MEMO# 24761

December 6, 2010

# ICI Letter On CFTC Proposal Restricting Investments Of Customer Funds In Money Market Funds

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TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 66-10
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 51-10
SEC RULES MEMBERS No. 133-10 RE: ICI LETTER ON CFTC PROPOSAL RESTRICTING INVESTMENTS OF CUSTOMER FUNDS IN MONEY MARKET FUNDS

As we previously indicated, 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. [*] 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. With respect to money market funds, the amendments would apply an asset-based concentration limit of 10% of total assets held in segregation. In addition, investments in any family of money market funds would be restricted to 2% of total assets held in segregation. Taken together, these proposed limits would be the most restrictive ones on any class of permitted investments.

ICI has filed a comment letter on the proposal. The letter is attached and briefly summarized below.

The letter first provides background information, including a brief description of the proposed changes to Regulation 1.25. It notes that Regulation 1.25 contains a general prudential standard that requires that all permitted investments be "consistent with the objectives of preserving principal and maintaining liquidity." It observes that money market funds are particularly well suited for holding FCM and DCO customer funds because their investment objectives correspond exactly to the regulation's prudential standard.

The letter refers to ICI's comment letter on the CFTC's 2009 advance notice of proposed rulemaking, which described in detail money market fund regulation and its proven success over time, as well as the response of money market funds to the financial crisis in 2008. The letter then reviews the most relevant elements of the SEC's recent money market fund reforms. It states that the cumulative effect of these reforms has been to improve meaningfully the safety and liquidity of money market funds, making them even more appropriate for holding FCM and DCO customer funds.

The letter indicates that the proposed 10% asset-based limit on investments in money market funds effectively will force FCMs and DCOs to manage at least 90% of their customer segregated funds themselves. It states that customer funds likely would be invested in portfolios consisting largely of Treasury securities, with some portion potentially allocated to bank certificates of deposit ("CDs") and municipal securities. The letter explains that investments in these instruments call for asset management skills that FCMs and DCOs may not have.

The letter notes that even a portfolio of securities backed by the full faith and credit of the United States must be properly structured to limit interest rate risks and provide liquidity. It points out that under the proposed amendments to Regulation 1.25, an FCM or DCO could invest customer funds in a self-managed portfolio of Treasury securities having a weighted average maturity ("WAM") of two years and with no restrictions on the final maturity of individual securities. The letter then provides a graph illustrating the relative (and substantially greater) volatility of two-year Treasury notes as compared to the shadow price of a hypothetical prime money market fund that constantly maintains the maximum WAM permitted by SEC Rule 2a-7.

The letter states that for many FCMs and DCOs, money market funds provide the most efficient means to obtain professional cash management at a relatively low cost. It comments that setting limits that cause FCMs and DCOs to "go it alone," regardless of the degree of their experience in cash management or the cost involved, cannot help to protect their customers' funds. In response to the CFTC's specific request for comment, the letter indicates that limiting money market fund investments to Treasury funds or to funds whose portfolios consist solely of other permitted investments would be too restrictive, given the minimal risks of money market funds.

The letter urges the CFTC not to treat money market funds as the least favored asset class under Regulation 1.25. It recommends that money market funds instead be classified based on their risk relative to other classes of permitted investments. The letter expresses the view that the CFTC would be justified in not subjecting money market funds to any asset-based concentration limit. It suggests that, at a minimum, Treasury funds (which the letter recommends be defined by reference to Rule 35d-1 under the Investment Company Act) should not be subjected to concentration limits. With respect to non-Treasury funds, the letter recommends that any concentration limits be higher than those imposed on bank CDs, given the relative risks of money market funds and bank CDs. The letter opposes imposing an issuer-based limit on money market fund investments and explains why any such limit likely would do little to promote the intended goal of greater diversification.

The letter supports the proposed modifications to Regulation 1.25(c)(5), which requires money market funds to be legally obligated to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request. In response to the CFTC's request for comment, it indicates that proposed changes to the settlement process for tri-party repurchase agreements should not disrupt the orderly settlement of fund redemptions.

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Deputy Senior Counsel

Attachment (in .pdf format)

**endnotes**

[*] See ICI Memo No. 24701, dated November 11, 2010.

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