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CFTC Proposes to Amend Regulations Regarding Investment of Customer Funds by FCMs and DCOs

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TO: ICI Members
Derivatives Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee
Money Market Funds Advisory Committee

SUBJECTS: Derivatives
Exchange-Traded Funds (ETFs)
International/Global
Investment Advisers
Money Market Funds
Trading and Markets RE: CFTC Proposes to Amend Regulations Regarding Investment of Customer Funds by FCMs and DCOs

On November 3, the Commodity Futures Trading Commission (CFTC or "Commission"), by seriatim, issued proposed amendments ("Proposal") to its rules governing the safeguarding and investment of funds deposited by customers to margin futures, foreign futures, and cleared swap transactions ("Customer Funds"). The Proposal primarily would amend Regulation 1.25 under the Commodity Exchange Act (CEA), which specifies Permitted Investments ("Permitted Investments") by futures commission merchants (FCMs) of Customer Funds, and by derivatives clearing organizations (DCOs) of Customer Funds that FCMs post with them as margin for their customers' positions.[1] The Proposal, which is summarized below, was informed by the CFTC's periodic assessment of Regulation 1.25, as well as two industry petitions it received.[2] Comments on the Proposal are due to the CFTC by January 17, 2024.

Permitted Investments

The Proposal would revise the list of Permitted Investments in Regulation 1.25 in several respects.[3]

A. Money Market Funds

The Proposal would limit the scope of money market funds (MMFs) whose interests qualify as Permitted Investments under Regulation 1.25(c) to government MMFs, for purposes of Rule 2a-7 under the Investment Company Act of 1940 ("1940 Act"), that have not elected to apply a discretionary liquidity fee. This proposed amendment is intended to reflect the amendments to Rule 2a-7 the SEC adopted in 2014 and, more recently, in August 2023.[4]

The CFTC explains that, following implementation of the SEC's 2014 amendments, the CFTC staff issued letters addressing the ability of FCMs and DCOs to invest in MMFs that have the authority to impose liquidity fees and suspend redemptions, in accordance with Rule 2a-7. Staff Letter 16-68[5] expressed the view of the CFTC's Division of Swap Dealer and Intermediary Oversight (now the Market Participants Division (MPD)) that Rule 2a-7's liquidity fee and redemption provisions were inconsistent with the requirements of Regulation 1.25 because they have the effect of potentially reducing the liquidity of prime MMFs, for purposes of Rule 2a-7, and government MMFs that elect to impose a redemption fee ("Electing Government MMFs"). As a result, the staff took the view that FCMs could not invest Customer Funds in such MMFs after the 2016 effectiveness of the SEC's 2014 amendments to Rule 2a-7.

In Staff Letter 16-69,[6] the CFTC's Division of Clearing and Risk (DCR) stated that a DCO may not hold assets in a prime MMF or Electing Government MMF, after the 2016 effectiveness of the SEC's 2014 amendments to Rule 2a-7. DCR stated that it is inconsistent with Regulation 39.11 for a DCO to invest funds belonging to clearing members or their customers in prime MMFs or Electing Government MMFs because investing in these MMFs did not, in the staff's view, sufficiently minimize the risk of loss or of delay in the access by the DCO to clearing member or customer assets, as that rule requires, or meet the requirement in Regulation 39.15[7] to invest in instruments with minimal credit, market, and liquidity risk. As a result of these staff positions, FCMs and DCOs have not been able to invest customer funds in prime MMFs or Electing Government MMFs since 2016.

The CFTC has evaluated the SEC's August 2023 amendments to Rule 2a-7 and preliminarily believes that the potential imposition of a liquidity fee by a MMF will "have the effect of reducing the liquidity of such funds and will reduce the principal of an FCM's or DCO's investments in MMF shares."[8] As a result, the CFTC believes that FCMs and DCOs should be allowed to invest Customer Funds only in MMFs that will not be subject to a liquidity fee—in other words, Government MMFs that do not elect to apply a discretionary liquidity fee ("Permitted Government MMFs"). The CFTC therefore proposes to largely codify the no-action positions taken by the staff in Letters Nos. 16-68 and 16-69 by limiting the scope of MMFs whose interests qualify as Permitted Investments for purposes of Regulation 1.25 to Permitted Government MMFs. To qualify as a Permitted Government MMF, consistent with Rule 2a-7, at least 99.5 percent of the fund's investment portfolio must be comprised of cash, government securities (i.e., US Treasury securities, securities fully guaranteed as to principal and interest by the US Government, and US agency obligations), and/or repurchase transactions that are fully collateralized by government securities.

B. Foreign Sovereign Debt

Regulation 1.25 currently permits FCMs and DCOs to invest in the sovereign debt only of the United States. Prior to 2011, Regulation 1.25 permitted Customer Funds to be invested

in the foreign sovereign debt of any country, provided that the investments were limited to balances owed by FCMs or DCOs to customers denominated in the currency of the applicable sovereign debt. In 2011, however, the CFTC amended Regulation 1.25 to eliminate foreign sovereign debt as a Permitted Investment because it believed it was not commonly used as an investment by FCMs and DCOs and raised risks due to the economic crises experienced by certain foreign governments.[9] In 2018, however, the CFTC issued an order under Section 4(c) of the CEA ("2018 Order") granting DCOs an exemption from these provisions of Regulation 1.25 to permit the investment of euro-denominated futures and cleared swaps customer funds in euro-denominated sovereign debt issued by France or Germany, as well as repurchase agreements involving French or German sovereign debt with foreign banks or broker-dealers, all subject to certain terms and conditions.[10]

As requested by FIA-CME in their rulemaking petition,[11] the Proposal would amend Regulation 1.25 to include the sovereign debt of France, Germany, Canada, Japan, and the UK (including repurchase or reverse repurchase agreements involving such foreign sovereign debt) as Permitted Investments, subject to conditions consistent with those in the 2018 Order. Among other conditions, an FCM or DCO could invest in permitted foreign sovereign debt only to the extent the FCM or DCO has balances in accounts owed to customers denominated in that country's currency, and only if the two-year credit default spread of the issuing sovereign is 45 bps or less.[12] The Commission also proposes to require that the dollar-weighted average of the remaining time-to-maturity of a portfolio of investments in permitted foreign sovereign debt may not exceed 60 calendar days, as that average is computed pursuant to Rule 2a-7, on a country-by-country basis. An FCM or DCO also would be prohibited from investing customer funds in any permitted foreign sovereign debt with a remaining maturity greater than 180 calendar days.

C. Interest in US Treasury Exchange-Traded Funds

As requested by Invesco and FIA-CME in their rulemaking petitions, the Proposal would revise the list of Permitted Investments in Regulation 1.25 to add shares of US Treasury exchange-traded funds (ETFs) that meet certain conditions ("Qualified ETFs"), which the Commission views as comparable to Permitted Government MMFs. These proposed conditions, most of which are consistent with the conditions required for Permitted Government MMFs, would require that a US Treasury ETF, among other things:

- be an investment company registered under the 1940 Act that holds itself out to investors as an ETF under Rule 6c-11 under the 1940 Act;
- is sponsored by a federally regulated financial institution, a bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, an investment adviser registered under the Investment Advisers Act of 1940, or a domestic branch of a foreign bank insured by the FDIC;
- be passively managed and seek to replicate the performance of a published short-term US Treasury security index;
- invest a minimum of 95 percent of its assets in eligible US Treasury securities;[13]
- must compute its NAV by 9 am of the business day following each business day and its NAV would be required to be made available to FCMs and DCOs by that time;
- is legally obligated to redeem its interests and make payment in satisfaction of those interests by the business day following a redemption request;[14] and
- be acceptable by a DCO as performance bond from clearing members to margin customer trades.

In addition, the agreement pursuant to which an FCM or a DCO acquires and holds its interest in the Qualified ETF would be prohibited from containing provisions that would prevent the pledging of the Qualified ETF's shares.

Importantly, the CFTC would require that, for an FCM or DCO to invest Customer Funds in a Qualified ETF, the FCM or DCO would need to be an authorized participant of the ETF. The CFTC believes this requirement is important to ensure that Customer Funds will be maintained in a segregated account in accordance with Section 4d or Part 30, as applicable, with a permitted depository, and to ensure that the FCM or DCO can complete the redemption and liquidation of the Qualified ETF's shares within one business day, as required by Regulation 1.25. The Commission, however, requests additional information on the availability and functioning of alternative mechanisms of purchasing and liquidating Qualified ETF interests in a manner compliant with Regulation 1.25 and compliant with the segregation requirements for Customer Funds.[15]

The Commission also proposes that Qualified ETFs be required to redeem their shares in cash, rather than in kind. The Commission is concerned that in-kind redemptions may hinder the ability of an FCM or DCO to satisfy Regulation 1.25's requirement that Permitted Investments must be capable of being converted to cash within one business day without material discount in value. The Commission requests information, however, on the availability and functioning of potential mechanisms or arrangements that may allow FCMs and DCOs to liquidate a Qualified ETF's shares in a manner compliant with Regulation 1.25 and the segregation requirements if the fund's interests were redeemed in kind.

D. Corporate Notes, Bonds, and Commercial Paper

The CFTC proposes to remove corporate notes, corporate bonds, and commercial paper from the list of Permitted Investments in Regulation 1.25. Under the current rule, these instruments are only Permitted Investments if they are fully guaranteed as to principal or interest by the United States under the Temporary Liquidity Guarantee Program (TLGP), administered by the FDIC. Given that the TLGP expired in 2012, these instruments have not been Permitted Investments for over 10 years.

E. Replace References to LIBOR

Regulation 1.25 includes certain Permitted Investments that contain variable or floating rates of interest, subject to certain conditions. The provisions that address these Permitted Investments reference, among other rates of interest, one-month or three-month LIBOR. In recognition of the anticipated termination of the publication of LIBOR and the increasing use of SOFR, the CFTC staff issued no-action relief in 2021 and 2022 to allow FCMs and DCOs to invest in Permitted Investments that contain adjustable rates of interest benchmarked to SOFR.[16] The Commission proposes to codify this staff relief by amending Regulation 1.25 to replace references to LIBOR with SOFR.

F. Bank Certificates of Deposit

The Commission requests comment on removing bank CDs from the list of Permitted

Investments in Regulation 1.25. The Commission notes that, in its experience, FCMs and DCOs do not invest in bank CDs.

I. Asset-Based and Issuer-Based Concentration Limits

Regulation 1.25 includes asset-based and issuer-based concentration limits for an FCM's and a DCO's investment of Customer Funds in Permitted Investments. These concentration limits are set at the same level for investments of futures customer funds, cleared swaps customer collateral, and 30.7 customer funds (foreign futures).

The Commission proposes to amend these concentration limits in certain respects. For ease of comparison, we have provided a table comparing, for select Permitted Investments, the current requirements under Regulation 1.25 with the proposed amendments to the asset-based and issuer-based concentration limits under the rule:

Current Asset-Based Limit

Current Issuer-Based Limit

Proposed Asset-Based Limit

Proposed Issuer-Based Limit

US government securities

100%

100%

(Unchanged)

(Unchanged)

US agency obligations

50%

25% (any single issuer)

(Unchanged)

(Unchanged)

Muni securities

10%

5% (any single issuer)

(Unchanged)

(Unchanged)

Larger[17] US gov't MMFs

100%

100% (any single gov't MMF)

N/A

N/A

Smaller[18] US gov't MMFs

10%

100% (any single gov't MMF)

N/A

N/A

Prime MMFs

50%

25% (in a single family of MMFs) and 10% (in a single MMF)

N/A

N/A

Larger[19] Permitted Gov't MMFs

N/A

N/A

50%

25% (in a single family of MMFs) and 5% (in a single MMF)

Smaller[20] Permitted Gov't MMFs

N/A

N/A

10%

25% (in a single family of MMFs) and 5% (in a single MMF)

Larger[21] Qualified ETFs

N/A

N/A

50%

25% (in a single family of ETFs) and 5% (in a single ETF)

Smaller[22] Qualified ETFs

N/A

N/A

10%

25% (in a single family of ETFs) and 5% (in a single ETF)

The Commission notes that the scope of underlying instruments in which a Permitted Government MMF would be allowed to invest is broader than that of the MMFs currently excluded from the concentration limits of Regulation 1.25(c) (i.e., MMFs investing solely in US government securities). The Commission believes it is necessary to "account for the potential increase in risk associated with such broader scope and in the interest of imposing a simple and consistent approach to concentration limits" and therefore is proposing a single concentration limit of 50% for all Permitted Government MMFs of a certain size, without distinguishing between funds investing solely in US government securities and those whose portfolios also may include US agency securities and/or other instruments permitted by Rule 2a-7.[23]

The CFTC believes concentration limits are appropriate for Permitted Government MMFs because MMFs, "like any institution relaying on electronic communications, are susceptible to cyber-attacks and operational incidents" that may affect their ability to timely process FCMs' and DCOs' redemption requests.[24] The Commission recognizes that cyber-attacks and other operational incidents may affect transactions in other Permitted Investments as well, but believes that the potential risk of Customer Funds becoming unavailable is greater when access to such funds "depends on the operations of a third party such as a MMF"[25] and that diversifying an FCM's or DCO's MMF portfolio "would not be burdensome."[26] The Commission also asserts that concentrating Customer Funds in any single MMF creates vulnerabilities that may impede the ability of FCMs and DCOs to provide customers with prompt access to their funds.[27]

The Commission proposes to treat Qualified ETFs like Permitted Government MMFs for purposes of both the asset- and issuer-based concentration limits. The amended rule would provide that, for purposes of determining compliance with the issuer-based concentration limits, securities issued by affiliated entities must be aggregated and deemed the securities of a single issuer, but an interest in a Permitted Government MMF or a Qualified ETF will not be deemed to be a security issued by its sponsoring entity. Further, the Commission notes that, because there are at least five US Treasury ETFs that may qualify as Qualified ETFs, the "proposed issuer-based concentration limits would not be overly restrictive."[28] US

Treasury ETFs, however, unlike Permitted Government MMFs, would be limited to those with a dollar-weighted average time to maturity of the portfolio, as that average is computed under Rule 2a-7, that does not exceed 24 months.

II. FCM and DCO Responsibility for Losses

CFTC rules provide that FCMs and DCOs are financially responsible for any losses resulting from Permitted Investments and are explicitly prohibited from allocating investment losses to customers or clearing FCMs.[29] The Commission proposes to amend Regulation 22.3(d) to clarify that DCOs also are financially responsible for any losses resulting from investments of cleared swap customer collateral in Permitted Investments, consistent with Regulation 1.29, which addresses financial responsibility for losses resulting from investment of futures customer funds.

III. Elimination of the "Read-Only Access Provisions"

The CFTC proposes to eliminate the "read-only access provisions" in Regulations 1.20 and 30.7, and Appendix A to Regulation 1.20, Appendix A to Regulation 1.26, and Appendices E and F to Part 30 of the Commission's regulations, which currently require depositories holding Customer Funds for FCMs to provide the Commission with direct, read-only electronic access to Customer Fund accounts. The Commission explains that it is able to obtain and verify FCM balances of Customer Funds through the CME and NFA daily segregation confirmation and verification processes and has concluded that it no longer needs direct-read-only electric access to obtain account information at depositories. It also notes the practical challenges it has encountered in implementing the read-only access provisions.

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Notes

[1] Investment of Customer Funds by Futures Commission Merchants and Derivatives Clearing Organizations, 88 Fed. Reg. 81236 (Nov. 21, 2023), available at https://www.govinfo.gov/content/pkg/FR-2023-11-21/pdf/2023-24774.pdf ("Proposing Release"). Please also see the Commission's Fact Sheet and Chair Behnam's Statement, Commissioner Goldsmith Romero's Statement, Commissioner Johnson's Statement, and Commissioner Pham's Statement.

[2] The rulemaking petitions submitted by FIA-CME and Invesco are available at https://www.cftc.gov/PressRoom/PressReleases/8818-23.

[3] In addition, in connection with the proposed amendments to the list of Permitted Investments, the Proposal specifies the capital charges that would apply to the proposed new categories of Permitted Investments described below and would make certain changes to the required contents of the Segregation Investment Detail Reports that FCMs file on a bi-monthly basis with the Commission and the FCM's designated self-regulatory

organization, to reflect the proposed changes to the list of Permitted Investments, as well as changes to the template acknowledgement letters to be signed by depositories holding customer funds.

[4] See Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers, Technical Amendments to Form N-CSR and Form N-1A, 88 Fed. Reg. 51404 (Aug. 3, 2023).

[5] See CFTC Letter No. 16-68 (Aug. 8, 2016).

[6] See CFTC Letter No. 16-69 (Aug. 8, 2016).

[7] Regulation 39.15(e) provides that any investment of customer funds or assets by a DCO must comply with Regulation 1.25.

[8] Proposing Release at 81241.

[9] See Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78776, 78781 (Dec. 19, 2011).

[10] Order Granting Exemption from Certain Provisions of the Commodity Exchange Act Regarding Investment of Customer Funds and from Certain Related Commission Regulations, 83 Fed. Reg. 35241 (Jul. 25, 2018).

[11] See supra note 2.

[12] If the credit default spread of a country were to exceed the 45-bps cap, FCMs and DCOs would not be permitted to make new investments in the country's foreign sovereign debt but would not be required to immediately divest existing investments.

[13] To ensure compliance with the proposed condition, FCMs and DCOs would be required to monitor the Qualified ETF's portfolio. If the portion of the ETF's assets invested in eligible US Treasury securities falls below 95 percent of the fund's total assets, the FCM or DCO would not be permitted to make additional investments of Customer Funds in the ETF.

[14] While the existing provisions in Regulation 1.25 for investments in MMFs provide certain exceptions to next-day redemption, the CFTC does not propose to include any exceptions to next-day redemption for Qualified ETFs. The CFTC notes that "no comparable provisions are provided under the rules of the SEC, and [the Commission recognizes] that the redemption process for ETFs involves the exchange of ETF share for cash by authorized participants." The CFTC does, however, request comment on the potential existence of extraordinary circumstances that may warrant an exception to the proposed next-day redemption requirement.

[15] The Commission notes that FCMs and DCOs may have access to other means of purchasing or liquidating interests in ETFs (e.g., acquiring interests in an ETF on a DVP basis through a securities broker or dealer at price equal to the next calculated NAV amount per share or another agreed upon price that approximates the last calculated NAV, selling Qualified ETF shares to a broker or dealer willing to buy them at a price corresponding to the NAV amount per share and later redeeming them from the fund). See Proposing Release at 81251.

[16] See CFTC Staff Letter 21-02 (Jan. 4, 2021); CFTC Staff Letter 22-21 (Dec. 23, 2022).

[17] MMFs with at least $1 billion in assets and/or with a management company comprising at least $25 billion in assets. Regulation 1.25(b)(3)(i)(E).

[18] MMFs with less than $1 billion in assets and/or with a management company comprising less than $25 billion in assets. Regulation 1.25(b)(3)(i)(G)

[19] MMFs with at least $1 billion in assets that have a management company managing at least $25 billion in assets. Proposed Regulation 1.25(c)(3)(i)(E).

[20] MMFs with less than $1 billion in assets that have a management company managing less than $25 billion. Proposed Regulation 1.25(c)(3)(i)(F).

[21] ETFs with at least $1 billion in assets that have a management company managing at least $25 billion. Proposed Regulation 1.25(c)(3)(i)(E).

[22] ETFs with less than $1 billion in assets or with a management company managing less than $25 billion. Proposed Regulation 1.25(c)(3)(i)(F).

[23] Proposing Release at 81256.

[24] Proposing Release at 81256. As support for this concern, the Commission cites the cyber-attack against ION Cleared Derivatives.

[25] Id. at 81257.

[26] Id.

[27] As support for this concern, the Commission cites the Reserve Primary Fund "breaking the buck" in September 2008. Proposing Release at n.239. The Reserve Primary Fund, however, was a prime MMF that held a range of privately issued debt in its portfolio, including commercial paper issued by Lehman Brothers.

[28] Proposing Release at 81257.

[29] See Regulations 1.29; 22.2(e)(1); 30.7(i).
