05-1
(3)

INVESTMENT COMPANY INSTITUTE

RECEIVED
C.F.T.C.
2005 APR -4 PM 4: 35
OFC. OF THE SECRETARIAT

April 4, 2005

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20006

COMMENT

Re: Proposed Withdrawal of Interpretation No. 10

Dear Ms. Webb:

The Investment Company Institute[1] opposes the proposed withdrawal of Financial and Segregation Interpretation No. 10 ("Interpretation No. 10").[2] The resulting disruption and costs to investment companies that are forced to restructure existing custody relationships will outweigh any theoretical benefits.

Many investment companies use third-party custodial accounts to house margin assets for their futures transactions in reliance on Interpretation No. 10.[3] They have established procedures and software programs to incorporate these arrangements in their back office systems. Typically, investment companies using third-party custodial accounts maintain these accounts at their primary custodian bank. These arrangements achieve important efficiencies by consolidating custody of the bulk of a fund's assets within a single bank.

For example, tracking of fund asset flows into and out of custodian accounts is a critical aspect of investment company operations. Investment companies establish and maintain wire connections and other communication systems with their custodians to

---

[1] The Investment Company Institute is the national association of the American investment company industry. More information about the Institute is included at the end of this letter.

[2] *See* "Proposed Withdrawal of Staff Interpretation," 70 Fed. Reg. 5417 (February 2, 2005) ("Proposing Release"). The proposal was issued by the Commodity Futures Trading Commission's Division of Clearing and Intermediary Oversight ("Division").

[3] Since its adoption in 1996, Rule 17f-6 under the Investment Company Act of 1940 has permitted registered investment companies to post margin assets directly with an FCM. Generally speaking, the rule does not require, nor does it express any preference for, posting margin assets with the FCM directly over maintaining them in third-party custodial accounts. It does not permit, however, the posting of margin funds directly with an affiliated FCM.

facilitate asset movements and tracking of asset movements. These arrangements facilitate the transfer of investment company assets into and out of third-party custodial accounts and other accounts of the investment company.

Withdrawal of Interpretation No. 10 will require these investment companies to maintain futures margin at an FCM which, in turn, will require new software programming, communication links, and reporting mechanisms to support and monitor daily flows of margin to and from the FCM. These investment companies will be forced to incur the costs of restructuring their relationships with their FCMs and will lose the ongoing efficiencies that their existing custodial arrangements provide.

While the benefits of third-party custodial arrangements to investment companies are real and the costs of eliminating them would be tangible and material, the rationales suggested in favor of withdrawing Interpretation No. 10 are not compelling. In particular, the Proposing Release refers to "potential systemic liquidity risks which could result from any potential diversion of FCM capital to cover undermargined customer accounts." The conditions established by Interpretation No. 10 were designed to address this concern and have met the test of time.[4] The Proposing Release does not cite, nor are we aware of, any specific evidence that the use of such accounts over the past two decades - including during periods of market volatility - has produced adverse market impacts. Further, investment company assets, by virtue of the requirements of the Investment Company Act, are highly liquid and represent low credit risk.[5]

Moreover, the risk of undermargined accounts to FCMs in turbulent markets, as the CFTC has commented, may be reduced in other ways such as by incorporating a "cushion" in margin levels, addressing the special risks presented by foreign traders and following sound risk management procedures. Notably, in a recent rulemaking concerning minimum financial and related reporting requirements for FCMs, the CFTC declined to reduce the period of time that a margin call remains outstanding before an account is deemed undermargined based upon its conclusion that the changes:

> were not proposed in response to observed specific deficiencies in the FCMs' processes for the collection of margin, and the Commission is persuaded that the existing Commission and exchange rules continue to reinforce the industry's own practices for collecting margin as soon as possible, while taking into consideration circumstances that may result in margin not being paid within one day of the issuance of a margin call which are commercially reasonable and not

[4] Essentially, these conditions assure that the FCM will in fact have sufficient control of the account so that the account operates as a separate segregated account of the FCM to which the FCM has immediate access.

[5] For example, Section 18(f) of the Investment Company Act has been construed to require that a registered investment company maintain liquid assets equal to the full notional amount of futures contracts entered into or other "cover" equal to the company's futures contract exposure. *See, e.g., Dreyfus Strategic Investing and Dreyfus Strategic Income,* SEC No-Action Letter (pub. avail. June 22, 1987).

indicative of any impaired financial capacity of the recipient to ultimately meet the margin call.[6]

In short, the CFTC determined to rely upon sound margin collection practices and indicia of the financial capacity of the customer, rather than imposition of undermargined account charges, to assure against the potential liquidity risks to FCMs posed by delayed margin flows. The CFTC's analysis is fully applicable here. The systemic liquidity risks referenced in the Proposing Release with respect to third-party custody accounts would apply at least equally to the international customers and other accounts highlighted by the CFTC in the Minimum Capital Release as likely to require more than one day to satisfy margin calls.

The Division also cites in support of the proposal "some uncertainty as to the treatment of funds in the event of an FCM insolvency," as well as "some potential for funds to be inadvertently released from the account without the prior knowledge or consent of the FCM." These uncertainties concerning interpretation of the Bankruptcy Code and the potential for human error affect investment companies to the same extent as FCMs and other futures customers and do not support withdrawal of Interpretation No. 10. In any event, under the CFTC's view that third-party account assets are subject to *pro rata* distribution in the event of an FCM's bankruptcy, the use of a third-party account would have no impact on the distribution of customer funds in these circumstances. To preclude or impede the use of third-party accounts out of a fear that the CFTC view might be rejected by a Bankruptcy Court seems to favor avoidance of an important legal issue rather than effective risk management.

Moreover, the Division's proposal will not eliminate the potential bankruptcy issue. The proposal would permit an FCM to continue to rely on Interpretation No. 10 if the FCM is not eligible to hold the assets of an investment company under Rule 17f-6 (*i.e.*, because the FCM is an affiliate of the investment company or its adviser). In addition, even if the Division withdraws Interpretation No. 10, third-party custodial accounts may still be used outside of the affiliated FCM situation, albeit on more financially onerous terms.

The potential for improper dispositions of customer funds also fails to support the withdrawal of Interpretation No. 10. This risk, to the extent it exists, is the same whether margin funds are maintained at the FCM or at a custodial bank.

For the foregoing reasons, the Institute urges the CFTC to refrain from withdrawing Interpretation No. 10 or, in the alternative, to institute a factual study to assess fully the costs and benefits of the proposal before undertaking further action.

---

[6] *See* Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers, 69 Fed. Reg. 49784, 49793 (Aug. 12, 2004) ("Minimum Capital Release").

Transition Period

If the Division nevertheless determines to proceed with the withdrawal of Interpretation No. 10, it is important to provide an appropriate transition period. The Proposing Release stated that the Division would expect that any withdrawal of Interpretation No. 10 would be made effective not less than six months following the publication of a final notice. Based on feedback from our members who would have to restructure existing futures margin custody arrangements, the Institute recommends a transition period of at least nine months.

* * *

We appreciate the opportunity to express our concerns about the Division's proposal to withdraw Interpretation No. 10. If you have any questions about our comments, please contact me at 202/326-5822.

Sincerely,

Frances M. Stadler
Deputy Senior Counsel

cc: Carlene S. Kim
Senior Special Counsel
Division of Clearing and Intermediary Oversight

About the Investment Company Institute

The Investment Company Institute's membership includes 8,534 open-end investment companies ("mutual funds"), 648 closed-end investment companies, 144 exchange-traded funds and 5 sponsors of unit investment trusts. Its mutual fund members manage assets of about $8.037 trillion. These assets account for more than 95% of assets of all U.S. mutual funds. Individual owners represented by ICI member firms number 87.7 million as of mid-2004, representing 51.2 million households.