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1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

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July 21, 2009

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

Re: Advance Notice of Proposed Rulemaking for Regulations 1.25 and 30.7

Dear Mr. Stawick:

The Investment Company Institute ("ICI")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") advance notice of proposed rulemaking on possible changes to its regulations regarding the investment of customer funds segregated pursuant to Section 4d of the Commodity Exchange Act and funds held in an account subject to Regulation 30.7.[2] In response to the market events of September 2008, the CFTC is reviewing "permitted investments," including the use of money market funds, under CFTC regulations. We strongly believe 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 these regulations.[3]

CFTC Notice

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

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $10.6 trillion and serve over 93 million shareholders.

[2] *See* Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, CFTC, 74 FR 23962 (May 22, 2009) ("Notice").

[3] *See* Regulation 1.25 under the Commodity Exchange Act.

principal and interest by the United States, and general obligations of any State or any political subdivision thereof. CFTC Regulation 1.25 provides that a derivatives clearing organization ("DCO") or a future commission merchant ("FCMs") holding customer segregated funds may invest those funds in certain permitted investments subject to specified requirements that are designed to minimize exposure to credit, liquidity, and market risks. Specifically, 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. According to the Notice, the CFTC is mindful that customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers upon demand and to enable these assets to be quickly converted to cash at a predictable value to minimize systemic risk. Indeed, to accomplish these goals, 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. Although the CFTC believes that DCOs and FCMs have managed customer segregated funds responsibly during this difficult time, the Notice notes that the market events of the past year, "notably the failures of certain government sponsored enterprises, difficulties encountered by certain money market mutual funds in honoring redemption requests, illiquidity of certain adjustable rate securities, and turmoil in the credit ratings industry, have challenged many of the fundamental assumptions regarding investments." As a result, the CFTC believes it is an appropriate time to review permitted investments of customer segregated funds.

In addition to its consideration of possible changes to Regulation 1.25, the CFTC is considering applying the investment requirements of Regulation 1.25, including any prospective changes, to a 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"). Currently, 30.7 funds are not limited to specific investments.

Money Market Fund Regulation

A money market fund is a type of mutual fund that has as its objective the generation of income and preservation of capital and liquidity through investments in short-term high quality securities. Money market funds, like all mutual funds, are subject to a comprehensive regulatory scheme under the federal securities laws that has worked extremely well for nearly 70 years. Their operations are subject to all four of the major federal securities laws administered by the Securities and Exchange Commission ("SEC"), including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment

Advisers Act of 1940, and, most importantly, the Investment Company Act of 1940 ("Investment Company Act").[4]

The Investment Company Act goes far beyond the disclosure and anti-fraud requirements that are characteristic of the other federal securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. Among the core objectives of the Investment Company Act are to: (1) provide for a high degree of oversight and accountability; (2) ensure that investors receive sufficient information about the fund, including its fees and expenses, and that the information is accurate and not misleading; (3) protect the physical integrity of the fund's assets by having explicit rules concerning the custody of portfolio securities; (4) prohibit or restrict affiliated transactions and other forms of self-dealing; (5) prohibit unfair and unsound capital structures (by, for example, placing constraints on the use of leverage); and (6) ensure the fairness of transactions in fund shares.[5]

In addition to the substantive requirements of the Investment Company Act listed above, money market funds are subject to Rule 2a-7 under the Investment Company Act, which addresses portfolio quality, diversification of issuers and guarantors of portfolio securities, and the maturity of those securities. One defining feature of money market funds is that, in contrast to other mutual funds, they seek to maintain a stable net asset value ("NAV") or share price, typically $1.00 per share. The Investment Company Act and applicable rules generally require mutual funds to calculate current NAV per share by valuing their portfolio securities for which market quotations are readily available at market value and other securities and assets at fair value as determined in good faith by the board of directors. Rule 2a-7 exempts money market funds from these valuation provisions but contains strict risk-limiting conditions designed to minimize the deviation between a money market fund's stabilized share price and the market value of its portfolio.[6]

Among these risk-limiting conditions include the requirement that money market funds only invest in high quality securities, which the fund's board of directors (or its delegate) determines present minimal credit risks, maturing in 13 months or less. The funds also must maintain a weighted average portfolio maturity of 90 days or less and at least 95 percent of a money market fund's assets must be held in U.S. Government obligations or privately issued securities carrying the highest short-term credit rating by at least two major rating agencies, or securities of comparable quality. In addition, money

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[4] Mutual funds also are subject to most of the requirements that apply to corporate issuers under the Sarbanes-Oxley Act of 2002.

[5] Each of these core objectives is discussed in detail in Section 4 of the Report of the Money Market Working Group ("MMWG Report"), available on ICI's website at http://www.ici.org/pdf/ppr_09_mmwg.pdf.

[6] Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, also must comply with the rule's risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7.

market funds are subject to diversification requirements designed to limit a fund's exposure to the credit risk of any single issuer.[7]

Money market funds that use the amortized cost method of valuation[8] also must periodically "shadow price" or mark their portfolios to market to ensure that the actual value of the fund does not deviate from $1.00 per share by more than one-half of 1 percent. Moreover, all funds must dispose of a defaulted or distressed security (*e.g.*, one that no longer presents minimal credit risks) "as soon as practicable," unless the fund's board of directors specifically finds that disposal would not be in the best interests of the fund.

Some money market funds also obtain credit ratings for the shares they issue; to receive a triple-A rating from an NRSRO, a money market fund must meet standards that are even higher than those currently required by Rule 2a-7. For example, among those higher standards is the requirement that triple-A rated money market funds invest in only the highest short-term rated securities and have a weighted average maturity that does not exceed 60 days.[9]

Historical Success of Money Market Fund Regulation

The comprehensive protections of the Investment Company Act, combined with the exacting standards of Rule 2a-7, have contributed to the success of money market funds. Since the SEC adopted Rule 2a-7 in 1983, money market fund assets have grown over 2,000 percent, from $180 billion to $3.8 trillion as of May 2009. Indeed, in the 25 years since Rule 2a-7 was adopted, $405 trillion have flowed in and out of money market funds. Today, retail and institutional investors alike rely on them as a low-cost, efficient cash management tool that provides a high degree of liquidity, stability in principal value, and a market-based yield. The SEC staff also recognizes that money market fund shares generally are equivalent to cash items.[10]

Indeed, until the unprecedented events of September 2008 that affected nearly every part of the financial markets, money market funds have operated successfully without federal insurance or access to

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[7] For a description of Rule 2a-7's risk-limiting conditions as well as a history of the rule, *see* MMWG Report, *supra* note 5, at Section 4 and Appendix E.

[8] To maintain a stable price per share, money market funds use the amortized cost method of valuation and/or the penny-rounding method of pricing. Under the amortized cost method of valuation, money market funds value their portfolio securities by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. Under the penny rounding method of pricing, share price is determined by valuing securities either at market value, fair value, or amortized cost, and rounding the per share NAV to the nearest cent on a share price of $1.00.

[9] Some rating agencies currently are reviewing their rating standards for money market funds. *See, e.g.*, *Exposure Draft: Global Money Market Fund Rating Criteria,* FitchRatings (January 26, 2009).

[10] *See Willkie Farr & Gallagher*, SEC No-Action Letter (pub. avail. October 23, 2000) (permitting operating companies to treat money market fund shares as "cash items" for purposes of determining whether the issuer is an investment company under the Investment Company Act and rules thereunder).

central bank liquidity facilities. In fact, until the recent market events, only once has a money market fund failed to repay the full principal amount of its shareholders' investments.[11] In that case, a small institutional money market fund "broke a dollar," because it had a large percentage of its assets in adjustable-rate securities that did not return to par at the time of an interest rate readjustment.[12] Even during the extraordinary events of September 2008, only a single money market fund failed to maintain a $1.00 NAV,[13] while another money market fund closed and then merged with an unaffiliated fund rather than "break a dollar."[14]

Swift government actions last fall—through the U.S. Treasury Department's Temporary Guarantee Program for Money Market Funds ("Treasury Guarantee Program")[15] and the Federal Reserve's programs that provided liquidity to the marketplace—helped to maintain confidence in

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[11] Community Bankers U.S. Government Money Market Fund "broke a dollar" in September 1994 and ultimately paid investors $0.96 per share.

[12] Since that time, the SEC has prohibited a money market fund from investing in an adjustable-rate security if its interest rate readjustment formula does not ensure that the market value of the security will return to par once a readjustment occurs.

[13] On September 16, 2008, the Reserve Primary Fund announced that its NAV had fallen below $1.00 to $0.97. *See* Reserve Press Release, available at http://www.reservefunds.com/pdfs/Press%20Release%202008_0916.pdf.

[14] On September 18, 2008, Putnam Investments announced the closing of the Putnam Prime Money Market Fund and the distribution to investors of the fund's assets. *See e.g.,* Diana B. Henriques, "Professional Money Fund is Closed by Putnam," *New York Times* (September 18, 2008), available at http://www.nytimes.com/2008/09/19/business/19money.html. The fund had no exposure to Lehman Brothers or other troubled issuers, but had experienced significant redemption pressures from its concentrated institutional investor base. The fund determined to close rather than sell portfolio securities into a liquidity constrained market; this action allowed the fund to treat all shareholders equitably. On September 24, 2008, the fund merged with Federated Prime Obligations Fund at $1.00 per share and shareholders did not lose any principal. *See* "Putnam Fund Shifts Investors to Federated," *New York Times* (September 24, 2008) (citing *Bloomberg News)*, available at http://www.nytimes.com/2008/09/25/business/25fund.html.

[15] Under the Treasury Guarantee Program, the Treasury Department will guarantee the share price of participating money market funds that seek to maintain a stable NAV of $1.00 per share, or some other fixed amount, subject to certain conditions and limitations. In particular, under the terms of the Treasury Guarantee Program, the Treasury Department guarantees that, upon the liquidation of a participating money market fund, the fund's shareholders will receive the fund's stable price for each fund share owned as of September 19, 2008. To date, no funds have been required to draw upon the guarantee. The Treasury Guarantee Program will expire on September 18, 2009. In addition, money market funds advisers are not legally obligated to guarantee or otherwise maintain the $1.00 share price of the funds they advise, and funds must prominently disclose in their prospectuses and sales literature that there is no guarantee that this price will be maintained. Many advisers, however, when faced with the prospect of their funds breaking a dollar, have voluntarily taken actions to support the funds' share price in order both to protect their shareholders, and to protect the very important "brand" associated with their entire fund and asset management enterprise.

money market funds by reversing an unusual volume of redemption requests and allowing these funds to continue their important liquidity function in the money market.[16]

The public's faith in money market funds also has been evident during the recent crisis in the credit markets. As a result of overall market volatility, retail and institutional investors alike have kept a greater proportion of their short-term investments in safe and liquid vehicles. Indeed, investors have added over $1.1 trillion to money market funds from the end of June 2007 to May 2009.

Money Market Fund Industry Response to Credit Crisis

The financial markets are working through the deepest and most pervasive crisis since the Great Depression. The fundamental causes of this crisis have been attributed to numerous factors, none of which is due to any actions directly taken by money market funds.[17] Although painful, these events have afforded the money market fund industry with the opportunity to assess the regulations that govern its operations, and the more stringent practices adopted by some money market funds that go beyond those regulations. To this end, in March, ICI and its members, working through our Money Market Working Group, issued a comprehensive report outlining a range of measures to strengthen money market funds and help them withstand difficult market conditions in the future.[18]

The Working Group's recommendations include proposed standards and regulations and are designed to ensure that money market funds are better positioned to sustain prolonged and extreme redemption pressures. Specifically, the report includes a number of recommendations that would: impose for the first time daily and weekly minimum liquidity requirements and require regular stress testing of a money market fund's portfolio; tighten the portfolio maturity limit currently applicable to money market funds and add a new portfolio maturity limit; raise the credit quality standards under which money market funds operate; address "client risk" by requiring money market fund advisers to adopt "know your client" procedures; and enhance risk disclosure for investors and the market and require monthly website disclosure of a fund's portfolio holdings.[19]

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[16] In the United States, the market for debt securities with a maturity of one year or less is generally referred to as the "money market." Securities that have final maturities of more than one year but whose yields are reset weekly, monthly, or quarterly also are generally considered part of the money market.

[17] "This crisis stemmed from exuberant borrowing and lending in the housing market, lax regulation and accounting standards, first easy and then tight credit conditions, excessive leverage, the so-called "originate to distribute" system used by banks and mortgage brokers to originate mortgages, and the packaging of mortgages into complex derivative securities." *See* MMWG Report, *supra* note 5 at 47.

[18] A copy of the press release announcing the formation of the Working Group is available on ICI's website at http://www.ici.org/mmfs/08_news_mm_group. *See generally* MMWG Report, *supra* note 5.

[19] For a detailed discussion of the Working Group's recommendations, *see* MMWG Report, *supra* note 5, at Section 7.

Regulatory Response to Credit Crisis

President Obama and his administration recently issued a white paper outlining a plan for financial services regulatory reform.[20] Consistent with the Working Group recommendations, the white paper specifically directs the SEC to move forward with plans to strengthen the money market fund regulatory framework to reduce the credit and liquidity risk profile of individual money market funds and to make the money market fund industry as a whole less susceptible to runs.[21] Indeed, last month the SEC proposed amendments to rules that govern money market funds.[22] The proposed amendments, many of which are similar to the Working Group's recommendations, are designed to make money market funds more resilient to certain short-term market risks. To this end, the amendments would, among other things, amend Rule 2a-7 by: revising portfolio quality and maturity requirements; introducing liquidity requirements; requiring money market fund boards to adopt procedures providing for periodic stress testing of the fund's portfolio; and requiring funds to disclose monthly on their websites information on portfolio securities.

Money market funds are a key component of the money market, relied upon by individuals and institutions alike. The resilience of money market funds is in no small measure attributable to the comprehensive protections of the Investment Company Act and, in particular, Rule 2a-7. Indeed, ICI strongly believes that the SEC's proposed amendments together with the Working Group's recommendations further strengthen an already resilient product. We therefore believe that money market funds continue to be an appropriate investment under CFTC's regulations.

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We look forward to working with the CFTC as it continues to examine these issues. In the meantime, if you have any questions, please feel free to contact me directly at (202) 326-5815 or Jane Heinrichs, Associate Counsel, at (202) 371-5410.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

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[20] *See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, Department of the Treasury (June 17, 2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[21] *Id.* at 38-39.

[22] *See Money Market Fund Reform*, SEC Release No. IC-28807 (June 30, 2009), 74 FR 32688 (July 8, 2009), available on the SEC's website at http://sec.gov/rules/proposed/2009/ic-28807.pdf.