

MEMO# 24700

November 11, 2010

CFTC Proposal Restricting Investment Of Customer Funds Would Impact Money Market Funds; November 16 Conference Call

[24700]

November 11, 2010

TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 60-10
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 46-10
SEC RULES COMMITTEE No. 52-10 RE: CFTC PROPOSAL RESTRICTING INVESTMENT OF CUSTOMER FUNDS WOULD IMPACT MONEY MARKET FUNDS; NOVEMBER 16 CONFERENCE CALL

The Commodity Futures Trading Commission has proposed changes to its regulations regarding the kinds of investments that futures commission merchants (“FCMs”) and derivatives clearing organizations (“DCOs”) are permitted to make with customer funds. [1] CFTC Regulation 1.25 currently provides that FCMs and DCOs holding customer segregated funds may invest those funds in certain “permitted investments,” including money market funds, subject to specified requirements that are designed to minimize exposure to credit, liquidity, and market risks. The proposed amendments would narrow the scope of investment choices and place new limits on certain permitted investments, including money market funds. [2] The proposed amendments, particularly those concerning investments in money market funds, are summarized below.

Comments are due to the CFTC by December 3, 2010. We will hold a conference call on Tuesday, November 16th at 4:00 p.m. Eastern to discuss the proposal. If you plan to participate, please respond to Gwen Kelly by email (gwen.kelly@ici.org) by Monday, November 15th. If you are unable to participate on the call but have comments on the proposal, please provide them to Frances Stadler prior to the call by email (frances@ici.org) or phone (202/326-5822).

Background

Under Section 4d(a)(2) of the Commodity Exchange Act, the investment of customer segregated funds is limited to obligations of the United States and obligations fully guaranteed as to principal and interest by the United States, and general obligations of any State or any political subdivision thereof. Regulation 1.25 expands the list of permitted investments to include government sponsored enterprise securities, bank certificates of deposit, commercial paper, corporate notes, general obligations of a sovereign nation, and interests in money market funds. In addition, Regulation 1.25 establishes a general prudential standard by requiring that all permitted investments be “consistent with the objectives of preserving principal and maintaining liquidity.”

In 2007, the CFTC’s Division of Clearing and Intermediary Oversight (“Division”) launched a review of the nature and extent of investments of, among other areas, customer segregated accounts in order to obtain an up-to-date understanding of investment strategies and practices and to assess whether any changes to the regulations would be appropriate. As part of this review, all CFTC-registered DCOs and FCMs carrying customer accounts provided responses to a series of questions. As the Division was conducting follow-up interviews with respondents, the market events of September 2008 occurred. In response to those events, the CFTC in 2009 issued an advance notice of proposed rulemaking to solicit public comment in connection with its plan to consider significantly revising Regulation 1.25. [\[3\]](#) ICI submitted a comment letter expressing the strong belief that “money market funds continue to be an investment ‘consistent with the objectives of preserving principal and maintaining liquidity’ and, therefore, should remain a permitted investment” under Regulation 1.25. [\[4\]](#)

As part of its advance notice of proposed rulemaking, the CFTC also requested comment regarding an FCM’s treatment of customer money, securities, and property associated with positions in foreign futures and foreign options under Regulation 30.7 (“30.7 funds”), which currently are not limited to specific investments. The CFTC expressed its belief at that time that it may be appropriate to impose the limitations on permitted investments under Regulation 1.25 to 30.7 funds because the same prudential concerns arise in both contexts.

Proposed Amendments

The Release states that in proposing amendments to Regulation 1.25, the CFTC “seeks to simplify the regulation and impose requirements that can better ensure the preservation of principal and the maintenance of liquidity.” In addition to removing credit rating requirements as noted above, the proposed amendments would, among other things, make changes to the list of permitted investments (including eliminating some instruments from the list) and impose stricter concentration limits in an effort to promote greater diversification. A chart available on the CFTC’s website compares the current provisions of Regulation 1.25 with the proposed changes in a user-friendly format. [\[5\]](#) The proposed amendments also would harmonize Regulation 30.7 with Regulation 1.25.

Regarding money market funds, the Release indicates that such funds have been widely used as an investment for customer segregated funds and that “they remain an attractive investment option due to their portfolio diversification, administrative ease, and heightened prudential standards recently imposed by the SEC.” The Release further notes, however, that experience during the recent financial crisis “underscores that investments in [money

market funds] are not without risk.”

Under the proposal, money market funds would remain a permitted investment, but certain new restrictions would apply. In particular, money market funds would be subject to a 10 percent asset-based concentration limit, meaning that no more than 10 percent of total assets held in segregation by an FCM or DCO could be invested in money market funds. In addition, a 2 percent issuer-based concentration limit would apply. As a result, no more than 2 percent of total assets held in segregation could be invested in any “single family of money market mutual funds.” The Release specifically requests comment on whether money market fund investments should be limited to Treasury money market funds, or to money market funds whose portfolios are limited to permitted investments under Regulation 1.25.

Other changes related to money market funds include a proposed clarification of the current requirement that the “sponsor of the fund and the fund itself” provide an acknowledgment letter when money market fund shares are held by a fund’s shareholder servicing agent. [6] The CFTC proposes instead to specify that an FCM or DCO must obtain the required acknowledgment letter “from an entity that has substantial control over the fund’s assets and has the knowledge and authority to facilitate redemption and payment or transfer of the customer segregated funds.” The proposal also would specify that such an entity may include the fund sponsor or investment adviser.

The proposal would revise a requirement in Regulation 1.25 that a money market fund be legally obligated to satisfy a redemption request by the business day following the request (“next-day redemption requirement”). In particular, the proposal would change the list of exceptions to the requirement to be more closely aligned with the language in Section 22(e) of the Investment Company Act (which will continue to be incorporated by reference) and to include new Rule 22e-3. [7] The CFTC proposes to include, as Appendix A to the rule text, safe harbor language that a money market fund could use to ensure that its prospectus complies with the next-day redemption requirement.

Frances M. Stadler
Deputy Senior Counsel

endnotes

[1] See Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, Commodity Futures Trading Commission, 75 Fed. Reg. 67642 (Nov. 3, 2010) (“Release”).

[2] In addition, pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the CFTC proposes to remove credit rating requirements from Regulation 1.25.

[3] See Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, Commodity Futures Trading Commission, 74 Fed. Reg. 23962 (May 22, 2009).

[4] See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Mr. David A. Stawick, Secretary, Commodity Futures Trading Commission, dated July 21, 2009, available at <http://www.ici.org/pdf/23643.pdf>.

[5] See

<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/comparisonchart125.pdf>.

[6] The Release explains that this requirement is an exception to the general rule set forth in Regulation 1.26, which requires an FCM or DCO which invests customer funds in instruments permitted under Regulation 1.25 to create a segregated account at a depository for such instruments and to obtain an acknowledgment letter from the depository.

[7] As noted in the Release, Rule 22e-3 permits a money market fund to suspend redemptions when the fund's board of directors has determined that the deviation between the fund's amortized cost per share and its current net asset value per share may result in material dilution or other unfair results and has irrevocably approved the liquidation of the fund. The fund must notify the SEC of its decision to liquidate and suspend redemptions.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.