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CFTC Limits Investment of Client Funds to Government Money Market Funds

Two recent letters from the CFTC staff hold that, beginning October 14, 2016, its regulations will prohibit investment of client funds by [futures commission merchants](#) ("FCMs") and [derivatives clearing organizations](#) ("DCOs") in prime money market funds ("Prime MMFs"). Although the staff's positions are clearly articulated, I found their relationship to [Regulation 1.25](#) questionable.

The Impact of Fees and Gates under Regulation 1.25

Regulation 1.25 governs the investment of customer money by FCMs. Regulation [39.15\(e\)](#) also imposes the limitations of Regulation 1.25 on the investment of customer funds and assets by DCOs. Regulation 1.25 permits investments in money market funds, but only if (among other requirements) the fund is "legally obligated to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request" "without material discount in value." One of the amendments to Rule 2a-7 taking effect on October 14 will permit, in extraordinary circumstances, a prime or tax exempt MMF to impose a liquidity fee of up to 2% on redemptions or suspend redemptions ("gate") for not more than 10 business days. Should a Prime MMF impose a fee or gate, it would not be obligated to redeem shares (in the case of a gate) or would redeem shares at a material discount in value (in the case of a fee). The question addressed in the CFTC letters is whether this means that Prime MMFs are no longer permitted investments under Regulation 1.25.

Staff's Reason for Prohibiting Prime MMFs

The FCM letter set forth the staff's analysis of Regulation 1.25 in a couple of footnotes. Here's the analysis regarding the potential for gates:

Pursuant to Regulation 1.25(c), a MMF is a permissible investment for customer funds by an FCM only if the FCM can redeem 100% of its investment "by the business day following the request." A MMF is a permitted investment even if it can suspend redemptions, so long as the fund may do so only in certain circumstances specifically defined under Regulation 1.25(c)(5)(ii). However, the redemption restrictions described in Rule 2a-7 are not covered by the exceptions enumerated in Regulation 1.25(c)(5)(ii) and, therefore, conflicts with the next-day redemption requirement of Regulation 1.25(c) rendering Prime MMFs ... ineligible for the investment of customer funds.

The staff states an FCM may still invest its proprietary funds in Prime MMFs, however.

Overlooked Exceptions?

I wonder if the CFTC staff fully considered the exceptions in Regulation 1.25(c)(5)(ii). Under one exception:

A fund may provide for the postponement of redemption and payment ... (E) For any period during which the [SEC] has, by rule or regulation, deemed that: (1) Trading shall be restricted; or (2) An emergency exists.

According to the SEC's staff (see [Q&A 47](#)):

Under rule 2a-7(c)(2)(i), a money market fund is allowed to impose a redemption gate only in extraordinary circumstances, i.e. if the fund's weekly liquid assets fall below 30% and the fund's board of directors determines that imposing a gate is in the best interest of the fund. In the staff's

view, such extraordinary circumstances would in effect likely create an emergency for the fund. Accordingly, the staff believes that a suspension of redemptions by a money market fund, as permitted by rule 2a-7(c)(2)(i), would be because of such an emergency.

Thus, a Prime MMF's ability to gate is pursuant to a rule under which the SEC has deemed an emergency to exist, which is a limitation Regulation 1.25 permits.

Impact of the CFTC Letters

I'm not sure that the CFTC letters will have much practical effect. Other amendments to Rule 2a-7 will require institutional Prime MMFs to have floating NAVs and limit retail Prime MMFs to natural persons. FCMs and DCOs are unlikely to risk even small losses from investing customer funds in institutional funds or take accountability for limiting investments in retail funds to customers who are natural persons. This simply adds further impetus to the shift from prime to government money market funds that we can expect before the amendments take effect.

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