09-6
(2)

PICKARD AND DJINIS LLP
ATTORNEYS AT LAW
1990 M STREET, N.W.
WASHINGTON, D. C. 20036

TELEPHONE
(202) 223-4418

TELECOPIER
(202) 331-3813

July 10, 2009

COMMENT

OFFICE OF THE SECRETARIAT
C.F.T.C.
2009 JUL 14 PM 4 05

Received CFTC
Records Section
7/14/09

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

Re: Advance Notice of Proposed Rulemaking for Regulations 1.25 and 30.7 (the Eligibility of Money Market Funds)

Dear Mr. Stawick:

We submit these comments on behalf of Federated Investors, Inc. ("Federated") regarding the Commodity Futures Trading Commission's ("CFTC") advance notice of proposed rulemaking and request for public comment concerning the scope and character of permitted investments for customer segregated funds (the "Advance Notice").[1] The CFTC is considering significantly revising the scope and character of permitted investments for customer segregated funds and Regulation 30.7 funds. Specifically, the CFTC has requested comment regarding which instruments should continue to be "permitted investments" for customer segregated funds under Regulation 1.25. Under Regulation 1.25 money market funds are permitted investments for customer money.

Federated is a major sponsor of money market funds regulated under Rule 2a-7 of the Investment Company Act of 1940, and therefore we focus our comments on the important role money market funds have performed as permitted investments under CFTC regulations and their role in protecting customer segregated funds.

Federated Investors, Inc.

Federated is a Pittsburgh-based financial services holding company and the sponsor of money market funds having aggregate assets in excess of $350 billion. Federated's money market funds are designed for use by regulated entities where a statute, rule or instrument limits an investment to high-quality, liquid short-term investments. Federated money market funds meet the requirements of CFTC Regulation 1.25 and are used by Futures Commission Merchants ("FCMs") as investments on behalf of their customers. We estimate that at any given time FCMs invest approximately three

[1] See CFTC, Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, Advance Notice of Proposed Rulemaking, 74 Fed. Reg. 23962 (May, 22, 2009).

billion dollars into Federated money market funds, which successfully serve the needs of FCMs in meeting their customer segregated fund requirement under CFTC Regulations.

For the reasons set forth below, money market funds as described in Regulation 1.25(c) continue to merit inclusion as permitted investments and should not be, and do not need to be, the subject of any CFTC proposal to amend Regulation 1.25. FCMs have found money market funds to be superior to many of the other alternative permitted investments under Regulation 1.25 in that they involve significantly less concentration, credit and operational risk, i.e., obviating the need to assemble a portfolio of individual securities, while at the same time benefiting from the diversification requirements of SEC Rule 2a-7 discussed below. As short-term investment vehicles, they contribute liquidity and safety to their users. In addition, money market funds are being further strengthened by the SEC with the strong endorsement of the U.S. Treasury.

I. Money market funds merit continued inclusion as "permitted investments" because they are subject to a comprehensive regulatory scheme under the Investment Company Act of 1940, SEC Rule 2a-7 and CFTC Regulation 1.25, which collectively provides liquidity and safety to customer money.

Money market funds holding customer money under Regulation 1.25 are subject to all four of the major federal securities laws administered by the Securities and Exchange Commission, 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. Beyond the broad general protections of the Investment Company Act, money market funds must meet the exacting requirements of Rule 2a-7. Moreover, the requirements of CFTC Regulation 1.25 provide further protections to customer money committed to money market funds.

This multi-layered, comprehensive regulatory framework has been an overall success in permitting FCMs to use money market funds to meet their regulatory requirements concerning customer money.

A. Overview of regulatory regime money market funds are subject to under the Investment Company Act of 1940.

Investment companies are one of America's primary savings and investment vehicles. The Investment Company Act of 1940, the principal statute that regulates investment companies, specifically addresses virtually every aspect of investment companies' operations. The Investment Company Act places substantive requirements or restrictions on a fund's governance and structure; its issuance of debt and senior securities; its investments, sales and redemptions of its shares; and its dealings with service providers and other affiliates.[2] The following summarizes some of the important

[2] See Paul Roye, Director, Division of Investment Management, Speech by SEC Staff: The Genius of the Investment Company Act – A Framework for Adaptation to Change, June 15, 2005.

attributes of the Investment Company Act's comprehensive regulatory program and puts into context their importance in connection with money market funds.[3]

Oversight, Accountability and Controls – A fund's operations are subject to both internal and external oversight. Internal oversight includes independent boards of directors and written compliance programs overseen by chief compliance officers (CCOs), both at the fund and adviser levels. External oversight includes the SEC, the Financial Industry Regulatory Association (FINRA), and external service providers, such as certified public accounting firms and custodians. At least 40 percent of directors on a fund's board are required under the Investment Company Act to be independent from fund management, and most investment companies (including all of Federated's money market funds) have boards comprised of at least 75% independent directors so as to qualify for safe harbors under the Investment Company Act.[4] Fund directors provide an independent check on the management of funds and in recent years the board's oversight has increased to include the annual review for adequacy and effectiveness of fund and adviser written compliance programs to prevent, detect, and correct violations of the federal securities laws. This internal oversight is supplemented by examinations by and reports to the SEC and self-regulatory organizations. Thus, the functionality and behavior of the money market fund, including its financial condition, is subject to multiple layers of oversight and control.

Prospectus and Other Disclosure – All important aspects of funds are required to be disclosed to investors and the market place. Funds are required to maintain a current prospectus, which discloses material information about the fund and its operations, investment objectives, investment strategies, risks, fees and expenses, and performance. In addition, detailed disclosure is provided through the fund's statement of additional information (SAI). These documents are updated at least once each year. Funds also provide shareholders with unaudited semi-annual and audited annual reports. These reports contain updated financial statements, a list of the fund's portfolio securities, and other current information. These disclosures mean that the investor in a money market fund is in a position to have more information to make investment decisions than is available for other types of investments.

Custody of Fund Assets – Funds are required to maintain strict custody of fund assets with a regulated bank or broker-dealer, separate from the assets of the adviser. The strict rules on the custody of fund assets serve to protect fund investors from the types of fraud-based losses that from time to time occur in less regulated investment products.

---

[3] The Report of the Money Market Working Group submitted to the Board of Governors of the Investment Company Institute, March 17, 2009 (the "ICI Report"), discusses six core objectives of the Investment Company Act.

[4] Section 15(f)(1) permits an investment adviser to receive compensation for the sale of its advisory business if its funds maintain a 75% independent board of directors for at least three years after the transactions. Most advisers require their investment companies to continuously maintain a 75% independent board so they always comply with this provision.

Prohibitions on Affiliated Transactions – The Investment Company Act contains a number of prohibitions on transactions between a fund and fund insiders or affiliated organizations. These prohibitions restrain over-reaching and self-dealing by investment company insiders with respect to, among other things, the purchase and sale of portfolio securities and other investments. The underlying portfolio assets of the money market fund may not be abused by the fund or its adviser.

Capital Structure – The Investment Company Act imposes various requirements on a fund's capital structure, including prohibiting the issuance of any "senior securities" and limiting the amount of any borrowings. These capital requirements limit the amount of leverage a fund may employ and simplifies the fund's capital structure. During the 2008 financial crisis and today, over-leveraging has been a serious financial problem. This is not the case with money market funds, nor can it occur with money market funds.

Liquidity of Fund Shares – Fund shares are highly liquid investments as investors may redeem fund shares each business day. Rule 2a-7, further discussed below, permits money market funds to determine their NAV using valuation methods that facilitate the maintenance of a stable value price of $1.00. These valuation methods contain strict risk-limiting provisions designed to minimize the deviation between a money market fund's stated share price and the actual value of its portfolio. A redeeming shareholder must be paid promptly. The Investment Company Act prohibits funds from suspending redemptions of their shares (subject to certain extremely limited exceptions) or delaying payments of redemption proceeds for more than seven days. To facilitate compliance with these prohibitions, money market funds are subject to a 10 percent illiquid investment limit. These requirements seek to ensure the important liquidity features of money market funds.

B. Money market funds are subject to the protections afforded by SEC Rule 2a-7.

As a second layer of protection, the SEC established a specific regulatory program for money market funds under Rule 2a-7 of the Investment Company Act, to further enhance the usefulness and safety of money market funds. Rule 2a-7, adopted in 1983, has been an unqualified success, and has been revised and strengthened periodically in light of money market funds' response to economic conditions.[5]

An initial objective of every money market fund is to attempt to maintain a stable value per share. Rule 2a-7(c)(7)(i) requires "the money market fund's board of directors, 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 money market fund's investment objectives, to stabilize the money market fund's net asset value per share, ..., at a single value." Rule 2a-7(c)(7)(ii) requires the board of directors to track the deviation between the fund's stable net asset value and

[5] See Release No. IC-13380 (July 11, 1983), 48 Fed. Reg. 32555 (July 18, 1983); Release No. IC-21837 (Mar. 21, 1996), 61 Fed. Reg. 13956 (Mar. 28, 1996).

its actual market net asset value, and to take appropriate action, if any, if the deviation exceeds 0.50%.

In order to achieve this objective, a money market fund's exposure to credit risk (the risk that the fund will not receive timely payment on an investment) and market risk (the risk of significant changes in value due to changes in prevailing interest rates) must be limited. Rule 2a-7 sets forth provisions specifically designed to reduce such risks by limiting the composition of a money market fund's portfolio.

Portfolio Maturity – Rule 2a-7 requires that money market funds hold portfolio securities with relatively short maturities. Rule 2a-7(c)(2) provides that a money market fund must not acquire any instrument with a remaining maturity of greater than 397 calendar days and may not maintain a dollar-weighted average portfolio maturity of more than 90 days. By constraining the average weighted portfolio maturity to 90 days or less, Rule 2a-7 assures that even an instantaneous 2% change in interest rates will not cause the fund's market net asset value to deviate by 0.50%. Moreover, most money market funds operate well within the 90 day limit, providing even greater protection against sudden interest rate changes. Further, the overall 397-day maturity limit and rating requirements prevent funds from taking undue credit risks, forcing money market funds out of companies with deteriorating credit well before insolvency.

Portfolio Quality – Rule 2a-7 requires money market funds to invest in high quality portfolio securities. Money market funds may purchase only securities that are highly rated and that pose "minimal credit risks" to the fund. Rule 2a-7(c)(3) requires that a money market fund have at least 95% of its portfolio investments qualifying for the top rating ("first tier") and the remainder may be in the second highest rating category ("second tier"). In addition, fund boards are required to make an independent assessment of the securities based on factors affecting the credit quality of the issuer. In other words, Rule 2a-7 has always prohibited money market funds from simply relying on ratings to protect against credit risks.

Portfolio Diversification – Rule 2a-7 provides that a money market fund "shall not have invested more than five percent of its total assets in securities issued" by the same entity, except for government securities. Historically, money market funds have only been affected by sudden, unexpected credit developments. The diversification requirements limit the impact of these credit events to, at most, 5% of the portfolio. As with the average weighted maturity limit, most funds operate well within the diversification requirements, rarely investing close to the 5% limit except through fully collateralized repurchase agreements.

These requirements effectively limit credit and market risk and enhance liquidity, providing a strong investor protection foundation for the continued use of money market funds under Regulation 1.25 for customer money. Coupled with the comprehensive protections of the Investment Company Act, Rule 2a-7 has contributed to the success of money market funds. Since the SEC adopted Rule 2a-7 in 1983, money market fund assets have grown from $180 billion to $3.9 trillion as of January 2009. The public's

faith in money market funds is also evident. As a result of overall market volatility, retail and institutional investors have kept a greater proportion of their short-term investments in safe and liquid vehicles, including money market funds. Indeed, investors have added over $1.2 trillion to money market funds from the end of June 2007 to January 2009.

We believe that under this comprehensive regulatory regime, money market funds continue to merit inclusion as permitted investments and should not be (and do not need to be) the subject of any CFTC proposal to amend Regulation 1.25.

C. The SEC has just proposed amendments to Rule 2a-7 designed to further enhance the safety and liquidity of money market funds.

On June 30, 2009, the SEC released for comment proposed comprehensive money market reforms to further tighten the risk-limiting conditions of Rule 2a-7 and other potential changes in the regulation of money market funds.[6] The reforms include the following proposed changes to Rule 2a-7:

- Money market funds investments would be limited to the highest short-term rating category or unrated securities of equivalent quality.
- The weighted average maturity of a money market fund's portfolio would be reduced from 90 to 60 days. The portfolios of money market funds would also be subject to a 120 day limit with the weighted average maturity determined without regard to any scheduled interest rate adjustments.
- Money market funds could not acquire any illiquid securities.
- Money market funds would have to maintain 5% to 10% of their portfolio in cash, direct U.S. government obligations and instruments with overnight maturities, and 15% to 30% of their portfolio in instruments with maturities of five business days or less.
- Boards of directors would have to adopt procedures for periodic stress testing of money market funds, the results of which would be reported to the directors.
- Money market funds would have to disclose their investment portfolios on a monthly basis.

These reforms would increase the safety of money market funds by further constraining the maturity and credit quality of their portfolios. They would also safeguard the liquidity of money market funds by requiring investment of a substantial portion of the portfolio in the most liquid or shortest-term securities. In addition, the reforms would increase oversight through stress testing and more frequent disclosures. Given the SEC's reform efforts, it would be reasonable for the CFTC to anticipate that the safety and liquidity of money market funds will increase in the near future, making them even more appropriate investments for customer segregated funds.

[6] Investment Company Act Release No. IC-28807.

D. CFTC Regulation 1.25 places additional requirements on FCM's use of money market funds which are designed to limit risk and protect customer funds.

Beyond the comprehensive regulatory regime of the Investment Company Act and the SEC's enforcement of Rule 2a-7 thereunder, the CFTC's risk-limiting standards provide an additional layer of customer protection.

The CFTC first allowed FCMs to use money market funds for purposes of "permitted investments" for customer segregated funds in 2000.[7] In its release, the CFTC stated that it was allowing FCMs to invest customer funds in money market funds based upon, in part, its conclusion that "an expanded list of permitted investments could enhance the yield available to FCMs, clearing organizations and their customers without compromising the safety of customer funds."[8] At that time, the CFTC also noted that the expansion of Rule 1.25 and the safeguards therein, would become a part of the broad set of protections built into the system intended to guard against financial risk at FCMs.

After several years of favorable experience, the CFTC amended its rule and allowed FCMs to use any money market fund.[9] In consideration of, among other things, (1) the risk-limiting standards imposed by Regulation 1.25(c) (to be discussed below), (2) the existence of extensive investor protections of SEC Rule 2a-7 that imposes 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, and (3) the board oversight imposed on money market funds regarding credit quality requirements and investment procedures, the CFTC eliminated the requirement that money market funds be rated by an NRSRO.[10]

As stated in Regulation 1.25(c), for a money market fund to be a "permitted investment," 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 Rule 2a-7. In addition, the fund must be sponsored by a federally-regulated financial institution, a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, an investment adviser registered under the Investment Advisers Act of 1940, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation.

---

[7] The rule initially limited FCMs to using money market funds that received the highest rating from a nationally recognized statistical rating agency, if rated.

[8] 65 Fed. Reg. 39008, 39014 (June 22, 2000) (rule proposal); 65 Fed. Reg. 77993 (Dec. 13, 2000) (rule adoption).

[9] See 68 Fed. Reg. 38654 (June 30, 2003); 70 Fed. Reg. 28190, 28194-95 (May 17, 2005).

[10] See 70 Fed. Reg. 28190, 28195 (May 17, 2005).