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INVESTMENT COMPANY INSTITUTE

August 7, 2000

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

COMMENT

Re: Rules Relating to Intermediaries of Commodity Interest Transactions

Dear Ms. Webb:

The Investment Company Institute[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") proposed revisions to its rules under the Commodity Exchange Act (the "Act") relating to intermediation of commodity futures and commodity options transactions.[2] The Commission's proposed revisions are intended to provide greater flexibility in several areas and further the Commission's ongoing regulatory reform process. One aspect of the proposed changes that is of great interest to the Institute is the Commission's proposed amendments to Rule 1.25 under the Act, which sets forth the types of instruments in which futures commission merchants ("FCMs") and clearing organizations are permitted to invest (the "permitted investments") cash segregated for the benefit of regulated commodity customers pursuant to Section 4d(2) of the Act.[3] The proposed amendments would expand the list of permitted investments to include, among other things,[4] shares of money market mutual funds, subject to certain conditions.[5]

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,235 open-end investment companies ("mutual funds"), 486 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $7.090 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

[2] CFTC Release, 65 Fed. Reg. 39008 (June 22, 2000)("Proposing Release").

[3] Rule 1.25 permits a FCM or clearing organization to invest segregated funds only in obligations of the U.S., in general obligations of any State or of any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the U.S.

[4] In addition to money market funds, the Commission's proposed list of permitted investments would be expanded to include: (1) obligations issued by any agency sponsored by the U.S.; (2) certificates of deposit issued by a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation ("FDIC"); (3) commercial paper; and (4) corporate notes.

[5] These conditions include: (1) a ratings requirement; (2) restrictions on instrument features; (3) concentration limits; (4) a time-to-maturity limit; (5) prohibitions on investments in instruments issued by affiliates; (6) recordkeeping requirements; (7) several conditions specific to money market funds; and (8) conditions specific to the use of repurchase and reverse repurchase agreements.

The Institute supports the Commission's proposal to include money market funds as a permitted investment. Money market funds have grown over the years and have become a valuable investment product for both retail and institutional investors.[6] Part of the reason for this growth has been a recognition that money market funds are a low risk investment vehicle due to the comprehensive regulatory framework that is imposed on these funds under the federal securities laws and by the Securities and Exchange Commission ("SEC"). As proposed by the Commission, however, not all money market funds would be a permitted investment. Accordingly, while the Institute supports the Commission's proposal to include money market funds as a permitted investment, we are concerned that the proposed conditions would limit the use of these funds as a permitted investment. In our view, these conditions are unnecessary in view of the stringent regulations governing money market funds. Accordingly, we recommend that all money market funds that meet the requirements of Rule 2a-7 under the Investment Company Act of 1940 be a permitted investment under Rule 1.25, and that no additional conditions be imposed thereunder.

I. *Money Market Funds: The SEC's Regulatory Framework*

The Commission notes in the Proposing Release that the proposed amendments to Rule 1.25 include several provisions intended to minimize credit, volatility, and liquidity risks associated with permitted investments under the Rule.[7] Money market funds, like all mutual funds, are already subject to a strict regulatory regime imposed by the SEC that addresses these concerns. In fact, mutual funds are the most stringently regulated entities under the federal securities laws. They are subject to the requirements of and the rules and regulations under the Securities Act of 1933, relating to the registration and offering of fund shares, the Securities Exchange Act of 1934, relating to registration of mutual fund underwriting, the Investment Advisers Act of 1940, relating to the registration and operation of investment advisers, and the Investment Company Act of 1940 (the "Investment Company Act"), relating to the registration and operation of mutual funds. In addition to these federal securities laws, a mutual fund that holds itself out to the public as a money market fund must satisfy additional requirements under Rule 2a-7 under the Investment Company Act ("Rule 2a-7").

Rule 2a-7 is a risk-limiting rule the purpose of which is to enable a money market fund to seek to offer and redeem shares at a stable net asset value ("NAV"). To achieve this, Rule 2a-7 imposes very strict limits on the quality of instruments in which a money market fund may invest, the diversification of instruments in the fund's portfolio, and the maturity of the instruments. The Rule requires, for example, that at least 95% of a taxable money market fund's assets be invested in instruments that are rated in one of the two highest short-term rating categories by a nationally recognized statistical rating organization ("NRSRO") or, if unrated,

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[6] As of December 31, 1999, assets of money market funds rose to $1.613 trillion, of which $965 billion were held by retail money market funds, and $648 billion were held by institutional money market funds – primarily businesses, pension plans, financial institutions, and governments. *See ICI Mutual Fund Fact Book* (40th ed.) at 7-8.

[7] Proposing Release at 39014.

are of comparable quality.[8] In addition, under Rule 2a-7 no more than five percent of a money market fund's assets generally may be invested in securities issued by a single issuer other than securities issued by the federal government and securities subject to a guarantee from a non-controlled person. As a further risk-limiting measure, Rule 2a-7 also imposes limitations on the maturity of a money market fund's portfolio. Specifically, a fund relying on the Rule cannot purchase any instrument with a remaining maturity greater than 397 calendar days and cannot maintain a dollar-weighted average portfolio exceeding 90 days.

A money market fund is also subject to the corporate governance requirements of the Investment Company Act, which requires the fund's board of directors to oversee the fund's operations and police conflicts of interest, among other tasks.[9] Rule 2a-7 also imposes additional oversight responsibilities on a money market fund's board of directors. Initially, the board must determine in good faith that it is in the best interests of the money market fund and its shareholders to maintain a stable NAV by using either the amortized cost method or penny-rounding method. If the amortized cost method is employed, the board must undertake, as a particular responsibility within the overall duty of care owed to its shareholders, to establish written procedures reasonably designed, taking into account current market conditions and the fund's investment objectives, to stabilize the fund's NAV per share.[10]

Because money market funds are subject to a comprehensive regulatory framework, money market funds are considered the lowest risk mutual funds available. For these reasons, the Institute believes that all money market funds constitute appropriate investment vehicles for FCMs and clearing organizations for the investment of customer funds. Accordingly, the Institute recommends that the Commission revise its proposal so that all money market funds that adhere to the requirements of Rule 2a-7 qualify as permitted investments for FCMs and clearing organizations when investing customer funds. Our specific comments are discussed below.

II. Proposed Amended Rule 1.25(b): General Terms and Conditions

A. The Ratings Requirement

Proposed subparagraph (b)(1)(D) would require money market funds that are rated by an NRSRO to be rated by the NRSRO at the highest rating, or if the fund is not rated,

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[8] Thus, a taxable money market fund may invest only up to five percent of its assets in so-called "second-tier securities" (*i.e.*, securities that are rated in the second highest rating category) or, if unrated, are of comparable quality. No more than the greater of one percent of the fund's assets or $1 million dollars may be invested in the second-tier of any single issuer. Tax-exempt money market funds are subject to credit quality limitations.

[9] Section 10(a) of the Investment Company Act requires that at least 40% of a mutual fund's board of directors consist of individuals who are not "interested persons," as defined in Section 2(a)(19) of that Act.

[10] The money market fund's board of directors is responsible for reviewing the deviation between the amortized cost and the current NAV, using available market quotations (or substitutions). In the event such deviation from the fund's amortized cost price per share exceeds ½ of 1%, the board must promptly consider what if any action should be taken.

investments made by the fund would have to comply with the requirements applicable to direct investments under Rule 1.25 under the Act.

We disagree with the imposition of a rating requirement on money market funds. Currently, money market funds are not required to be rated. As such, the Commission's proposed condition would add a new requirement not presently imposed under the federal securities laws. Imposing a rating requirement on a money market fund itself would be unnecessary given that its portfolio of investments is already subject to the numerous risk-limiting conditions of Rule 2a-7 discussed above. In light of the comprehensive regulatory framework under which money market funds operate, imposing a rating requirement would result in an additional, unnecessary layer of regulation that would provide few, if any, additional safeguards for customer funds. Accordingly, we recommend that the proposed rating requirement be eliminated and replaced with a condition that a money market fund satisfy the requirements of Rule 2a-7 in order to be considered a permitted investment under Rule 1.25, as proposed to be amended.[11]

We also disagree with the proposed requirement that if the money market fund is not rated, its investments would have to comply with the requirements applicable to direct investments under Rule 1.25. Thus, a money market fund's investment in any of the permitted investments listed in subparagraph (b)(1), other than U.S. government securities, would have to be rated.[12] This condition would impose a requirement that is not currently imposed under Rule 2a-7. Currently, Rule 2a-7 permits a money market fund to invest in unrated securities if the fund determines that the securities are of comparable quality to otherwise eligible securities. Accordingly, we recommend that this requirement also be modified consistent with the provisions of Rule 2a-7.

B. Investments In Instruments Issued By Affiliates

Subparagraph (b)(5) seeks to impose limitations on investments of money market funds. In particular, subparagraph (b)(5)(ii) would provide an exemption to the prohibition in subparagraph (b)(i) against investments by FCMs and clearing organizations in affiliated funds by permitting FCMs or clearing organizations to invest customer funds in a money market fund affiliated with the FCM or clearing organization, provided that the fund itself does not invest in any instrument issued by the FCM, clearing organization, or affiliate thereof. As proposed, the term "affiliate" is defined to encompass "parent companies, including all entities through the ultimate holding company, subsidiaries to the lowest level, and companies under common ownership of such parent company or affiliates."

The Institute disagrees with the investment prohibition of subparagraph (b)(5)(ii) and recommends that it be eliminated. This condition is not needed in light of the prohibitions already in place for money market funds under the Investment Company Act with respect to

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[11] As noted previously, any mutual fund that holds itself out as a money market fund must comply with the requirements of Rule 2a-7.

[12] This would include an investment in municipal securities, government sponsored agency securities, certificates of deposit, commercial paper, and corporate notes.

investments in affiliated entities.[13] Imposing this condition would add an additional and unnecessary layer of regulation that is already addressed by this regulatory framework.

Nevertheless, should the Commission determine that it is necessary to maintain this requirement we have one comment with respect to the proposed definition of the term "affiliate." Although not explained in the Proposing Release, the definition seems to focus on control relationships, which we presume is an attempt to address the Commission's apparent interest in preventing a controlling company from being in a position to improperly influence a transaction involving a controlled company. As drafted, however, the proposed definition is overly broad and, consequently, would inappropriately limit the universe of eligible money market funds. Accordingly, we suggest that the proposed definition be substituted by the following:

> (b)(5) An affiliate of a futures commission merchant or clearing organization means any person directly or indirectly controlling, controlled by or under common control with the futures commission merchant or clearing organization.

This definition would more appropriately address the Commission's concerns with respect to control relationships and obviate the need to otherwise limit the investment of a money market fund if such investment were otherwise permitted by the Investment Company Act or by order of the SEC.[14]

III. *Proposed Rule 1.25(c): Money Market Funds*

A. *SEC Registration Requirement*

Proposed subparagraph (c)(1) would require a money market fund to be registered as such with the SEC. Under the Investment Company Act, however, the entity that registers with the SEC is a mutual fund (technically, an open-end management investment company). Although such mutual fund may hold itself out as a money market fund, it does not register with the SEC as a *money market* fund. Instead, by virtue of a fund holding itself out as a money market fund it agrees to comply with the requirements of Rule 2a-7. Thus, we recommend revising the first sentence to conform to Rule 2a-7 as follows:

> (c)(1) Generally, the fund must be an investment company that is registered under the Investment Company Act of 1940 with the Securities and Exchange Commission and that holds itself out to investors as a money market fund, in accordance with the provisions of Rule 2a-7 under the Act ~~compliance with applicable requirements~~.

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[13] Section 17 of the Investment Company Act, for example, contains numerous safeguards that are designed to prevent a person with the potential power to influence or control a mutual fund from using that power to the person's own pecuniary advantage, *i.e.*, from engaging in self-dealing.

[14] On a technical point, we also recommend that the phrase "money market" be inserted before the two uses of the term "fund" in subparagraph (b)(5)(ii) to clarify that it is the money market fund that is prohibited from investing in instruments issued by the FCM, clearing organization, or an affiliate of such FCM or clearing organization.

B. The "Sponsor" Requirement

Proposed subparagraph (c)(2) would require that a money market fund be "sponsored"[15] by one of three financial institutions listed in the Proposing Release.[16] Not included in this provision are investment advisers registered under the Investment Advisers Act of 1940. Most money market mutual funds are advised by registered investment advisers (or by advisers exempt from registration under that Act). Thus, to exclude registered investment advisers from the list of permitted "sponsors" would significantly limit the universe of money market funds that may be a permitted investment under the Commission's proposal. Therefore, we recommend that subparagraph (c)(2) be amended to explicitly include a money market fund that is advised by a registered investment adviser.[17]

C. The Custody and Acknowledgement Letter Requirement

Proposed subparagraph (c)(3) would require that an acknowledgement letter (as required by Rule 1.26(a) under the Act) be provided by the sponsor of the fund and the fund itself to an FCM or clearing organization, if the FCM or clearing organization holds fund shares with the fund's shareholder servicing agent. The acknowledgement letter would provide that the sponsor and the fund were informed that the instruments belong to commodity or option customers and are being held in accordance with the provisions of the Act and Part 1 of Section 17 of the Code of Federal Regulations.

In recognition of the fact that mutual fund shares are generally *uncertificated* and are transferred via a book-entry system, and that shareholder servicing agents for mutual funds generally provide pricing and bookkeeping related services and do not custody fund shares for shareholders, we recommend two revisions to this subparagraph.[18] First, we recommend that the first sentence be revised to provide that the ownership of fund shares must be noted (by book-entry or otherwise) in a custody account of the FCM or clearing organization. Next, we recommend that the second sentence be modified to require that the FCM or clearing organization that purchases money market fund shares with customer funds maintain the confirmation relating to the purchase in its records in accordance with Rule 1.27 under the Act.[19]

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[15] As a technical point, the term "sponsor" is not defined in the Investment Company Act, but the term "adviser" is defined and relates more appropriately to the advisory relationship between a mutual fund (including a money market fund) and its adviser.

[16] Specifically, the list includes: (1) a federally-regulated financial institution; (2) a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934; or (3) a domestic branch of a foreign bank insured by the FDIC.

[17] We note that this could be accomplished by adding to subparagraph (c)(2) a requirement that a money market fund must be advised by an investment adviser registered under the Investment Advisers Act of 1940 or by an investment adviser exempt from registration under that Act.

[18] Mutual fund shareholder servicing agents (*i.e.*, transfer agents) are registered with the SEC and thus are subject to the recordkeeping and record retention requirements imposed under the Securities Exchange Act of 1934.

[19] Alternatively, the second sentence should be deleted and Rule 1.26 should be modified to permit an FCM or clearing organization to hold shares in an account opened by an FCM or clearing organization with a fund's distributor or other registered broker-dealer.

D. The Morning Pricing Requirement

Proposed subparagraph (c)(4) would require the NAV of a money market fund to be computed by 9:00 a.m. each business day and made available to the FCM or clearing organization by that time. The Proposing Release does not explain the purpose for this requirement. The Institute notes that this condition is problematic for money market funds. Despite the fact that Rule 2a-7 exempts money market funds from the daily pricing requirements imposed under the Investment Company Act,[20] as a practical matter, money market funds generally price their securities each business day. Such pricing, however, generally occurs later in the day – typically at 4:00 p.m., at the time of the close of the New York Stock Exchange.[21] Accordingly, we recommend that the Commission amend this requirement to permit the use of the current day's NAV when it is calculated by the fund.

E. The One-Day Redemption Requirement

Proposed subparagraph (c)(5) would require that an interest in a money market fund be able to be liquidated by the business day following a request to liquidate by the FCM or clearing organization. The Institute notes that this condition is inconsistent with the Investment Company Act, which permits a fund up to seven days in which to satisfy a redemption request.[22] Although most money market funds typically satisfy a redemption request within the proposed time frame, they are not statutorily required to do so. Moreover, given that various other securities listed in the Proposing Release tend to have a longer settlement period than the one proposed for money market funds, it is unclear why money market funds should be treated differently. Accordingly, we recommend that this provision be modified to permit a money market fund to operate in accordance with the seven-day time period set forth in Section 22(e).

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The Institute appreciates the opportunity to present its views on the Commission's proposal. If you have any questions or would like additional information, please contact me at (202) 326-5923.

Sincerely,

Barry E. Simmons
Assistant Counsel

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[20] See Rule 2a-7(c).

[21] In addition, as noted above, money market funds seek to maintain a stable NAV, thus their value rarely fluctuates from day-to-day.

[22] Section 22(e) states that "[n]o registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption." The redemption proceeds, however, are calculated based on the NAV of the fund the day the redemption request is received. Thus, the investor can determine as of the date of the redemption request the amount of proceeds to be received.

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