+2 or longer. With tokenization, settlement can occur almost instantaneously (so-called 'atomic settlement') due to the decentralized nature of DLT-based platforms which allow for direct peer-to-peer transaction settlement without the need for traditional intermediaries.

- Instant (or near-instant) settlement accelerates the subscription and redemption process, increasing the speed by which collateral can be moved between parties. This, in turn, reduces settlement risk significantly by minimizing the period between the trade date and the date on which the collateral settles.

- Traditional financial market infrastructure can be slow and cumbersome, requiring manual reconciliation. Through tokenization, many of these manual processes could be automated through the use of smart contracts. This may be particularly useful for managing the distributions of income from the fund and any required reinvestment.

- Tokenization could offer lower transaction costs by reducing the need for intermediaries.

There are also potential disadvantages that need to be considered:

- There are many different types of tokenization structure, each with different levels of decentralization. The extent of decentralization can impact considerably on the governance framework, with highly decentralized systems having very light-touch governance mechanisms. Depending on the nature of the structure, there may be legal uncertainty concerning the nature of any asset recorded on the platform and nature of any rights conferred to the 'owner' of such an asset. For reference, please see: Navigating Bankruptcy in Digital Asset Markets.

- The operational benefits achievable by a specific DLT or blockchain platform will be influenced significantly by the nature of the technology, including its scalability and latency i.e., is the platform large enough and quick enough to record transactions in the necessary volumes and within the required timeframes.

- The use of smart contracts within such platforms – while introducing potential efficiency benefits – could introduce risk into the system if they do not operate as expected or are compromised by a bad actor.

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

At this time, if a counterparty holds MMF units to post as collateral, they must redeem into cash, post cash, and then use that case to resubscribe for units in a MMF. This process takes time, increases settlement risk as compared to directly posting tokenised MMF units as collateral.

The proposed use-case is the development of tokenization structures that are capable of recording settlement and ownership of MMF units within a custodian's books and records. Such tokenised fund units would be readily and rapidly transferable and may increase the resilience of MMF's by reducing the transactional activity in the funds underling government bonds bought about from the traditional subscription and redemption process.

While this use-case may offer greater efficiencies as compared to the traditional redemption and subscription process, under this more limited implementation it is likely that many of the advantages and disadvantages outlined above may be less pronounced as compared to a more decentralized system designed to replace more expansive, intermediated networks.

For example,

- While reduction of settlement risk is a fundamental benefit of tokenization, settlement risk may, as a general matter, be less pronounced for less volatile assets such as MMFs,

- Reduction of transaction costs are likely to be less pronounced within certain structures, such as that where a custodian holds the MMF units and assets on behalf of its clients and uses tokenization primarily for recording ownership of such assets within its own books and records.

- A DLT system designed to record and manage MMF fund units within a custodian's own books and records is likely to present fewer issues from a governance, legal or regulatory perspective as compared with a significantly more (or completely) decentralized structure.

In summary, ISDA is supportive of using MMFs as collateral for uncleared derivatives margin requirements and supports the advancement of tokenised MMFs to be used as collateral, in an effort to increase collateral mobility, reduce collateral-related transaction costs and related settlement risks.

Yours sincerely,

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Appendix: About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 79 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on X, LinkedIn, Facebook and YouTube.