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Division of Clearing and Risk

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Interpretation
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Division of Clearing and Risk

Staff Interpretation Regarding CFTC Part 39 In Light Of Revised SEC Rule 2a-7

Part 39 of the Commodity Futures Trading Commission (“CFTC”) regulations governs the activities of derivatives clearing organizations (“DCOs”).¹ The CFTC published Part 39 in 2011 to implement revised Section 5b(c)(2) of the Commodity Exchange Act (“CEA”), which sets forth core principles a DCO must comply with in order to be registered and to maintain registration as a DCO.² As relevant here, Part 39 regulations restrict the types of assets in which a DCO may choose to hold initial margin and funds belonging to clearing members and their customers.³ An additional regulation under Part 39 restricts the types of assets in which a SIDCO or Subpart C DCO may hold its own funds.⁴ Each of these regulations contains provisions requiring DCOs to minimize the liquidity risk of financial resources relied upon by the DCO. In this letter, the Division of Clearing and Risk (“Division”) interprets these provisions in light of amendments to Securities and Exchange Commission (“SEC”) Rule 2a-7 to the Investment Company Act that will take effect on October 14, 2016.⁵

SEC Rule 2a-7

Rule 2a-7 is the principal rule governing money market funds. The rule’s provisions include: requirements pertaining to the maturity, quality, diversification, and liquidity of the assets comprising a fund’s portfolio; recordkeeping and reporting obligations; and share price calculation requirements. In 2014, the SEC published amendments to Rule 2a-7, including several pertaining to a money market fund that is not a “government money market fund”

¹ CFTC regulations are codified in Chapter I of Title 17 of the C.F.R.

² DCO General Provisions and Core Principles, 76 Fed. Reg. 69,334 (Nov. 8, 2011). In 2013, the CFTC amended Part 39 to establish additional standards for compliance with the DCO core principles for systemically important DCOs (“SIDCOs”) and DCOs that elect to opt into the SIDCO regulatory requirements (“Subpart C DCOs”) (DCOs and International Standards, 78 Fed. Reg. 72,476 (Dec. 2, 2013)).

³ Regulations 39.11(e)(1), 39.13(g)(10), and 39.15(c) and (e).

⁴ Regulation 39.36(f).

⁵ SEC Rule 2a-7 is codified in 17 C.F.R. 270.2a-7. The SEC published the amendments to Rule 2a-7 in Money Market Fund Reform, 79 Fed. Reg. 47,736 (Aug. 14, 2014) (compliance dates described at 47,932).

(hereinafter, a “Prime Fund”).⁶ These amendments include: new reporting rules;⁷ new stress testing requirements; the requirement that a Prime Fund compute its price per share according to a floating net asset value instead of according to a stable \$1 per share; and the requirement that a Prime Fund charge a fee on redemptions if the fund has less than 10 percent of its total assets invested in “weekly liquid assets,” unless the fund’s board of directors, including a majority of the directors who are not interested persons of the fund, determines that imposing this fee would not be in the fund’s best interests.⁸

One provision of revised Rule 2a-7 that will take effect on October 14, 2016 requires the board of directors of a Prime Fund to reserve the right to suspend redemptions in the fund for up to 10 days under certain circumstances. Specifically, redemptions may be suspended if the fund has less than 30 percent of its total assets invested in weekly liquid assets, and the fund’s board of directors, including a majority of the directors who are not interested persons of the fund, determines that such a suspension would be in the fund’s best interests.⁹ This provision is intended to enable a Prime Fund to manage high levels of redemptions, as well as to create time for the fund to rebuild its own internal liquidity and for shareholders to reconsider whether redemptions are still desired or warranted.¹⁰ Rule 2a-7 does not permit a fund’s board of directors to waive the right to suspend redemptions. Whereas it may not be in the best interests of some of the fund’s shareholders for a fund to suspend redemptions, Rule 2a-7(c)(2)(i) requires the board to consider the best interests of the *fund*, *not* the interests of particular shareholders.

Finally, revised Rule 2a-7 permits a “government money market fund” “to choose to rely on the ability to impose liquidity fees and suspend redemptions” in the same manner that a Prime Fund must consider imposing a liquidity fee and suspending redemptions under Rule 2a-7(c)(2)(i).¹¹ A government money market fund that opts into this framework (“Electing Government Fund”) would notify investors of the election in Form N-1A.¹²

⁶ Id. A government money market fund is “a money market fund that invests 99.5 percent or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized fully” (Rule 2a-7(a)(16)).

⁷ At the same time that SEC amended 2a-7, the SEC also revised disclosure requirements for money market funds, pursuant to amendments to Rules 270.30b1-8 and 270.30b2-7 and Forms N-1A, N-MFP, and N-CR (Money Market Reform, supra).

⁸ Weekly liquid assets includes cash, direct obligations of the U.S. government, certain short-term securities of U.S. government instrumentalities (maturities of 60 days or less) and other short-term securities (maturities of five days or less) (Rule 2a-7(a)(34)).

⁹ Rule 2a-7(c)(2)(i). Under the same circumstances that a Prime Fund may suspend redemptions, Rule 2a-7(c)(2)(i) provides that the fund may also institute a liquidity fee not to exceed two percent of the value of the shares redeemed.

¹⁰ Money Market Fund Reform, supra, at 47,749-47,751.

¹¹ Rule 2a-7(c)(2)(iii).

¹² Item 4(b)(1)(ii).

Regulation 39.13(g)(10)

Regulation 39.13 obligates a DCO to follow certain risk management practices. Under Regulation 39.13(g)(10), a DCO “shall limit the assets it accepts as initial margin to those that have *minimal* credit, market, and *liquidity risks* [emphasis added].” To date, the Division has not defined “minimal.” A dictionary definition of “minimal” is “least possible.”¹³ Together with the other Part 39 regulations discussed below, Regulation 39.13(g)(10) requires a DCO to maintain liquid financial resources in order that the DCO can accomplish one of its most important functions: making on-time payments to its members with net gains, despite any default by members with net losses.¹⁴ In the event of a default by a member, it is crucial for a DCO to maintain initial margin in assets that can be promptly liquidated in order that the DCO can, even on the day of default, make prompt payments to members with positions opposite the defaulting member.

As a result of the fact that under revised Rule 2a-7(c)(2)(i), a Prime Fund might suspend redemptions for up to 10 days, the Division believes that a Prime Fund poses more than minimal liquidity risks. With regard to other securities, such as equities and U.S. government securities, a secondary market may generally be available even when an issuer is in financial distress. Such securities may be sold at a discount (which may be a material discount to face value), but can still be liquidated. By contrast, the Division has not been presented with any evidence suggesting there may be a secondary market for interests in a Prime Fund or Electing Government Fund for which redemptions have been suspended. For all the reasons stated above, **the Division interprets Regulation 39.13(g)(10) to prohibit a DCO from holding or accepting shares in a Prime Fund or Electing Government Fund as initial margin beginning October 14, 2016.**

Regulation 39.11(e)(1)

Regulation 39.11 specifies a DCO’s minimum financial resources requirements and related obligations. Regulation 39.11(e)(1)(i) requires a DCO to “effectively measure, monitor, and manage its liquidity risks, maintaining sufficient liquid resources such that it can, at a minimum, fulfill its cash obligations when due” and to “hold assets in a manner where the risk of loss *or delay in its access to them* is minimized [emphasis added].” To date, the Division has not defined “minimize.” A dictionary definition of “minimize” is “to make...as small as possible.”¹⁵ As discussed above, making on-time payments to members is among a DCO’s most important functions.

The fact that revised SEC rule 2a-7 will, after October 14, 2016, require a Prime Fund or Electing Government Fund to consider suspending redemptions for up to 10 days under certain

¹³ Merriman-Webster dictionary, available at: www.m-w.com

¹⁴ See also Regulation 39.14(b) (Daily settlements), which generally requires a DCO to “effect a settlement with each clearing member at least once each business day.”

¹⁵ Merriman-Webster dictionary, supra.

circumstances means that a DCO holding assets in Prime Funds or Electing Government Funds would face the risk that its access to such assets would be delayed, and thus the risk of such delay would not be minimized. In other words, such funds will have a liquidity profile that is materially different than other asset classes. The Division believes that in order for a DCO effectively to minimize the risk that the resources the DCO relies on to fulfill its cash obligations may become illiquid, a DCO cannot rely on an investment in a Prime Fund or Electing Government Fund after revised Rule 2a-7(c)(2)(i) takes effect. For all the reasons stated above, **the Division interprets Regulation 39.11(e)(1)(i) to prohibit a DCO from holding assets in a Prime Fund or Electing Government Fund beginning October 14, 2016.**

Regulation 39.15(c) and (e)

Regulation 39.15 sets standards a DCO must follow to protect and ensure the safety of funds and assets belonging to members and their customers. Regulation 39.15(c) requires a DCO to “hold funds and assets belonging to clearing members and their customers in a manner *which minimizes the risk of loss or of delay in the access by the DCO to such funds and assets* [emphasis added].” Similarly, Regulation 39.15(e) limits a DCO to investing funds and assets belonging to clearing members and their customers in instruments with “*minimal credit, market, and liquidity risks* [emphasis added].” Regulation 39.15(e) also cross references Regulation 1.25, which governs the investment of customer funds by DCOs and futures commission merchants. Since a DCO’s guaranty fund generally consists of funds belonging to the DCO’s members, Regulation 39.15(c) and (e) indirectly requires a DCO’s guaranty fund to consist only of assets having minimal liquidity risks.

Like Regulations 39.13(g)(10) and 39.11(e)(1), Regulation 39.15(c) and (e) promote the liquidity of a DCO’s financial resources in order that the DCO can always make on-time payments to members, even when a member defaults on its obligations to the DCO. Accordingly, the Division believes that holding funds and assets in an investment (a Prime Fund or Electing Government Fund) which may, under certain circumstances, suspend redemptions for 10 days does not minimize the risk of delay in the access by the DCO to such funds and assets. Therefore, the Division believes that a Prime Fund or Electing Government Fund is an instrument having more than minimal liquidity risk. For all the reasons stated above, **the Division interprets Regulation 39.15(c) and (e) to prohibit a DCO from holding funds belonging to clearing members or their customers in a Prime Fund or Electing Government Fund beginning October 14, 2016.**

Regulation 39.36(f)

Regulation 39.36 lists risk management standards and procedures that must be followed by SIDCOs and Subpart C DCOs. Regulation 39.36(f) provides that the custody and investment arrangements for the funds and assets of such DCOs are subject to the same requirements that apply to the holding of funds and assets of clearing members pursuant to Regulation 39.15(c) and (e). Accordingly, a SIDCO or Subpart C DCO must maintain its own assets in a manner *which minimizes the risk of loss or of delay in the access by the DCO to such funds and assets* [emphasis added].” As discussed above, the Division believes that holding funds and assets in

an investment (a Prime Fund or Electing Government Fund) which may, under certain circumstances, suspend redemptions for 10 days does not minimize the risk of delay in the access by the DCO to such funds and assets. For all the reasons stated above, **the Division interprets Regulation 39.36(f) to prohibit a SIDCO or Subpart C DCO from investing its own funds in a Prime Fund or Electing Government Fund beginning October 14, 2016.**

This letter represents the position of the Division only and does not necessarily represent the views of the CFTC or those of any other division or office of the CFTC. It should be noted that any different, changed, or omitted material facts or circumstances may require a different conclusion. Finally, as with all interpretative letters, the Division retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the interpretation provided herein, in its discretion.

Should you have questions regarding this matter, please contact Peter A. Kals, Special Counsel, at (202) 418-5466.

Sincerely,

Jeffrey M. Bandman
Acting Director