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IN MANAGED FUNDS

COMMENT

April 8, 2004

Mr. James Carley
Director
Division of Clearing and Intermediary Oversight
Commodity Futures Trading Commission
1155 21st Street, N.W.
3 Lafayette Center
Washington, DC 20581

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RECEIVED
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Re: Section 1.25 of CFTC General Regulations—Investment of
Customer Funds

Dear Mr. Carley:

I am writing on behalf of Federated Investors, Inc., Pittsburgh, Pennsylvania ("Federated"), concerning Section 1.25 of the General Regulations under the Commodity Exchange Act, as amended ("Section 1.25"), of the Commodity Futures Trading Commission (the "Commission") regarding the investment of customer funds.

Background

Federated is the sponsor, distributor, and investment adviser for the Federated Family of open-end investment companies registered under the Investment Company Act of 1940, as amended (the "1940 Act"), which held \$198 billion in total assets as of December 31, 2003 (the "Federated Funds"). Approximately 66 percent of the assets in the Federated Funds are held in 55 money market mutual funds that operate in accordance with Rule 2a-7 promulgated by the Securities and Exchange Commission under the 1940 Act ("Rule 2a-7").

For the reasons that follow, Federated believes that Section 1.25 should be amended to eliminate the requirement in Section 1.25(b)(2)(E) under which, in order to qualify as a permitted investment for customer funds, a money market mutual fund that is rated by a nationally recognized statistical rating organization ("NRSRO") must be rated at the highest rating of the NRSRO.

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Unrated Money Market Mutual Funds Are Commonly Used as Permitted Investments

According to Federated, the money market mutual funds that most commonly are used by futures commission merchants ("FCMs") as investments for customer funds are unrated. These unrated funds account for the majority of the investments of customer funds by FCMs, according to Federated. These funds generally do not qualify for the highest rating by an NRSRO because they hold split-rated and other securities in their portfolios which are not approved by the NRSROs for triple-A rated funds and because the average maturity of their portfolios may exceed 60 days.

The unrated funds are used as investments for customer funds by FCMs because of their higher yield – typically about five basis points higher than a triple-A rated fund.

The Rating Requirement Creates a Competitive Inequity

The rating requirement in Section 1.25(b)(2)(E) creates a competitive inequity for rated money market mutual funds that have similar yield and portfolio characteristics as the unrated funds that are commonly used as FCM investments.

For example, Federated offers a single-A rated money market mutual fund that carries a yield that is comparable to that of the unrated funds and has similar portfolio characteristics.¹ This fund, called the Federated Prime Value Obligations Fund, had total assets of \$ 12.4 billion as of December 31, 2003, and is used by certain of Federated's institutional customers who seek a higher yield money market mutual fund but whose investment parameters require the fund to be rated. Federated has been told by a number of FCMs that they would like to have the option of using the Federated Prime Value Obligations Fund as an investment for their FCM accounts.

¹ Federated believes that only four single-A rated money market mutual funds exist in the market at present. Federated offers five triple-A rated money market mutual funds in its institutional investor series. These funds generally are not used by FCMs and their customers, however, because they carry a lower yield than an unrated money market mutual fund. Federated presently does not offer any unrated money market mutual funds.

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The Prime Value Obligations Fund is not a permitted investment under Section 1.25(b)(2)(E), however, because it does not qualify for the highest NRSRO rating. It does not qualify for the same reasons that the unrated funds used by FCM investors do not qualify for this rating—because it holds split-rated and other securities in its portfolio not approved by the NRSROs for triple-A rated funds and because the average maturity of its portfolio may exceed 60 days.

Federated believes that Section 1.25(b)(2)(E) creates an artificial competitive disadvantage for the Prime Value Obligations Fund. The Fund has essentially the same yield and portfolio characteristics as its unrated competitors yet, solely because of the fact that it is rated, it fails to qualify as a permitted investment under Section 1.25. If anything, the fact that it is rated should make it a more acceptable investment than an unrated fund, but that currently is not the case.

Section 1.25(b)(2)(E) Should be Eliminated or Revised

All of the commodities exchanges permit FCM customer funds to be invested in unrated money market mutual funds and, as a result, the rating requirement in Section 1.25(b)(2)(E) fails to serve a useful purpose. The rating requirement does not prevent FCM customer funds from being invested in money market mutual funds that fail to qualify for the highest NRSRO rating and, indeed, most FCM customer funds are invested in funds that do not so qualify and are unrated. The rule limits the investment options available for FCM customer funds without providing additional investor protections and creates a competitive inequity for money market mutual funds that are rated below the highest rating but which have the same yield and portfolio characteristics as unrated funds. Accordingly, we propose that the rating requirement in Section 1.25(b)(2)(E) be eliminated or revised as set forth in Appendix A hereto in order to permit all money market mutual funds which are maintained in accordance with Rule 2a-7 to qualify as permitted investments for FCMs.

Rule 2a-7 Affords Ample Investor Protection

In addition to the competitive disadvantage discussed above, Federated believes that Section 1.25 should be amended to eliminate the rating requirement of Section 1.25(b)(2)(E) because the investor protections included in Rule 2a-7 have rendered it unnecessary and superfluous. Money market mutual funds are open-end management investment companies registered under the 1940 Act

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which have as their investment objectives generation of income and preservation of principal and liquidity through investments in short-term, high quality securities.² These funds generally seek to maintain a stable price of \$1.00 per share pursuant to the requirements of Rule 2a-7, which are designed to minimize the deviation between a fund's share price (using either the amortized cost method or the penny-rounding method of valuation, each as specified under Rule 2a-7) and the market value of its portfolio. Largely as a result of the restrictions of Rule 2a-7, money market mutual funds have been almost universally successful in continually meeting the standard of a \$1.00 stable share price.³ This has "encouraged investors to view these funds as alternatives to bank deposit and checking accounts" according to the Securities and Exchange Commission, despite the fact that they are not subject to federal deposit insurance and the share price is not guaranteed.⁴ Money market mutual funds have won wide acceptance among both retail and institutional investors in recent years as a cash management tool.

Under Rule 2a-7, money market mutual funds must meet strict portfolio quality, diversification and maturity standards which greatly limit the possibility of significant deviation between the share price of a fund and its per share net asset value. In addition, these funds are subject to board oversight regarding credit quality requirements and investment procedures. Federated believes that these restrictions are sufficiently protective of customers of FCMs that the additional restrictions of Section 1.25(b)(2)(E) are not needed to ensure the credit quality of permitted investments for customer funds.

The portfolio quality of money market mutual funds is regulated by both broad and specific requirements under Rule 2a-7. Generally, a money market mutual fund may only invest in U.S. dollar-denominated securities which the Board of Directors (or Trustees) of such fund (the "Board") has determined present minimal credit risks, based on various measures of the issuer's credit

² *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 21837 (March 28, 1996), 61 Fed. Reg. 13956, 13957 (1996).

³ The liquidation and distribution of less than \$1.00 per share of the US Government Money Market Fund, a series of Community Bankers Mutual Fund, Inc., in September, 1994 is an exception to this otherwise consistent pattern.

⁴ *Revisions to Rules Regulating Money Market Funds*, supra note 2, 61 Fed. Reg. at 13957.

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quality as well as any rating assigned by an NRSRO.⁵ The rating assigned by an NRSRO is a factor in this review but is not determinative and must be supplemented by additional issuer credit information gathered by the Board. While the Board may delegate the responsibility for this and other determinations required by Rule 2a-7 to a fund's investment adviser or officers, the Board is required to establish and periodically review written guidelines and procedures regarding these determinations, to review fund investments and investment procedures, and to review investment decisions in the event of a portfolio security default.⁶ In all cases, the Board retains sole responsibility for reassessing the credit quality of any portfolio security which is downgraded by an NRSRO or, if unrated, experiences a decline in credit quality.⁷

The portfolio quality of a money market mutual fund is further assured by the fact that the fund is limited to investing only in "eligible securities", which are defined as those which are rated by at least two NRSROs in one of the two highest short-term rating categories, or, if unrated, are of comparable quality in the view of the Board.⁸ As an additional portfolio quality requirement, we note that Rule 2a-7 requires funds to invest at least 95 percent of their assets in "first tier securities", which must be rated at the highest NRSRO short-term rating level or, if unrated, be of comparable quality (or must consist of securities issued by another money market mutual fund or U.S. government securities).⁹

Rule 2a-7 also requires that money market mutual funds hold diversified portfolios of securities. Generally, a taxable money market mutual fund may not invest greater than 5 percent of its total assets in the securities of a single issuer (with an exception for temporary larger investments in first tier securities under certain circumstances).¹⁰ In addition, a fund may not invest more than the greater of one percent of its total assets or \$1,000,000 in "second tier securities" issued by

⁵ Rule 2a-7(c)(3)(i).

⁶ Rule 2a-7(e).

⁷ Rule 2a-7(c)(6).

⁸ Rule 2a-7(a)(10).

⁹ Rule 2a-7(a)(12).

¹⁰ Rule 2a-7(c)(4)(i)(A).

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a single issuer.¹¹ Single state fund and tax-exempt funds are also subject to similar diversification requirements with respect to both first tier securities and second tier securities.¹²

Finally, a money market mutual fund is required under Rule 2a-7 to maintain a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share.¹³ More specifically, a money market mutual fund generally may not acquire any instrument having a remaining maturity of greater than 397 calendar days and may not maintain a dollar-weighted average portfolio maturity of more than 90 days.¹⁴ The SEC has stated that the purpose of the maturity provisions of Rule 2a-7 is to limit the exposure of money market funds to interest rate risk.¹⁵

* * * *

¹¹ Rule 2a-7(c)(4)(i)(C).

¹² Rule 2a-7(c)(4)(i)(A) and Rule 2a-7(c)(4)(C)(2).

¹³ Rule 2a-7(c)(3)(i).

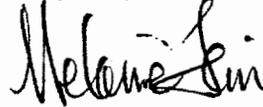
¹⁴ Rule 2a-7(c)(2). An exception to this rule is that a money market fund not using the amortized cost method (as defined in Rule 2a-7(a)(2)) may not acquire any government security with a remaining maturity of greater than 762 calendar days.

¹⁵ *Revisions to Rules Regulating Money Market Funds*, supra note 2, 61 Fed. Reg. at 13971.

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We appreciate your attention to this matter and request the opportunity to meet with you at your earliest convenience to discuss it with you. Please do not hesitate to contact me or my colleague Jonathan Dinwoodie at (617) 570-1000 should you have any questions.

Very truly yours,



Melanie L. Fein

cc: John Lawton
Deputy Director and Chief Counsel
Division of Clearing and Intermediary Oversight

Eugene F. Maloney, Esq.
Senior Vice President and Corporate Counsel
Federated Investors, Inc.

Richard Recker
Federated Investors, Inc.

APPENDIX A

Sec. 1.25 Investment of customer funds.

(b) *General terms and conditions.* A futures commission merchant or a clearing organization is required to manage the permitted investments consistent with the objectives of preserving principal and maintaining liquidity and according to the following specific requirements.

(1) *Marketability.* Except for interests in money market mutual funds, investments must be “readily marketable” as defined in Sec. 240.15c3-1 of this title.

(2) *Ratings. (i) Initial requirement.* Instruments that are required to be rated by this section must be rated by an NRSRO. For an investment to qualify as a permitted investment, ratings are required as follows:

(A) U.S. government securities need not be rated;

(B) Municipal securities, government sponsored agency securities, certificates of deposit, commercial paper, and corporate notes, except notes that are asset-backed, must have the highest long-term ratings of an NRSRO;

(C) Corporate notes that are asset-backed must have the highest ratings of an NRSRO;

(D) Sovereign debt must be rated in the highest category by at least one NRSRO; and

(E) Money market mutual funds ~~that are~~ need not be rated by an NRSRO ~~must~~ and, if rated, may be rated at the ~~highest~~ any rating of the ~~an~~ NRSRO.