

MEMO# 25706

December 13, 2011

CFTC Adopts Restrictions Regarding the Investment of Customer Funds in Money Market Funds and Other Investments

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TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 66-11
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 58-11
SEC RULES MEMBERS No. 138-11 RE: CFTC ADOPTS RESTRICTIONS REGARDING THE INVESTMENT OF CUSTOMER FUNDS IN MONEY MARKET FUNDS AND OTHER INVESTMENTS

The Commodity Futures Trading Commission has adopted amendments 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 amendments would narrow the scope of investment choices and place new limits on certain permitted investments, including money market funds, in an effort to promote greater diversification. The amendments, particularly those concerning investments in money market funds, are summarized below.

Amendments

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 (“U.S. government securities”), and general obligations of any State or any political subdivision thereof (“municipal securities”). Regulation 1.25 expands the list of permitted investments and establishes a general prudential standard by requiring that all permitted investments enhance the preservation of principal and maintenance of liquidity consistent with Section 4d of the Act.

According to the Release, the final rules narrow the scope of the investment choices in order to “eliminate the potential use of portfolios of instruments that may pose an unacceptable risk to customer funds” and “increase the safety of Regulation 1.25 investments by promoting diversification.” To this end, the amendments:

- Retain investments in U.S. agency obligations, including implicitly backed GSE debt securities, and impose limitations on investments in debt issued by Fannie Mae and Freddie Mac;
- Remove corporate debt obligations not guaranteed by the United States from the list of permitted investments;
- Eliminate foreign sovereign debt as a permitted investment; [\[2\]](#)
- Eliminate in-house and affiliate transactions;
- Restrict CDs to only those instruments that can be redeemed at the issuing bank within one business day, with any penalty for early withdrawal limited to accrued interest earned according to its written terms; and
- Retain investments in money market funds (but with additional restrictions discussed below).

The CFTC also adopted stricter asset-based concentration limits that would restrict the amount of customer funds an FCM or DCO can hold in any one class of investments (other than U.S. government securities) in addition to specific issuer-based concentration limits.

Regarding money market funds, the amendments impose different concentration limits for investments in Treasury-only funds than for investments in all other money market funds. The amendments also distinguish between funds that do not have both \$1 billion in assets and a management company that has at least \$25 billion in money market fund assets under management (“small funds”) and those that do (“large funds”). Specifically, while the amendments do not impose any asset-based concentration limit for large Treasury-only funds, FCMs and DCOs may only invest up to 50 percent of their segregated funds in non-Treasury-only funds. Furthermore, investments in small funds (regardless of type) may not exceed 10 percent of the total assets held in segregation by the FCM or DCO. Additionally, FCMs and DCOs investing in non-Treasury-only funds may invest no more than 25 percent in one family of funds and no more than 10 percent in any individual money market fund.

Other changes relating to money market funds include a 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. The CFTC now requires that an FCM or DCO 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. The amendments also specify that such an entity may include the fund sponsor or depository acting as custodian for fund shares.

The amendments also 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 amendment changes 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. [\[3\]](#) The amendments also added, as an appendix to the rule text, safe harbor language that a money market fund can use to ensure that its prospectus complies with the next-day redemption requirement.

Finally, the amendments impose the limitations on permitted investments under Regulation 1.25 to an FCM’s treatment of customer money, securities, and property associated with positions in foreign futures and foreign options under Regulation 30.7, which currently are not limited to specific investments. Finally, pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the CFTC amended Regulations 1.25 and 30.7 by removing all references to credit rating requirements.

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endnotes

[1] See *Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions*, Commodity Futures Trading Commission, RIN 3038-AC79 (December 5, 2011) (“Release”).

[2] The Release indicates that the CFTC is amenable to considering applications for exemptions to investment in foreign sovereign debt by FCMs or DCOs upon a demonstration that the investment in the sovereign debt of one or more countries is appropriate in light of the objectives of Regulation 1.25 and that the issuance of an exemption satisfies the criteria in Section 4(c) of the Act.

[3] 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.

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