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CLIENT ALERT

CFTC Amends Regulation on the Investment of Customer Funds

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The Commodity Futures Trading Commission has amended its rules regarding permitted investments for customer funds held by futures commission merchants ("**FCMs**") and derivatives clearing organizations ("**DCOs**").[1] The CFTC was responding to requests from the derivatives industry to expand the types of instruments in which customer assets may be invested. In adopting the final rule, the CFTC provided FCMs and DCOs with a greater diversity of investment choices across all customer account classes while establishing guardrails to ensure that permitted investments do not expose customers to undue risks.

The protection of customer assets is a core mission of the CFTC and a stated purpose of the Commodity Exchange Act ("**CEA**").[2] FCMs and DCOs are required to segregate customer assets supporting futures, foreign futures, and cleared swaps (collectively, "**customer funds**") from their own funds and use such funds only to cover the liabilities

1 *Investment of Customer Funds by Futures Commission Merchants and Derivatives Clearing Organizations*, 90 Fed. Reg. 7810 (Jan. 22, 2025), available here.

2 7 U.S.C. § 5(b) (stating that, to foster certain public interests, the purpose of the CEA is "to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets").

of customers, among other segregation requirements. The customer protection framework is designed to ensure that if an FCM or DCO becomes insolvent or becomes a debtor in a bankruptcy proceeding, customer assets will be returned promptly. CFTC regulation 1.25 allows FCMs and DCOs to invest these segregated customer funds in certain permitted investments "consistent with the objectives of preserving capital and maintaining liquidity" in such investments.[3]

Since its original adoption in 1968, the list of permitted investments evolved largely in response to the failures of large FCMs or major financial crises. The CFTC is further amending the list of permitted investments under CFTC regulation 1.25 by: (i) limiting the scope of investments in money market funds ("**MMFs**"); (ii) adding specified foreign sovereign debt instruments and U.S. Treasury exchange-traded funds ("**ETFs**"); and (iii) removing certificates of deposit, commercial paper, corporate notes, and corporate bonds. The CFTC also made several conforming changes and clarifications, in addition to modernizing CFTC regulation 1.25. Each change to the list of permitted investments is generally described below.

Limiting the scope of investments in government MMFs.

Going forward, FCMs and DCOs may only invest customer funds in a more limited set of MMFs. MMFs whose redemptions may be subject to a liquidity fee do not qualify as a permitted investment, and as a result, FCMs and DCOs may invest customer funds only in government MMFs, as defined in Securities and Exchange Commission ("**SEC**") regulation 270.2a-7, that do not elect to be subject to liquidity fees in accordance with SEC regulation 270.2a-7(c)(2)(i).[4] The imposition of liquidity fees on redemptions may help decrease outflows from certain MMFs, particularly during times of economic or market stress. However, the CFTC believes that these provisions may reduce the principal of an FCM's or DCO's investment in government MMF shares and thus affect the liquidity of the FCM or DCO customer accounts and potentially prevent the FCM and DCO from repaying customers in full.[5] FCMs and DCOs must also consider the CFTC's conforming changes, including amendments to the template acknowledgment letter to include a template representation regarding liquidity fees.

Adding U.S. Treasury ETFs as an asset class.

FCMs and DCOs will now be able to invest customer funds in certain ETFs. The CFTC added to the list of permitted investments certain U.S. Treasury ETFs, as defined in SEC regulation 270.6c-11. To qualify as a permitted investment, the ETF must replicate the performance of a published short-term U.S. Treasury security index that is

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3 17 C.F.R. § 1.25(b).

4 A government MMF must be an investment company registered under the Investment Company Act with the SEC and hold itself out as a government MMF, in accordance with SEC regulation 270.2a-7.

5 90 Fed. Reg. 7816.

composed of bonds, notes and bills. The index components must have a remaining maturity of 12 months or less and be issued, or unconditionally guaranteed by, the U.S. Treasury.[6]

An investment in U.S. Treasury ETFs must conform to certain conditions. For example, the securities comprising the short-term U.S. Treasury index (together with cash) must represent, effectively, 95% of the ETF's investment portfolio. Additionally, for primary market transactions, purchases and sales of ETF shares must be effected on a delivery-versus-payment basis using a net asset value determined in accordance with the Investment Company Act and regulations promulgated thereunder. ETF shares may be redeemed in cash within one business day of the redemption request and the shares may also be redeemed in kind, assuming that the FCM or DCO has the operational ability to convert such instruments into cash within one business day of the redemption request. However, an FCM or DCO that is not an authorized participant must have a contractual agreement with the authorized participant to transfer cash into the segregated account within one business day of the redemption request. U.S. Treasury ETF shares may also be acquired or sold on the secondary market.[7]

The CFTC believes that the inclusion of U.S. Treasury ETFs in the list of permitted investments "would foster innovation and promote competition in the ETF market and the financial services industry more generally."[8] According to the CFTC, this amendment is designed to "provide FCMs and DCOs with an efficient means for investing indirectly in permitted investments, specifically U.S. Treasury securities, while allowing FCMs and DCOs to reduce the expenses and resources required to manage individual, direct investments in such instruments."[9]

Adding certain foreign sovereign debt as an asset class.

With some adjustments, the CFTC codified the "tightly circumscribed risk characteristics" set forth in the order it issued in 2018 that permitted "DCOs to invest futures customer funds and Cleared Swaps Customer Collateral in the foreign sovereign debt of France and Germany."[10] FCMs and DCOs may invest customer funds in the sovereign debt of Canada, Japan, and the United Kingdom, in addition to France and Germany, to the extent the FCM or DCO has balances in accounts owed to customers or FCMs denominated in the country's currency.

Investments in permitted foreign sovereign debt must also conform to certain conditions. For example, the two-year credit spread of the issuing sovereign must be 45 basis points or less. Additionally, the dollar-weighted average time-to-maturity of investments in permitted sovereign debt must not exceed 60 calendar days, computed on a portfolio of securities on a country-by-county basis, with special considerations for repurchase and reverse repurchase agreements. The CFTC imposed a 180-calendar day maximum remaining time-to-maturity for each

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6 A U.S. Treasury ETF must be an investment company registered under the Investment Company Act with the SEC and hold itself out as an ETF, in accordance with SEC regulation 270.6c-11.

7 FCMs and DCOs must maintain records of confirmations, document ownership in their custody accounts, and review the government ETF's investments.

8 90 Fed. Reg. 7831.

9 *Id*. at 7836.

10 *Id*. at 7828, 7813.

security. The CFTC believes this amendment will help FCMs and DCOs manage foreign exchange risk that may arise from administering and investing customer funds.[11]

The CFTC also made changes to the conditions applicable to the purchase and sale of permitted investments through repurchase and reverse repurchase agreements. Specifically, the CFTC expanded the permissible counterparties and depositories that can be used in connection with these instruments to include foreign banks and foreign broker-dealers meeting certain requirements, the European Central Bank, and the central banks of Canada, France, Germany, Japan, and the United Kingdom.

A foreign bank must qualify as a depository under CFTC regulation 1.49(d)(3). The foreign broker-dealer must be located in a money center country and be regulated by a foreign financial regulator or a provincial financial regulator with respect to a Canadian securities broker-dealer. The CFTC noted that these conditions are meant to ensure that permitted counterparties are "regulated entities comparable to those counterparties already permitted under Commission regulation 1.25(d)(2)."[12]

***Removing or modifying certain permitted investments and making conforming changes*.**

The final rule also made additional amendments to modernize the rules, provide regulatory clarification, and conform the CFTC's rules with the changes made to the list of permitted investments, which are generally described below.

- Commercial paper, corporate notes, and corporate bonds no longer qualify as permitted investments because they have not been permitted investments since the expiration of the Temporary Liquidity Guarantee Program ("**TLGP**") in 2012. They were only permitted if they were guaranteed under the TLGP administered by the FDIC.

- Bank certificates of deposit ("**CDs**") were removed from the list of permitted investments because, based on the CFTC's experience, FCMs and DCOs do not invest customer funds in bank CDs.

- LIBOR was replaced with SOFR as a permitted benchmark for variable and floating interest rates for adjustable-rate securities that qualify as permitted investments, given the cessation of LIBOR and the adoption of SOFR as the replacement rate.

- The CFTC amended certain capital charges, financial reporting requirements, and asset-based and insurer-based concentration limits to cover the new permitted investments and reflect the CFTC's experience administering CFTC regulation 1.25.

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11 *Id*. at 7824.

12 *Id*. at 7828.

- The CFTC clarified that DCOs are responsible for losses that result from investing cleared swaps customer collateral in permitted investments, which provides legal certainty that cleared swaps customers do not bear investment losses.

- FCMs are no longer required to provide the CFTC with direct, read-only electronic access to customer fund accounts, which was superfluous given that Chicago Mercantile Exchange ("**CME**") and National Futures Association ("**NFA**") receive daily reports of account balances from depositories and the operational challenges the CFTC experienced in implementing this requirement. The direct-access language has been removed from acknowledgment letters from depositories.

- The content of the segregation investment detail report ("**SIDR Report**") providing information about segregation investments must be amended to reflect the updates to the list of permitted investments.

- Customer risk disclosure statements must be amended to reflect the changes to the list of permitted investments.

Effective and compliance dates.

The effective date of the final rule is February 21, 2025. The compliance date for the amendments to the SIDR Report and risk disclosure statement is March 31, 2025. The CFTC offered a longer compliance date, giving time for FCMs to update policies, procedures, systems, and practices to comply with the amendments to the SIDR Report; the CFTC, NFA, and CME to update the electronic filing systems used to receive and process those amended SIDR Reports; and FCMs (and introducing brokers) to update their risk disclosure statements and revise any electronic account opening documents and processes.[13]

These dates may, however, be impacted by a recent executive order, issued on January 20, 2025, calling for a regulatory freeze or the immediate withdrawal of any rule that was sent to the Office of the Federal Register but had not been published as of such date. The CFTC rules are subject to the review of Acting Chair Caroline Pham. Whether or not this rulemaking will be impacted by the executive order, we note that Acting Chair Pham voted in favor of it. Presumably, the CFTC will clarify this point for the industry.

[13] 90 Fed. Reg. 7856.

If you have any questions regarding this client alert, please contact one of the authors, any member of our CFTC team listed below, or the Willkie attorney with whom you regularly work.

Willkie has a dedicated team of attorneys with extensive knowledge and experience in all aspects of the Commodity Exchange Act and the CFTC regulatory regime. We would be pleased to assist on your matters.

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