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Division of Swap Dealer and
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CFTC Staff Advisory No. 16-75
Other Written Communication
October 18, 2016
Division of Swap Dealer and Intermediary Oversight

Audience: Futures Commission Merchants

**Topic: Practical Application of No-Action Letter No. 16-68 Regarding
Investments in Money Market Mutual Funds**

I. Introduction

The Division of Swap Dealer and Intermediary Oversight (“DSIO” or “Division”) of the Commodity Futures Trading Commission (“Commission”) is issuing this advisory in response to inquiries regarding the practical application and effect of the Division’s letter No. 16-68 of August 8, 2016, granting no-action relief regarding investments in money market funds (“the Letter”).¹

II. Background and Request for Guidance

Futures commission merchants (“FCMs”) are required to hold funds deposited by customers to margin futures, foreign futures and cleared swap transactions in specially designated “segregated” accounts that are maintained with a bank, trust company, clearing organization, or another FCM or foreign broker. An FCM may invest segregated funds pursuant to the terms and conditions of Regulation 1.25. Regulation 1.25(a)(1) currently contains five permitted investment instruments: (1) U.S. Government securities; (2) municipal securities; (3) U.S. agency obligations; (4) certificates of deposit issued by a bank; and (5) interest in money market mutual funds (“MMFs”). The FCM is required to manage the investments consistent with the overall objectives of preserving principal and maintaining liquidity.² Each investment must be “highly liquid” such that the investment may be liquidated and converted into cash within one business day without material discount in value.³ Most importantly for purposes of this advisory, MMFs are subject to

¹ See CFTC Ltr. No. 16-68, available at <http://www.cftc.gov/LawRegulation/CFTCStaffLetters/Advisories/index.htm>.

² Regulation 1.25(b).

³ Regulation 1.25(b)(1).

further specific liquidity requirements. A MMF must be legally obligated to pay a fund investor (including an FCM) by the close of business on the day following a redemption request.⁴

On August 14, 2014, the Securities and Exchange Commission (“SEC”) published final revisions to Rule 2a-7 (17 CFR 270.2a-7) (“Rule 2a-7”), which governs MMFs. These revisions are effective October 14, 2016. Revised SEC Rule 2a-7 requires a MMF to retain the authority under defined conditions to impose “liquidity fees” or suspend participant redemptions. Such suspensions are referred to as “gates.” These provisions are mandatory for MMFs that invest primarily in corporate debt securities (“Prime MMF”), and the provisions may be voluntarily adopted by MMFs that invest primarily in U.S. government securities (“Government MMF”).⁵

The liquidity fee and redemption restrictions introduced by revised SEC Rule 2a-7 conflict with two provisions of Regulation 1.25: (b)(1) (general terms and conditions for investments) and (c)(5) (terms and conditions for investments in MMFs). Consequently, when the revisions to SEC Rule 2a-7 take effect on October 14, 2016, FCMs would no longer be permitted to invest customer funds in Prime MMFs, or in Government MMFs that voluntarily elect to be subject to liquidity fees or redemption restrictions (“Electing Government MMFs”). However, pursuant to CFTC Letter No. 16-68, the Division has issued a no-action position which allows an FCM to invest the amount of funds held in the segregated accounts, secured accounts and cleared swaps accounts that is in excess of the firm’s targeted residual interest in Prime MMFs and Electing Government MMFs under certain conditions as outlined in the Letter.

Since publication of CFTC Letter No. 16-68 on August 8, 2016, registrants have sought guidance regarding the practical implementation of the no-action position.

III. Guidance

A. If an FCM invests in a Prime MMF or Electing Government MMF, is its buffer over the residual interest target reduced by the amount of its investment?

No, the buffer over the residual interest target is not reduced. The Letter allows an FCM to invest funds held in segregation that are in excess of its targeted residual interest with a Prime MMF and Electing Government MMF. These funds still qualify as a segregated asset and would, therefore, qualify as part of the FCM’s excess above its targeted residual interest.

B. Does the FCM’s investment in a Prime MMF or an Electing Government MMF reduce the FCM’s excess segregation for reporting purposes, or for any other calculation?

No, the FCM’s investment in a Prime MMF or Electing Government MMF remains a segregated asset, held in segregation pursuant to the Letter, and, therefore, qualifies as a segregated asset in all respects, including for reporting purposes.⁶ As a reminder, and consistent with current

⁴ Regulation 1.25(c)(5)(i).

⁵ According to revised SEC Rule 2a-7(a)(16) and (c)(2)(iii), a Government MMF is a MMF investing at least 99.5% of the fund’s total assets in cash, government securities, or fully collateralized repurchase agreements and is not required to comply with the new liquidity fee and redemption restrictions but may choose to do so.

⁶ The reporting provisions include the daily segregation computations required by Regulations 1.32, 22.2(g), and 30.7(l).

requirements, FCMs must take the appropriate capital charges for investments in MMFs.

C. How should an FCM report on its daily segregation calculation an investment of funds in a Prime or Electing Government MMF that has suspended redemptions?

If a Prime or Electing Government MMF suspends redemptions, an FCM must take a 100% deduction for such funds from its segregation calculation. Such funds are deemed illiquid and may not be counted as a segregated asset by the FCM in preparing the daily segregation calculation. The FCM would also have to recognize a non-allowable asset for the full amount of the MMF balance that is subject to the redemption suspension in computing the FCM's capital.

D. Is it a violation of a condition of the Letter if the FCM invests amounts in excess of the residual interest target in Prime MMFs or Electing Government MMFs, but subsequently determines that the investment exceeds the amount of excess above the targeted residual interest due to market events or other activity in the segregated accounts?

Pursuant to the Letter, an FCM may invest the amount of funds held in segregation that is in excess of the firm's targeted residual interest amount in Prime MMFs and Electing Government MMFs. For purposes of these investments, the amount in excess of the FCM's targeted residual interest is determined each business day based upon the firm's segregation calculations which are required to be completed by noon each business day.⁷

Staff has been asked if it is a violation of the conditions of the Letter if an FCM performs its daily segregation calculation and, based upon the calculation, determines that through market moves and other factors the FCM has invested more than the excess above the targeted residual interest in Prime MMFs or Electing Government MMFs. In such a situation, assuming that the FCM has acted in good faith and the over-investment is inadvertent, it will not be considered a violation of the conditions of the Letter. However, the FCM must promptly act to come back into compliance with the conditions of the Letter by either: (1) moving proprietary money into the segregated account, or (2) initiating the liquidation of the Prime or Electing Government MMF in an amount necessary to come into compliance.

The Division understands that in the case of a liquidation, the MMF may not be able to move funds until the next business day; therefore, to avoid a violation of the conditions of the Letter, the FCM must initiate the liquidation request promptly upon discovery. If the FCM promptly requests liquidation of an appropriate amount from the Prime or Electing Government MMF then the FCM is complying with the conditions of the Letter. However, if the FCM fails to promptly request liquidation, or if the Prime or Electing Government MMF does not move the requested funds within one business day, then a violation of the conditions of the Letter has occurred and the FCM will be in violation of Commission Regulation 1.25. The FCM must report the Regulation 1.25 violation to the Commission and to its designated self-regulatory organization, and take steps to come into compliance.

E. How are the asset-based and issuer-based concentration limits applied to the SEC Rule 2a-7 Government MMFs?

Regulation 1.25(b)(3) currently imposes asset-based and issuer-based concentration limits

⁷ If an FCM uses a range to set its targeted residual interest amount, the high point of the range should be used in computing the amount of funds the firm holds in segregated accounts in excess of its targeted residual interest.

on the investment of customer funds, including investments in MMFs. These asset-based concentration limitations are as follows:

- Investment in a MMF that is comprised only of U.S. government securities is not subject to asset-based concentration limits, provided that the MMF has at least \$1 billion in assets and the management company that manages the MMF has at least \$25 billion of assets under management;⁸
- Investment in a MMF that is comprised only of U.S. government securities may not exceed 10 percent of the total assets held in segregation by the FCM if the MMF has less than \$1 billion in assets and/or the management company that manages the MMF has less than \$25 billion in assets under management;⁹
- Investment in a MMF that is not comprised only of U.S. government securities may not exceed 50 percent of the total assets held in segregation by the FCM, provided that the MMF has at least \$1 billion in assets and the management company that manages the MMF has at least \$25 billion in assets under management;¹⁰ and
- Investment in a MMF that is not comprised only of U.S. government securities may not exceed 10 percent of the total assets held in segregation by the FCM if the MMF has less than \$1 billion in assets and/or the management company that manages the MMF has less than \$25 billion in assets under management.¹¹

To provide consistency in the definition of a Government MMF, the Division, in its Letter, stated that it would not recommend an enforcement action if an FCM invests customer funds in a Government MMF as defined in SEC Rule 2a-7 provided that it is not subject to SEC Rule 2a-7 liquidity fees and redemption restrictions (i.e., provided the MMF is not an Electing Government MMF). Pursuant to the terms and conditions of the Letter, an FCM may invest up to 100 percent of the customer funds it holds in segregation in a Government MMF as defined in SEC Rule 2a-7 that does not retain rights to impose liquidity fees or to suspend redemptions provided that the Government MMF has at least \$5 billion in assets and the management company that manages the MMF has at least \$25 billion in assets. Therefore, under the Letter, investments in SEC Rule 2a-7 MMFs are subject to the following asset-based concentration limits:

- Investments in SEC Rule 2a-7 Government MMFs are not subject to an asset-based concentration limit, provided that the MMFs have at least \$5 billion in assets and the management companies that manage each of the funds have at least \$25 billion in assets under management;
- Investment in an SEC Rule 2a-7 Government MMF may not exceed 50 percent of the total assets held in segregation by the FCM if the SEC Rule 2a-7 Government MMF has at least \$1 billion in assets but less than \$5 billion and the management company that manages the MMF has at least \$25 billion in assets under management; and

⁸ See Regulations 1.25(b)(3)(i)(E) and 1.25(b)(3)(i)(G).

⁹ See Regulation 1.25(b)(3)(i)(G).

¹⁰ See Regulation 1.25(b)(3)(i)(F).

¹¹ See Regulations 1.25(b)(3)(i)(F) and 1.25(b)(3)(i)(G).

- Investment in a MMF that is an SEC Rule 2a-7 Government MMF may not exceed 10 percent of the total assets held in segregation by the FCM if the SEC Rule 2a-7 Government MMF has less than \$1 billion in assets and/or the management company that manages the MMF has less than \$25 billion in assets under management.

The current issuer-based concentration limits apply only to MMFs that are not comprised exclusively of U.S. government securities. Regulation 1.25(b)(3)(ii)(C) currently limits the interest of an FCM in a single family of MMFs that are not comprised exclusively of U.S. government securities to no more than 25 percent of the total assets held in segregation by the FCM. Regulation 1.25(b)(3)(ii)(D) currently limits the interest of an FCM in an individual MMF that is not comprised exclusively of U.S. government securities to no more than 10 percent of the total assets held in segregation by the FCM.

The Division's Letter did not provide relief from the issuer-based concentration limits for SEC Rule 2a-7 Government MMFs. Accordingly, an FCM must limit its investment in a single SEC Rule 2a-7 Government MMF to no more than 10 percent of the FCM's total assets held in segregation, and an FCM must limit its investment in a single family of MMFs that offer SEC Rule 2a-7 Government MMFs to no more than 25 percent of the total assets held in segregation by the FCM.

F. May the acknowledgment letter template for a Prime or Electing Government MMF include a provision stating the authority of the fund to suspend redemptions or impose liquidity fees pursuant to SEC Rule 2a-7? May the prospectus of a Prime or Electing Government MMF include a statement of its authority to suspend redemptions or impose liquidity fees in the MMF prospectus consistent with SEC Rule 2a-7?

The Letter provides limited relief to FCMs to invest the amount of residual interest that exceeds their targeted residual interest amounts held in customer segregated accounts in Prime and Electing Government MMFs. As emphasized in the Letter, the relief is limited only to the amount of funds that the FCM would otherwise be permitted to withdraw from the segregated accounts. Accordingly, in order to give effect to the Letter, the acknowledgment letter that the FCM executes with the Prime or Electing Government MMF may contain a provision that the MMF may suspend redemptions or impose liquidity fees consistent with SEC Rule 2a-7. The prospectus of the Prime or Electing Government MMF also may include a statement that the fund may suspend redemptions or impose liquidity fees consistent with SEC Rule 2a-7. FCMs, however, are not required by the Letter to obtain new acknowledgment letters for existing Prime or Electing Government MMF accounts.

Issued in Washington, D.C. on October 18, 2016, by the Division of Swap Dealer and Intermediary Oversight.

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