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Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

COMMENT

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

Dear Mr. Stawick:

The Commodity Futures Trading Commission (CFTC) requests comments on possible changes to its regulations regarding the investment of customer segregated funds as well as funds held in an account subject to Commission Regulation 30.7. In this paper, we specifically address the continued inclusion of Money Market Mutual Funds (MMMFs) as a permitted investment. As indicated below, MMMFs fundamental qualities meet the CFTC requirements of minimizing credit, liquidity, and market risks:

- **Credit Risk** – is safeguarded by the restriction of investing in the highest credit quality assets. Portfolio diversification spreads the credit risk across multiple securities types and obligors. In addition, MMMFs have robust credit departments that provide independent analysis and do not solely rely upon credit agency ratings.

- **Liquidity Risk** – is minimized by the short-term maturities of underlying assets and restrictions on illiquid securities. The diversification of investors' needs lessens liquidity risk by spreading out the timing of withdrawals, while the diversification of investment types reduces the impact of a liquidity event in a single market.

- **Market Risk** – Investors rely on the stable $1 net asset value (NAV) of funds, ensuring their principal is protected. Fund managers have stepped in with private sources of capital to support the NAV when the fund has experienced losses in one or more of its portfolio securities.

The fundamental framework of MMMFs results in strong credit quality, liquidity, and minimal market risks for customer-segregated funds as invested by Futures Commission Merchants (FCMs). MMMFs provide the unique ability for FCMs to invest in a combination of the eligible securities. Almost all other acceptable instruments under CFTC 1.25 expose FCMs to the credit risk of a single issuer. The MMMF solution affords FCMs diversification of risk and operational benefits not possible with individual deposits and/or securities. The implications of removing MMMFs from the list of permissible investments would remove a valuable investment option as well as have the potential to increase systemic risk of the financial system.

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MMMFs Offer Liquidity, Stability of Principal, and Competitive Yields

In the 25 years since the adoption of Securities and Exchange Commission (SEC) Rule 2a-7, MMMFs have realized enormous growth, becoming a $3.5 trillion industry. The characteristics of safety, simplicity, and dollar-in, dollar-out certainty of MMMFs have attracted a wide variety of important investor groups from corporate and institutional investors (approximately 60%) to individual consumers (approximately 40%). Corporate investors, whose primary short-term investment goal is preservation of principal, also value the wide variety of benefits offered by 2a-7 MMMFs.

- **A very secure repository** for these deposits – governed by Rule 2a-7. Money funds are managed by professional managers, governed by independent boards, and subject to rigorous credit analysis, valuation and compliance testing on an ongoing basis.
- **A high level of diversification** – dozens of high-quality instruments, either U.S. government backed or rated by independent rating agencies.
- **Risk management** – provided by the fund's manager, resulting in an additional level of scrutiny and quality beyond that provided by rating agencies.
- **Liquidity** – the ability to redeem on a daily basis.
- **Administrative ease** – one click gets you in or out.
- **Cost savings** – the fixed costs of portfolio management, credit analysis and administration are spread among all of the funds investors.

Minimizing Credit, Market, and Liquidity Risk

The CFTC requires that customer segregated funds are invested in instruments that minimize exposure to credit, liquidity, and market risks 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.

When SEC Rule 2a-7 was adopted in 1983, it ensured MMMFs would remain stable through some of the most challenging economic times. The strict guidelines on maturity, diversification, credit quality, and liquidity have given MMMFs a strong foundation of integrity and a substantial degree of self-regulation. The success of these guidelines is evidenced by the strong performance of money market funds during the current credit crisis. During this time, only one MMMF "broke the buck," with no cost to the government and shareholders likely to get back 95 plus cents on the dollar. On the other hand, there have been 77 bank failures in the last two years. The Investment Company Institute (ICI) and SEC have reviewed the recent market events and identified recommendations to further safeguard the MMMF market, which are identified in the section titled, "Enhancement of MMMFs through SEC Recommendations."

1. **Credit Risk** – MMMF credit risk is safeguarded by the restriction of investing in the highest credit quality assets and the degree of portfolio diversification. It would be very difficult for an FCM to achieve the credit due diligence and portfolio diversification offered by a MMMF.

    - *Credit Quality:* MMMFs are currently allowed to invest in the highest two tiers of investment securities, with only 5% of their assets in the second tier.

    - *Diversification:* No more than 5% of their assets can be tied to any one issuer, lending itself to a type of diversification that would be difficult for a portfolio manager to match on their own.

    - *Independent Credit Analysis:* MMMFs have robust credit departments that provide independent analysis and do not solely rely upon credit agency ratings.

2. **Liquidity Risk** – MMMFs maintain liquidity through a limitation on the underlying asset maturity in its portfolio as well as a diversification of investment type, which limits its exposure to a single market.

    - *Short-Term Maturities:* Underlying assets must mature in 397 days or less, and the total portfolio's weighted average maturity can be no longer than 90 days, preserving the short-term nature of these funds.

    - *Limitation on Illiquid Securities:* MMMFs are currently unable to invest more than 10% of its assets in illiquid securities (more than seven days from redemption request) per section 22(e) of the Act, but it is not explicitly listed in Rule 2a-7.

    - *Diversification of Investment Types:* MMMFs invest in multiple types of securities, reducing the impact of a liquidity event in a single market.

    - *Diversification of Investors:* MMMFs have a large number of investors with different underlying liquidity needs, spreading out the timing of withdrawal demands and lessening the impact on liquidity.

3. **Market Risk** – MMMFs are founded upon the principle for every dollar investors invest in an MMMF, investors will receive at least $1 back when they sell their shares. If the NAV deviation becomes significant, which is deemed to be a ½ of 1 percent diminution against par value, the fund is required to take steps to address the deviation, including selling appropriate underlying security holdings and redeeming shares. MMMFs have only "broken the buck" twice in the past 40 years. Fund managers have significant sources of private capital they have made available to support the NAV of the fund when it has experienced losses in one or more if its portfolio securities.

    - *Orderly Liquidity:* Under Rule 22e-3, there is to be an orderly redemption of funds to ensure liquidity to all investors of the fund. The SEC proposes a new Rule 22e-3 that would exempt MMMFs from sections 22(e) to permit them to suspend redemptions in order to facilitate an orderly liquidation of the fund. This would replace a current temporary rule allowing this to occur.

- *Stress Testing*: Under the SEC proposed amendments to Rule 2a-7, the board of each fund must use the amortized cost method to adopt procedures providing for periodic stress testing of the portfolio. This would include its ability to maintain a stable NAV based on hypothetical events, on intervals as deemed by the board in light of current market conditions.

MMMF Provides Benefits Not Provided by Individual Investments

Each of the CFTC permitted investments offers a tradeoff in terms of risk and return. In addition, each has also been impacted by the recent credit crisis.

- Bank Certificates of Deposit – while bank CDs are similar to MMMFs in terms of capital preservation (dollar-in, dollar-out), the recent turmoil in the banking industry has limited the number of banks with acceptable risk profiles, resulting in concentration risks among a relatively small number of banks. Eliminating the MMMF option and potentially moving these funds into bank deposits will further exacerbate the concentration problem and stress deposit insurance programs.

- Treasury Securities – are regarded by many as the "least risky" investment available to U.S. investors. However, there are tradeoffs to that safety including lower yields, limited depth of market (particularly during a flight to safety), and the accounting implications due to fluctuating values as the securities trade at a discount or premium to achieve market yields.

- Corporate Notes and Commercial Paper – are short-term corporate obligations, some of which have been dramatically impacted by the recent credit crisis. Obligations of some firms that were once household names saw rapid declines in credit quality and liquidity. While the overall market is typically very liquid and rates are attractive, the credit analysis and transaction costs make it difficult for an investor to create a diversified portfolio.

- Municipal Securities – typically deemed as low risk securities, this market is seeing a concentration issue similar to the bank market. Investors are flocking to a limited number of higher quality issuers as many local and state governments credit risks are negatively affected by the impact of the economy on their budgets and cash flow.

MMMFs provide the ability for FCMs to invest in a combination of these securities to achieve the benefits of each while minimizing the risks. Under Rule 2a-7, money market mutual funds are required to be highly diversified. No more than 5% of a fund's assets can be invested in the securities of any one issuer. Almost all of the other acceptable instruments under CFTC 1.25 expose FCMs to the credit risk of a single issuer. The MMMF solution affords FCMs an operational benefit not possible with individual deposits and/or securities. An FCM could execute a single transaction to purchase shares in a MMMF and achieve a diversified portfolio with the credit analysis and portfolio administration largely handled by the fund management company. In order to achieve the same level of secure diversification offered by MMMFs, an FCM would need to purchase and manage numerous different securities, each of which would incur transaction costs, credit analysis and added administrative burden.

Enhancement of MMMFs through SEC Recommendations

Based on the review of the past year's events along with the recommendations put forth by the ICI, the SEC has announced amendments to Rule 2a-7 for review. According to the SEC, their proposals "are designed to increase the resilience of money market funds to market disruptions...reduce the vulnerability of money market funds to breaking the buck by, among other things, improving money market funds' ability to satisfy significant demands for redemptions." A brief overview of the amendments is included below:

1. ***Portfolio Quality:*** Fund managers are currently allowed to invest in the highest and second highest tier securities and are limited to 5% of its total assets in "second tier securities." The amendment would limit fund managers to investing only in the highest ratings category. In addition, the SEC is considering an approach that would require the fund's board to designate three or more Nationally Recognized Statistical Rating Organizations to look to for determining an asset's eligibility.

2. ***Portfolio Maturity:*** To limit the exposure of investors to certain risks, there is a current limit of 90-day dollar-weighted average portfolio maturity. The SEC would like to reduce the maximum weighted average portfolio maturity to 60 days and also impose a maturity test that would limit the portion of a fund's portfolio that could be held in longer-term variable- or floating-rate securities. This maturity test would limit the weighted average life maturity of portfolio securities to 120 days. In addition, the SEC proposed reducing the maximum maturity for non-government securities from 397 days to 270 days.

3. ***Portfolio Liquidity:*** MMMFs are currently unable to invest more than 10% of their assets in illiquid securities (more than seven days from redemption request) per section 22(e) of the Act, but it is not explicitly listed in Rule 2a-7. The SEC proposes to amend the rule by adding new risk-limiting conditions designed to improve MMMFs ability to meet redemption.

    a. **Minimum Daily Liquidity Requirements**
        i. Taxable Retail Funds: MMMFs must invest at least 5% of their assets in cash, U.S. Treasury securities, or securities that can provide daily liquidity.
        ii. Taxable Institutional Funds: MMMFs must hold at least 10% of their total assets in daily liquid assets. In addition, the money market's board must decide at least once a year whether the fund is an institutional money fund or retail for purposes of meeting the liquidity requirement.
        iii. Tax Exempt Funds: These funds will be exempt from minimum daily liquidity requirements.

    b. **Minimum Weekly Liquidity Requirement**
        i. Retail and institutional funds could not acquire any securities if immediately after the acquisition: (a) the retail fund would have invested less than 15 percent of its total assets in weekly liquid assets and (b) the institutional fund would have invested less than 30 percent of its total assets in weekly liquid assets. Excluded from this restriction are U.S. Treasury securities or securities that mature or are subject to a demand feature exercisable and payable in five business days.

c. **Stress Testing**

    i. The board of each fund must use the amortized cost method to adopt procedures providing for periodic stress testing of the portfolio. This would include its ability to maintain a stable NAV based on hypothetical events. Stress testing is done on intervals as deemed by the board in light of current market conditions.

4. ***Diversification:*** MMMFs are currently restricted to 5% of assets from any one issuer, except government securities, as well as being limited to no more than 10% of fund assets from any one provider.

5. ***Repurchase Agreements:*** MMMFs typically invest a large portion in repurchase agreements as they typically mature the next day. The SEC proposes MMMFs be limited to investing in repurchase agreements collateralized by bank deposits or government securities. In addition, the board of the fund must evaluate the creditworthiness of the counterparty in repurchase agreements, regardless of whether the agreement is collateralized fully.

6. ***Disclosure of Portfolio Information***
    a. **Public Website Posting:** MMMFs are currently required to report portfolio holdings information to the SEC four times a year. Per the SEC recommendations, the fund would be required to post, among other things, the issuer, the title of the issue, the principal amount of the security, and its current amortized cost on a monthly basis, no later than the second business day of the month. This information would be maintained on the website for at least twelve months.
    b. **Reporting to the Commission:** The SEC will require MMMFs to provide the Commission a monthly electronic filing of more detailed portfolio holdings information to create a central database, providing additional oversight of the industry.

7. ***Processing of Transactions:*** The MMMF boards must determine if the fund has the capacity to redeem and sell its securities at a price based on the current NAV per share on an annual basis.

8. ***Exemption for Affiliate Purchases:*** MMMFs currently have an exemption from section 17(a) that permits affiliated persons of a fund to purchase distressed portfolio securities from the fund. The SEC is considering amending this rule to expand the circumstances to which affiliated persons can purchase MMMFs portfolio securities and how that purchase is reported.

Conclusion

The growth and sustainability of the MMMF industry is a clear indicator of its ability to provide a sound balance between capital preservation, liquidity, and yield. When Rule 2a-7 was adopted in 1983, it ensured MMMFs would remain stable through one of the most challenging economic times. The success of these guidelines is evidenced by the strong performance of money market funds during the current credit crisis. During this time, only one MMMF "broke the buck," with no cost to the government and with shareholders likely to get back 95 plus cents on the dollar. The provisions of Rule 2a-7, with the addition of the new SEC amendments, will further strengthen MMMF stability by adding additional safeguards around: liquidity, credit quality, capital preservation, disclosure, and regulatory oversight.

In addition, investors value the wide variety of benefits offered by MMMFs including: diversification of risk, robust credit analysis by MMMF credit departments, preservation of capital, market liquidity, and administrative efficiencies. The costs to investors to conduct the required credit analysis and transaction costs to create these portfolios on their own would be prohibitive.

In conclusion, the fundamental framework of MMMFs results in strong credit quality, liquidity, and minimal market risks for customer-segregated funds as invested by FCMs. The implications of removing MMMFs from the list of permissible investments would remove a valuable investment option and have the potential to increase systemic risk of the financial system. No other investment option offers the stability of principal, diversification of risk, and administrative efficiency provided by MMMFs.

Sincerely,

Anthony J. Carfang, Partner
Treasury Strategies, Inc.