**MEMO# 35966**

December 19, 2024

# CFTC Adopts Revisions to Regulation 1.25 Permitted Investments

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TO: ICI Members
Derivatives Markets Advisory Committee
ETF (Exchange-Traded Funds) Committee
Money Market Funds Advisory Committee
Registered Fund CPO Advisory Committee SUBJECTS: CPO/CTA
Derivatives
Exchange-Traded Funds (ETFs)
Money Market Funds RE: CFTC Adopts Revisions to Regulation 1.25 Permitted Investments

On December 17, 2024, the Commodity Futures Trading Commission (CFTC) approved a final rule amending CFTC Regulation 1.25, which provides for the safeguarding and investment of customer funds by futures commission merchants (FCMs) and derivatives clearing organizations (DCOs).[1] Among other amendments,[2] Regulation 1.25 now (i) allows short-term Treasury exchange-traded funds meeting certain conditions to qualify as permitted investments ("Permitted Treasury ETFs"), (ii) limits the scope of money market funds as permitted investments to government money market funds within the meaning of SEC Rule 2a-7 that do not elect to apply a discretionary liquidity fee ("Permitted Government MMFs"), and (iii) amends the concentration limits for investing customer funds into permitted investments.

ICI previously submitted comments to the proposed Regulation 1.25 amendments on January 17, 2024.[3] While ICI supported adoption of the rule amendments, ICI focused on suggested amendments to the proposed conditions related to Permitted Treasury ETFs and the concentration limits. This memorandum outlines what was suggested by ICI and what the CFTC ultimately adopted. Regarding the proposed amendments to align permitted money market funds with "government money market funds" as defined in Rule 2a-7 that do not elect to have a discretionary liquidity fee, ICI did not comment on this aspect of the amendments and they were adopted primarily as proposed. The compliance date for the adopted amendments is 30 days after the rule is published in the Federal Register, which as of the date of this memo has not yet occurred.[4]

## Permitted Treasury ETFs

As proposed, ICI believed that certain of the CFTC's conditions for Permitted Treasury ETFs were overly restrictive and could be broadened to better to achieve Regulation 1.25's regulatory objectives. In its letter, ICI recommended the following revisions to the proposed conditions:

- To better align with existing ETF market structure, ICI strongly urged the CFTC to revise its proposed condition of requiring an FCM or DCO to be an authorized participant (AP) of a Permitted Treasury ETF to allow an FCM or DCO to either be an AP of the Permitted Treasury ETF or have entered into an agreement with an AP to execute agency transactions on the FCM's or DCO's behalf.
- As opposed to requiring Permitted Treasury ETFs to redeem in cash, ICI recommended that the CFTC should permit redemptions to be in 1) cash or 2) in-kind with a same-day redemption option.
- ICI also recommended that any final portfolio requirement should include cash as satisfying the threshold. Further, in response to the CFTC proposing a 95% threshold for portfolio investment in eligible US Treasury securities, ICI recommended that, for the avoidance of doubt, the CFTC explicitly confirm that it is establishing a separate portfolio test for a Permitted Treasury ETF and not requiring such ETF to change any existing investment policy, potentially adopted pursuant to SEC Rule 35d-1 ("Names Rule"), or associated disclosure.
- ICI also recommended that redemption exceptions for MMFs under Regulation 1.25(c)(5)(ii) should be extended to Permitted Treasury ETFs.

In response to ICI's comments, the CFTC primarily adopted all of the suggestions. In particular:

- An FCM or DCO is able to invest customer funds in Permitted Treasury ETFs either as an AP of the ETF or by entering into an agency agreement with an AP, whereby the AP would transact with the ETF on behalf of the FCM or DCO. In both instances, the transactions must take place on a delivery-versus-payment (DVP) basis, such that no customer funds are transferred out of the segregated customer accounts until property of equal or greater value is deposited in the customer segregated accounts. Any fee paid to the AP for services provided to the FCM or DCO may not be paid with customer funds.[5]
- The CFTC did not mandate that the ETF redeem in cash as proposed but rather that (i) for FCMs that are APs of Permitted Treasury ETFs, redemptions in-kind are allowed, provided that the FCM has the operational ability to convert the instruments received pursuant to the redemption into cash within one business day; and (ii) an FCM or DCO conducting the redemption through an AP must ensure that its contractual agreement with the AP requires the AP to transfer cash to the customer segregated account of the FCM or DCO, on a DVP basis, within one business day.
- The CFTC included cash in the 95% portfolio threshold requirement. Further, the CFTC clarified that the 95% portfolio threshold requirement is satisfied if the Permitted Treasury ETF effectively invests 95% or more of its assets in eligible securities and cash, even if the ETF's registration statement sets a lower threshold due to the Names Rule.[6]
- The CFTC allowed Permitted Treasury ETFs to rely on the redemption exceptions under Regulation 1.25(c)(5)(ii).

Additionally, the CFTC also made the following amendments, which ICI also supported:

- FCMs and DCOs may buy and sell Permitted Treasury ETFs in the secondary market, provided such transactions are in compliance with the CFTC's segregation requirements and consistent with Regulation 1.25's liquidity requirements, as well as all other applicable provisions. However, FCMs would be subject to a 6% capital charge on investments in Permitted Treasury ETF shares that do not comprise a full creation unit, in accordance with SEC guidance applying a capital charge of 2% on the market value of a creation unit of ETF shares and a capital charge of 6% on the market value of ETF shares that do not comprise a full creation unit.
- The CFTC did not adopt the proposed requirement that a Permitted Treasury ETF be acceptable by a DCO as performance bond from clearing members to margin customer trades.
- The CFTC amended the final rule to clarify that the FCM or DCO should obtain the acknowledgment letter mandated by Regulation 1.20, as required for any investment of customer funds in permitted investments except certain MMF custody situations, and removed reference to a Regulation 1.26 acknowledgment letter that was creating confusion among market participants.

All other proposed conditions to be a Permitted Treasury ETF were generally agreed upon and adopted without material amendment.[7]

## Concentration Limits

As proposed, ICI believed the single-issuer concentration limits of 5% for each of Permitted Government MMFs and Permitted Treasury ETFs were overly restrictive and not properly calibrated to balance the CFTC's underlying policy objectives with potential risk concerns. For concentration limits, ICI recommended that the CFTC revise its proposed issuer-based concentration limits for each of Permitted Government MMFs and Permitted Treasury ETFs from 5% to 25%, consistent with the current concentration limits for US agency obligations.

Based on conversations with CFTC staff and Commissioners, it seemed likely that the CFTC would adopt something greater than 5% but less than 25%. As adopted, the CFTC raised the proposed 5% individual fund concentration limit for each of Permitted Government MMFs and Permitted Treasury ETFs to 10%. Collectively, the concentration limits for each of Permitted Government MMFs and Permitted Treasury ETFs are as follows:

- Asset-based concentration limit of 50% for each of Permitted Government MMFs and Permitted Treasury ETFs that hold at least $1 billion in assets and whose management company manages at least $25 billion in assets.
- Asset-based concentration limit of 10% for each of Permitted Government MMFs and Permitted Treasury ETFs that hold less than $1 billion in assets or have a management company with less than $25 billion in assets under management.
- Issuer-based concentration limit of 25% per family of funds and 10% per fund for each of Permitted Government MMFs and Permitted Treasury ETFs.[8]

Kevin Ercoline
Assistant General Counsel

**Notes**

[1] Investment of Customer Funds by Futures Commission Merchants and Derivatives, RIN

3038-AF24 (Dec. 17, 2024), available at
https://www.cftc.gov/media/11616/VotingCopy120624Regulation1_25/download.

[2] The CFTC also made amendments (i) allowing certain foreign sovereign debt instruments issued by Canada, France, Germany, Japan, and the United Kingdom as permitted investments; (ii) removing certificates of deposit issued by a bank, corporate notes, corporate bonds, and commercial paper as permitted investments; (iii) making certain related and conforming changes to reflect the amendments to the list of permitted investment (i.e. specifying capital charges that apply to the new categories of permitted investments, updating template acknowledgement letters, etc.); (iv) replacing LIBOR with SOFR; (v) eliminating the read-only access provisions; and (vi) amending Regulation 22.3(d) to clarify that DCOs are financially responsible for any losses resulting from investments of cleared swaps customer collateral in permitted investments.

[3] Letter from Sarah Bessin, Deputy General Counsel, and Kevin Ercoline, Assistant General Counsel, ICI, to Christopher Kirkpatrick, Secretary, CFTC (Jan. 17, 2024), available at https://comments.cftc.gov/Handlers/PdfHandler.ashx?id=35157. See also 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.

[4] Amendments to the SIDR Report and Risk Disclosure Statement, which were not a focus of ICI's comment letter, have a compliance date of March 31, 2025.

[5] The CFTC later states that "[R]egardless of the exact process used by FCMs and DCOs to transact with an authorized participant, for the transaction to be compliant with Commission regulations, the FCM or DCO must ensure that: (i) all Commission segregation requirements are met throughout the process; (ii) the transaction occurs on a DVP basis; (iii) no fees and/or other costs associated with the transaction are charged to the customer segregated accounts; and (iv) no person, including, but not limited to, the ETF or the authorized participant has any claim over Customer Funds held by the FCM or DCO."

[6] To ensure that an ETF meets the conditions for qualification as a Permitted Treasury ETF, FCMs and DCOs must verify that the Permitted Treasury ETF satisfies the 95% threshold requirement.

[7] A "Permitted Treasury ETF" must also (i) be a registered investment company under the Investment Company Act of 1940 with the SEC and hold itself out as an ETF under SEC Rule 6c-11; and (ii) be passively managed and seek to replicate the performance of a published short-term U.S. Treasury security index. "Short-term US Treasury securities" are bonds, notes, and bills with a remaining maturity of 12 months or less, issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the US Department of the Treasury. Additionally, (i) the Permitted Treasury ETF must be 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 Federal Deposit Insurance Corporation; (ii) the NAV for the Permitted Treasury ETF must be computed by 9 a.m. of the business day following each business day and made available to an FCM or DCO that acquires and holds interests in Permitted Treasury ETFs, as applicable, by that time; and (iii) the Permitted Treasury ETF must be legally obligated to redeem its interests and make payment in satisfaction of the interests by the business day following a redemption request. Further, FCMs and DCOs may not enter into an agreement that would prevent it

from pledging the Permitted Treasury ETF's shares. FCMs and DCOs must also maintain confirmations relating to their purchase of interests in a Permitted Treasury ETF in their records as well as other recordkeeping requirements under Regulation 1.25.

[8] To be clear, an FCM or DCO could invest (i) 50% of its assets in Permitted Government MMFs and 50% of its assets in Permitted Treasury ETFs, and (ii) 25% of its assets in a family of Permitted Government MMFs and 25% of its assets in a family of Permitted Treasury ETFs even if the family of Permitted Government MMFs and Permitted Treasury ETFs was the same.

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