The Asset Management Industry
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INVESTMENT COMPANY INSTITUTE

MEMO# 30125

August 10, 2016

CFTC Staff Issues Interpretation and No-Action Relief Regarding the Use of Money Market Funds as Investment Vehicles by DCOs and FCMs

[30125]

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TO: DERIVATIVES MARKETS ADVISORY COMMITTEE No. 41-16
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 19-16 RE: CFTC STAFF ISSUES INTERPRETATION AND NO-ACTION RELIEF REGARDING THE USE OF MONEY MARKET FUNDS AS INVESTMENT VEHICLES BY DCOS AND FCMS

The staff of the Commodity Futures Trading Commission ("CFTC" or "Commission") recently issued two letters that would prohibit a futures commission merchant ("FCM") from investing customer funds, and a Derivatives Clearing Organization ("DCO") from investing amounts deposited as initial margin, in money market funds that may impose redemption restrictions and liquidity fees. Both letters were issued in light of the effectiveness on October 14, 2016, of Securities and Exchange Commission ("SEC") amendments to rule 2a-7 under the Investment Company Act of 1940 ("1940 Act"). The letters are summarized briefly below.

Background on Rule 2a-7 Amendments

In 2014, the SEC adopted amendments to rule 2a-7. [1] These amendments, among other things, allow a money market fund the flexibility to impose fees (up to 2 percent) and/or gates (up to 10 business days in a 90-day period) after the fund's weekly liquid assets have crossed below 30 percent of its total assets, if the fund's board of directors (including a majority of its independent directors) determines that doing so is in the best interests of the fund. The amendments also require a money market fund that is not a "government money market fund," as defined under rule 2a-7, (i.e., a "Prime Fund"), if its weekly liquid assets fall below 10 percent of its total assets, to impose a 1 percent liquidity fee on each shareholder's redemption, unless the fund's board (including a majority of its independent directors) determines that such a fee would not be in the best interests of the fund, or determines that a lower or higher (not to exceed 2 percent) fee would be in the best interests of the fund. The amendments permit a government money market fund to choose to rely on the ability to impose liquidity fees and suspend redemptions, although it is not

required to do so (“Electing Government Fund”). An Electing Government Fund must notify investors of the election in its Form N-1A. These amendments take effect on October 14, 2016.

Staff Interpretation

The staff interpretation [2] addresses the ability of a DCO to invest in Prime Funds and Electing Government Funds under the CFTC’s Part 39 regulations. The letter expresses the view that it would be inconsistent with these regulations for a DCO to accept or hold initial margin in Prime Funds and Electing Government Funds, or to invest assets belonging to the DCO, its clearing members, or clearing members’ customers, in such funds, as discussed below.

CFTC regulation 39.13 obligates a DCO to follow certain risk management practices and requires, in part, that the DCO “limit the assets it accepts as initial margin to those that have minimal credit, market, and liquidity risks.” [3]; The staff states that, because a Prime Fund or Electing Government Fund might suspend redemptions for up to 10 days, these funds pose more than minimal liquidity risks. The staff therefore interprets regulation 39.13(g)(10) to prohibit a DCO from holding or accepting shares in a Prime Fund or Electing Government Fund as initial margin beginning October 14, 2016.

CFTC regulation 39.11 specifies a DCO’s minimum financial resources and related obligations and requires the DCO to “effectively measure, monitor, and manage its liquidity risks, maintaining sufficient liquid resources such that it can, at a minimum, fulfill its cash obligations when due” and “hold assets in a manner where the risk of loss or delay in its access to them is minimized.” [4] The staff believes that the amendments to rule 2a-7 would result in a DCO invested in a Prime Fund or Electing Government Fund after October 14, 2016 to face the risk that its access to such assets would be delayed, and the risk of such delay would not be minimized. The staff therefore interprets regulation 39.11(e)(1)(i) to prohibit a DCO from holding assets in a Prime Fund or Electing Government Fund beginning October 14, 2016.

CFTC regulation 39.15 sets standards a DCO must follow to protect and ensure the safety of funds and assets belonging to clearing members and their customers, and requires a DCO to “hold funds and assets belonging to clearing members and their customers in a manner which minimizes the risk of loss or of delay in the access by the DCO to such funds and assets.” [5] Regulation 39.15(e) limits a DCO to investing funds and assets belonging to clearing members and their customers in instruments with “minimal credit, market, and liquidity risks.” [6] The staff believes that a Prime Fund or Electing Government Fund is an instrument having more than minimal liquidity risk. It interprets regulation 39.15(c) and (e) to prohibit a DCO from holding funds belonging to clearing members or their customers in a Prime Fund or Electing Government Fund beginning October 14, 2016.

Regulation 39.36 sets out risk management standards and procedures that must be followed by systemically important DCOs (“SIDCOs”) [7] and subpart C DCOs. [8] Under regulation 39.36, the custody and investment arrangement for the funds and assets of these DCOs are subject to the same requirements applicable to the holding of funds and assets of clearing members under regulation 39.15(c) and (e). As a result, a SIDCO or subpart C DCO must maintain its funds and assets “in a manner which minimizes the risk of loss or of delay in the access by the derivatives clearing organization to the funds and assets.” [9] The staff believes that holding assets in a Prime Fund or Government Fund that may, under certain circumstances, suspend redemptions for 10 days does not minimize the risk of delay in the DCO’s access to such funds and assets. The staff therefore interprets

regulation 39.36(f) to prohibit a SIDCO or subpart C DCO from investing its own funds in a Prime Fund or Electing Government Fund beginning October 14, 2016.

No-Action Relief

The CFTC staff also issued a no-action letter addressing the ability of FCMs, under CFTC regulation 1.25, to invest customer or other funds in Prime Funds and Electing Government Funds, following the October 14, 2016 effective date of the amendments to SEC rule 2a-7. [10]

CFTC regulations require that all funds held by an FCM in customer segregated accounts, secured accounts, and cleared swaps accounts be subject to the investment limitations of regulation 1.25, including any residual interest maintained by the FCM. [11] Regulation 1.25 specifies permitted investments for segregated funds, and includes money market funds. The rule requires that, to be permitted investments, all investments be "'highly liquid' such that they have the ability to be converted into cash within one business day without material discount in value." [12] The rule further requires that money market funds meet certain terms and conditions to be permitted investments, including generally being obligated to redeem an interest and make payment by the next business day after a redemption request. [13]

The CFTC staff's letter states that the liquidity fee and redemption restrictions under amended rule 2a-7 conflict with the liquidity requirements of CFTC regulation 1.25. The staff therefore concludes that, following the October 14, 2016 effective date of the amendments to rule 2a-7, FCMs will no longer be permitted to invest customer funds in Prime MMFs or in Electing Government MMFs. The staff believes, however, that an FCM should be able to invest the amount of its own funds held in segregated accounts that is in excess of the targeted residual interest in Prime MMFs and Electing Government MMFs, so as to not create a disincentive for the FCM to post its own funds. The staff therefore states that it will not recommend enforcement action under regulation 1.25 against an FCM that continues to invest, on or after October 14, 2016, its own funds held in customer segregated, secured, and cleared swaps accounts in Prime MMFs and Electing Government MMFs provided that the funds invested in such MMFs represent the FCMs residual interest that is in excess of the targeted residual interest amount for each such account. The staff notes that this relief should not impact a firm's targeted residual interest calculation, and that a firm should continue to maintain appropriate written policies and procedures to establish the total amount of targeted residual interest in the customer segregated, secured, and cleared swap accounts in accordance with regulation 1.11(e)(3)(i)(D).

The CFTC staff also notes that the provision in regulation 1.25(b)(3)(i)(E) that excludes from the rule's concentration limits an investment of customer funds in money market fund comprised only of U.S. government securities, is different that the definition of "government money market fund" under rule 2a-7 under the 1940 Act. [14] The staff states that, to provide consistency in the definition of government money market fund, the staff will not recommend an enforcement action if an FCM invests customer funds in government money market funds, as defined in SEC rule 2a-7, provided that they are not subject to rule 2a-7's liquidity fees and redemption restrictions (i.e., provided they are not Electing Government MMFs) and the FCM treats such investments as consistent with regulation 1.25(b)(3)(i)(E) and, therefore, not subject to asset-based concentration limits. The staff further states that this position is conditioned upon the government money market fund meeting the conditions in regulation 1.25(b)(i)(3)(G), provided that the level of assets be increased from the current $1 billion to $5 billion.

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endnotes

[1] For a description of the amendments, please see ICI memorandum 28290 (July 31, 2014), available at https://www.ici.org/govaffairs/fin_srv/mmf/memo28290.

[2] CFTC Letter No. 16-69 (Aug. 8, 2016), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/16-69.pdf.

[3] See regulation 39.13(g)(10).

[4] See regulation 39.11(e)(1)(i).

[5] See regulation 39.15(c).

[6] The staff explains that regulation 39.15(e) also cross references regulation 1.25, and since a DCO's guaranty fund generally consists of funds belonging to the DCO's members, regulation 39.15(c) and (e) indirectly requires a DCO's guaranty fund to consist only of assets having minimal liquidity risks.

[7] Under CFTC regulation 39.2, a SIDCO is defined as a financial market utility that is a registered DCO under section 5b of the Commodity Exchange Act ("CEA"), which is currently designated by the Financial Stability Oversight Council to be systemically important, and for which the Commission acts as the supervisory agency pursuant to section 803(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

[8] A subpart C DCO is a DCO registered with the CFTC pursuant to section 5b of the CEA that is not a SIDCO and has elected to become subject to the requirements of Subpart C of Part 39 of the Commission's regulations. See CFTC regulation 39.2.

[9] See regulation 39.15(c).

[10] CFTC Letter No. 16-68 (Aug. 8, 2016), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/16-68.pdf.

[11] See regulations 1.23(a), 22.2(e), and 30.7(g).

[12] See regulation 1.25(b)(1).

[13] See regulation 1.25(c).

[14] Rule 2a-7 defines a "government money market fund" as a fund that invests 99.5 percent or more of its total assets in cash, government securities, and/or repurchase agreements that are fully collateralized.

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