April 14, 2011

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

Re: RIN No. 3038-AC15: Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions

Dear Secretary Stawick:

We are writing on behalf of the Business Law Society[1] to comment on the Commodity Futures Trading Commission's ("CFTC's" or "Commission's") request for comments on swap collateral.[2] Specifically, we are writing to comment on the Commission's proposal to amend Rule 1.25 to restrict the total amount of collateral that can be placed in a Money Market Fund ("MMF") for certain purposes.

Amended Rule 1.25 would limit the total amount of collateral that can be placed in MMFs by Futures Commission Merchants ("FCMs") and Derivatives Clearing Organizations ("DCOs") to 10% of assets held in segregation, with a 2% limit for MMFs within the same family of funds. To date, FCMs and DCOs have been permitted to invest up to 100% of collateral in MMFs because MMFs have a long history as a safe, liquid investment. Recent Securities and Exchange Commission ("SEC") regulatory reforms have made MMFs even safer and more liquid, and the SEC and industry members intend to make additional improvements in the future. In contrast, assets in which the Commission would permit the same or higher percentages of collateral to be invested present greater risk than MMFs. If the Commission's goal is to ensure investments in safe collateral by FCMs and DCOs, for the reasons set forth below the use of MMFs should not be limited.

[1] The Business Law Society is a national network of law students who collaborate on business-law-related projects.

[2] Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 75 Fed. Reg. 67642 (proposed November 3, 2010)

I. MMFs Have an Unparalleled Record of Safety and Liquidity.

The proposed Rule 1.25 greatly restricting the percent of collateral that FCMs and DCOs can place in MMFs during swaps is ill-founded. Money market funds have a virtually unblemished safety record. They have lost principal ("broken a dollar") only twice in their three-decade history – a period during which thousands of banks have failed. In each case where an MMF failed, shareholders lost, at most, a few pennies on the dollar. The first failure, a small, institutional fund, lost less than 4 percent of its value.[3] The second, the Reserve Primary Fund, lost 3 percent of its value.[4]

The remarkable record of MMFs is attributable to portfolio restrictions under which they operate. Rule 2a-7 under the Investment Company Act requires that an MMF hold a diversified portfolio of high-quality, short-term assets the value of which necessarily fluctuates very little.[5] Diversification reduces the risk that credit problems experienced by single issuer will have a material effect on an MMF's portfolio.[6] The high quality of debt instruments minimizes the likelihood that a systemic credit crunch that causes weaker issuers to fail will affect an MMF.[7] The short term of the instruments minimizes the likelihood that interest rates will rise so quickly as to materially reduce their value.[8]

II. MMFs Are Even *Safer* with New Requirements and Industry Reforms.

A. Rule 2a-7 Amendments

Recent amendments to Rule 2a-7 have strengthened the safety and liquidity of MMFs.[9]The amendments are as follows:

- **Stress Testing**. Scenarios requiring testing include changes in short-term interest rates, higher redemptions, downgrades, and defaults.
- **Monthly Portfolio Disclosure**. Money Funds must report portfolio-holdings, including market-based values of securities and "shadow" NAVs to the SEC on a monthly basis. The information is publicly available after 60 days.

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[3] The first institutional MMF to have lost principal is the U.S. Government Fund, which suffered losses on derivatives investments. *See generally In the Matter of Craig Vanucci*, Admin. Proc. File No. 3-9804 (Jan. 11, 1999).
[4] On September 16, 2008, the Reserve Management Company, the investment adviser to a prominent family of fixed income mutual funds with approximately 2 million shareholders, announced the liquidation of 17 of its funds and suspended redemptions for 15 of those funds because of a run on assets by shareholders. *See* Kevin McCoy, USA TODAY, Nov. 11, 2008, at 7A. *See generally* Complaint, In the Matter of Reserve Management Company, Inc., Docket No. 2008-0079 (Jan. 13, 2009) *available at* http://www.sec.state.ma.us/sct/sctreserve/reservecomplaint.pdf.
[5] *See* 17 C.F.R. § 270.2a-7 (2008). *See generally Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 7275 at Part I (1996). Modern money market funds owe their creation to rule 2a-7 under the Investment Company Act, which was adopted in 1983.
[6] *See generally Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 6882 at Part II.B (1991) (discussing diversification test).
[7] *See generally id.* (discussing portfolio quality test); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U.L.Q. 619, 698 - 99 (1999) (same).
[8] *See generally Revisions to Rules Regulating Money Market Funds*, *supra*, at Part II.C.
[9] *See* http://www.sec.gov/rules/final/2010/rule2a-7amendments.pdf.

- **Provides additional liquidity during a market crisis by borrowing from the discount window.** PLF will be a state-chartered member bank or trust company eligible to access the discount window in the ordinary course under Regulation A.

The initial capital of the PLF will come from prime MMF sponsors and ongoing commitment fees from member funds.[11] Such a backstop will further ensure market confidence, decreasing the risk of substantial shareholder redemptions. The PLF will purchase high-quality short-term assets from prime MMFs during times of unusual market stress. By these purchases, the PLF will enable prime money market funds to satisfy shareholder redemptions without selling assets into a down market.[12] The proposal indicates the MMF industry is working to provide even greater safety and liquidity risk to maintain MMFs' standing as a premier cash vehicle for investment and a strong repository for swap collateral.

III. MMFs Are Safer Relative to Other Permitted Investments.

Money market funds provide safer and more liquid collateral than many of the financial instruments in which the Commission has proposed to permit the same or higher percentage of collateral to be invested.[13] These instruments and their permitted collateral limits are as follows:

- U.S. Government Securities – 100%
- U.S. Agency Obligations – 50%
- TLGP Guaranteed Commercial Paper and Corporate Notes and Bonds – 25%
- Non-negotiable CDs – 25%
- Municipal Securities – 10%
- Money Market Funds – 10%

The relative risk that these instruments entail is illustrated by their risk characteristics, as discussed below.

A. Interest Rate Risk

The limit for U.S. government securities is 100%, notwithstanding that they may actually pose greater interest-rate risk than MMFs. When interest rates rise, the value of longer-term government bonds may decline more than short-term MMF assets. Thus, as a government bond increases in maturity, it may present greater interest-rate risk than an MMF invested in short-term instruments. However, the Commission makes no distinction between government securities with short-term maturities and long-term maturities.

[11] *See* ICI's comment letter in response to President's Working Group Report on Money Market Reform Options, *available at* http://ici.org/pdf/11_sec_pwg_com.pdf.
[12] Both Fidelity and BlackRock made competing proposals. *See* Fidelity comment to the SEC on the Report of the President's Working Group on Money Market Fund Reform Options, *available at* http://www.sec.gov/comments/4-619/4619-36.pdf. *See Also* BlackRock comment to the SEC on the Report of the President's Working Group on Money Market Fund Reform Options, *available at* https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111123530.
[13] Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 75 Fed. Reg. 67642 (proposed November 3, 2010).

The absence of any limit on collateral invested in long-term government bonds exposes counterparties to much greater interest-rate risk compared to MMFs. MMFs cannot hold much long-term debt because of their maturity restrictions. For example, a 10% investment in an MMF is allowed a *maximum* weighted-average maturity of 60 days. In contrast, the Commission allows a 100% investment in a 10-year T-note. The T-note's maturity exposes counterparties to a decline in the value of the T-note for a longer time period than an MMF.

The lower interest rates on short-term Treasuries may tempt FCMs and DCOs to chase yield with long-term government securities because of the lack of a maturity distinction under Rule 1.25. For example, a 3-month bond drawing .05% and a 5 year T-note drawing 2% are treated identically under Rule 1.25. A FCM or DCO treats the risk of losing bond value for the two securities as identical. The absence of a maturity distinction tempts an FCM or DCO to choose the greater return, the 5-year T-note. This risk indifference subjects counterparties to a greater risk of losing bond value.

TLGP securities and U.S. guaranteed agency obligations face the same problem as government securities. The maturities on both these instruments may exceed the permissible maturities under Rule 2a-7, thereby increasing their interest-rate risk compared to MMFs.

B. Default Risk

The Commission should not assign the same 10% concentration limit to municipal securities as to MMFs, considering the former's significantly greater default risk. An estimated 1.5 billion dollars of municipal bonds from 35 issuances defaulted in the first six months of 2010 alone. Some have predicted 50 to 100 municipal defaults in 2011.[14] More investors are exiting the municipal bond market, with 23.3 billion dollars exiting municipal bond mutual funds in the eight weeks prior to January 10th.[15] Adding to the uncertainty is a proposal to allow state bankruptcies,[16] as well as Fed Chairman Bernanke's refusal to lend to municipal markets or use any other mechanism for intervention.[17] Despite all these indications and the February 2008 municipal auction rate securities market freeze, the asset concentration limit for municipal securities and MMFs is 10%, with the per-issuer limit for municipal bonds 5%, compared to 2% for Money Funds. The track history of MMFs even *before* 2a-7 amendments shows MMFs should not be remotely within the same range as municipal securities when determining both asset and issuer-based concentration limits.

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[14] 60 Minutes, *State Budgets: Day of Reckoning* (*available at* http://www.cbsnews.com/video/watch/?=id7166293n&tag=contentBody;housing); *Wave of Muni Defaults to Spur Layoffs, Social Unrest: Whitney*, CNBC.com (Dec. 21, 2010). (http://www.cnbc.com/id/40769692/Wave_of_Muni_Defaults_to_Spur_Social_Unrest_Whitney).
[15] Dan Seymour, *Mutual Fund Cash Exodus Continues*, The Bond Buyer (Jan. 10, 2011).
[16] William Selway, *State Bankruptcy Proposal Criticized by Both Parties at Hearing*, BLOOMBERG, February 14, 2011, *available at* http://www.bloomberg.com/news/2011-02-14/state-bankruptcy-proposal-criticized-by-both-parties-at-hearing.html.
[17] Jon Hilsenrath and Neil King Jr., *Bernanke Rejects Bailouts, Fed Chief Says State and Local Governments Shouldn't Expect Federal Loans*, The Wall Street Journal (Jan. 8, 2011).

The Commission should not allow a higher 25% concentration limit for non-negotiable CDs than MMFs. This limit[18]allows any amount above the FDIC $250,000 insurance limit to be subject to a complete loss of principal in the event of a bank default. From 2008 through March of 2011, investors have lost approximately $681 million of uninsured deposits.[19] In the same period, one MMF has failed, losing $108 million.[20] Despite thousands of bank failures compared to only two MMF failures over the past 40 years, the asset concentration limit on CDs is 2 ½ times higher than MMFs.

C. Diversification Risk

Non-negotiable CDs and municipal securities have the same or higher percentage limit as MMFs although both of the former create substantial diversification risk. Diversification risk is the default of one issuer as opposed to many issuers in a diversified pool. For non-negotiable CDs, the Commission would allow 25% of collateral to be invested in securities of only 5 issuers. The Commission allows 10% of collateral to be invested in municipal securities of only 2 issuers. In contrast, FCMs and DCOs using a 10% MMF allocation must spread it across at least 5 issuers, notwithstanding that each portfolio itself is broadly diversified. Although MMFs pose less diversification risk than non-negotiable CDs and municipal securities, the Commission imposes a stricter standard for MMFs.

D. Systemic Risk

The relative percentage collateral limits also increase systemic risk. For example, non-negotiable CDs pose greater systemic risk than MMFs. For non-negotiable CDs, instability comes from bank deposits matching short-term assets to long-term liabilities.[21] This term-mismatch sets banks up to inevitably fail in the event of a mass exodus of depositors. In contrast, MMFs minimize systemic risk by matching short-term assets with short-term liabilities.[22] As a result, at least 330 banks have failed since the financial crisis of 2008.[23] During the same period, only one MMF broke the buck. Therefore, MMFs are more stable than bank CDs in times of financial stress.

Any amounts below the FDIC insured limit for bank deposits ignore systemic risk and pass it from counterparties to taxpayers. Since 1971, bank failures and assistant transactions to prevent failure have cost the FDIC $164,820,462,000.[24] During the same time period, the two MMFs

[18] "Non-negotiable" refers to CDs that are a direct obligation of the issuing bank to the purchaser and are wholly owned by the purchaser until early redemption or final maturity. The terms must allow the purchaser to redeem at the issuing bank within one business day (penalty limited to accrued interest earned). *See* Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 75 Fed. Reg. 67642 (proposed November 3, 2010).
[19] Philip van Doorn, *Bank Failure Map*, *available at* http://www.thestreet.com/stock-market-news/10607062/bank-failure-map.html.
[20] Daisy Maxey, *Reserve Primary Fund Nears End of Its Cash*, WALL STREET JOURNAL, July 17, 2010, *available at* http://online.wsj.com/article/SB10001424052748704913304575371003663559266.html; See also http://ther.com/pdfs/Primary%20Distribution_71510.pdf.
[21] Bullard, Mercer, *Federally-Insured Money Market Funds and Narrow Banks: The Path of Least Insurance*, B.U. Rev. Banking Fin. L. (forthcoming 2011) *available at* SSRN: http://ssrn.com/abstract=1351987.
[22] *Id.*
[23] FDIC Failed Bank List, *available at* http://www.fdic.gov/bank/individual/failed/banklist.html.
[24] FDIC Database of Failures and Assistance Transactions, *available at* http://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30.

failures have cost taxpayers zero dollars. In 2011 alone, 28 banks have already entered default.[25] The proposed concentration limits exacerbate systemic risk by favoring non-negotiable CDs that simply shift risk from counterparties to taxpayers.

IV. Conclusion

The proposal to amend Rule 1.25 to limit FCMs' and DCOs' use of Money Funds to hold customer cash runs contrary to the Commission's goals of risk minimization and protection of collateral. MMFs are much safer for collateral than indicated by the proposal. This proposal not only blocks risk minimization benefits of MMFs' diversified portfolios, but simultaneously increases overall risk to swap collateral by effectively shifting collateral investment into riskier permitted investments.

We thank the Commission for the opportunity to comment on Rule 1.25, we are available to discuss our comments at the convenience of the Commission and Commission staff.

Sincerely,

Michael Horne
Business Law Society
University of Mississippi J.D. Candidate '12

Ben Deneka
Business Law Society
University of Mississippi J.D. Candidate '12

cc: Hon. Gary Gensler
Hon. Michael Dunn
Hon. Jill E. Summers

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[25] FDIC Failed Bank List, *available at* http://www.fdic.gov/bank/individual/failed/banklist.html.

Hon. Bart Chilton
Hon. Scott D. O'Malia

Ananda Radhakrishnan
Director

Phyllis P. Dietz
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