U.S. COMMODITY FUTURES TRADING COMMISSION

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Market Participants Division
Division of Clearing and Risk

Re: CFTC Regulation 1.25 – Investment of Customer Funds in Securities with an Adjustable Rate of Interest Benchmarked to the Secured Overnight Financing Rate – Extension of Time-Limited No-Action Position Concerning Investments by Futures Commission Merchants and No-Action Position Concerning Investments by Derivatives Clearing Organizations

The U.S. Commodity Futures Trading Commission ("Commission" or "CFTC") Market Participants Division ("MPD") is extending the expiration of CFTC Staff Letter 21-02 concerning futures commission merchants ("FCMs") and, with the Division of Clearing and Risk ("DCR") (together, the "Divisions"), is expanding the scope of the position taken in that letter to provide relief to derivatives clearing organizations ("DCOs") consistent with the terms of the letter.[1]

CFTC Staff Letter 21-02 was issued in response to two separate requests for relief submitted by R.J. O'Brien & Associates LLC, a registered FCM,[2] and the Futures Industry Association ("FIA") on behalf of its member FCMs and similarly situated FCMs,[3] respectively. CFTC Staff Letter 21-02 provided, subject to the conditions therein, that MPD would not recommend enforcement action to the Commission prior to December 31, 2022, if FCMs invest

[1] CFTC Staff Letter No. 21-02 (Jan. 4, 2021), available here: https://www.cftc.gov/csl/21-02/download.

[2] Letter from Augustine Perrotta, Senior Director, Associate General Counsel, R.J. O'Brien & Associates LLC, dated October 2, 2020.

[3] FIA submitted a *Petition for Order under Section 4(c) of the Commodity Exchange Act* on September 4, 2019, requesting that the Commission issue an exemptive order under section 4(c) of the Commodity Exchange Act, or to issue such other relief as the Commission deems appropriate, to permit FCMs to invest customer funds in, among other instruments, certain securities that contain an adjustable rate of interest benchmarked to the Secured Overnight Financing Rate ("SOFR"). For the reasons discussed in CFTC Staff Letter 21-02, MPD deemed it appropriate to address FIA's request for relief for FCMs to invest customer funds in securities that contain an adjustable rate of interest benchmarked to SOFR through a no-action position.

customer funds pursuant to Commission regulation 1.25 in certain securities that contain an adjustable rate of interest that is benchmarked to SOFR.[4] By joint letter dated December 12, 2022, FIA, on behalf of its member FCMs and similarly situated FCMs, and CME Group Inc. ("CME") on behalf of its affiliated DCO, Chicago Mercantile Exchange, Inc., requested that the Commission take action to allow FCMs to continue to benefit from the position taken in CFTC Staff Letter 21-02 beyond the letter's current termination date of December 31, 2022. FIA and CME further requested that the Commission extend the relief provided in CFTC Staff Letter 21-02 to DCOs investing customer funds pursuant to Commission regulation 1.25, in addition to FCMs.[5]

I. Regulatory Background

Commission regulation 1.25(a) permits FCMs and DCOs to invest customer funds in the following defined investments ("permitted investments"): (i) United States ("U.S.") Treasury securities and other obligations fully guaranteed as to principal and interest by the U.S. government; (ii) general obligations of any State or of any political subdivision of a State; (iii) obligations of any U.S. government corporation or enterprise sponsored by the U.S. ("U.S. agency obligations"); (iv) certificates of deposit issued by banks; and (v) money market mutual funds.[6] The list of permitted investments applies to "futures customer funds"[7] and "cleared swaps customer collateral"[8] held by an FCM or DCO,[9] and "30.7 customer funds"[10] held by an FCM.[11] Commission regulation 1.25(b)(2)(iv)(A) further provides that if an FCM or a DCO elects to invest customer funds in a permitted investment that contains an adjustable rate of interest, the interest rate must correlate closely with, or be determined solely by reference to, a benchmark of either the Federal Funds target or effective rate, the prime rate, the three-month Treasury Bill rate, the one-month or three-month London Interbank Offered Rate ("LIBOR"), or the interest rate of any fixed rate instrument that is a permitted investment.

LIBOR, which is one of the authorized benchmark rates, is a benchmark interest rate at which major global banks lend to one another in the international interbank market for short term

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[4] 17 CFR 1.25 (2022).

[5] Letter from Allison Lurton, General Counsel and Chief Legal Officer, FIA, and Christopher Bowen, Managing Director and Chief Regulatory Counsel, CME, dated December 12, 2022.

[6] In addition, Commission regulation 1.25(a) lists commercial paper and corporate notes or bonds that are fully guaranteed as to principal and interest by the U.S. under the Temporary Liquidity Guarantee Program ("TLGP") administered by the Federal Deposit Insurance Corporation as permitted investments. The TLGP expired on December 31, 2012, and, accordingly, commercial paper and corporate notes or bonds are no longer permitted investments.

[7] 17 CFR 1.3.

[8] 17 CFR 22.1.

[9] 17 CFR 1.25(a), 22.2(e)(1) and 22.3(d).

[10] 17 CFR 30.1(h).

[11] 17 CFR 30.7(h)(1).

loans. In 2017, the United Kingdom Financial Conduct Authority ("FCA"), which regulates LIBOR's administrator, ICE Benchmark Administration Limited, raised questions regarding the sustainability of LIBOR and encouraged market participants and other stakeholders to begin planning a transition away from LIBOR.[12] The LIBOR panel banks, which provide information to compute LIBOR, agreed to continue submitting information until the end of 2021, later extended to the end of June 2023 for certain U.S. dollar LIBOR settings only, to provide time for market participants to move away from LIBOR.[13]

In parallel, in response to significant concerns regarding the robustness and reliability of the interbank offered rates ("IBORs"), including LIBOR, and their likely discontinuance, the Financial Stability Board ("FSB") called for the identification of alternative benchmarks and transition plans to support the implementation of such alternative benchmarks.[14] The U.S. Financial Stability Oversight Council ("FSOC") also made calls for member agencies to work closely with market participants to identify and mitigate risks that may arise during an IBOR transition process.[15] In response to ongoing efforts such as these, central banks in various

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[12] *See* Speech by Andrew Bailey, Chief Executive of the FCA, at Bloomberg London, UK, July 27, 2017, available at https://www.fca.org.uk/news/speeches/the-future-of-libor (announcing that the FCA had commitments from LIBOR panel banks that provide information to compute LIBOR to continue to contribute such information through the end of 2021, but that the FCA would not use its powers to compel or persuade contributions beyond such date). *See also*, Record of the Financial Policy Committee Meeting Held on September 20, 2017, Publication Date October 3, 2017, available at https://www.bankofengland.co.uk/-/media/boe/files/record/2017/financial-policy-committee-meeting-september-2017 (noting that it had become increasingly apparent that the absence of active underlying markets and the scarcity of term unsecured deposit transactions raised serious questions about the future sustainability of the LIBOR benchmarks).

[13] *See* Speech by Andrew Bailey, *supra* note 7. *See also*, FCA Press Release, Further Arrangements for the Orderly Wind-Down of LIBOR at end-2021, September 29, 2021, available at https://www.fca.org.uk/news/press-releases/further-arrangements-orderly-wind-down-libor-end-2021.

[14] *See* FSB statement, "Interest rate benchmark reform – overnight risk-free rates and term rates" (July 12, 2018), available at https://www.fsb.org/2018/07/interest-rate-benchmark-reform-overnight-risk-free-rates-and-term-rates/ ("Because derivatives represent a particularly large exposure to certain IBORs, and because these prospective [risk-free rate] RFR-derived term rates can only be robustly created if derivatives markets on the overnight RFRs are actively and predominantly used, the FSB believes that transition of most derivatives to the more robust overnight RFRs is important to ensuring financial stability."). In addition, the FSB's July 2014 recommendation to move to RFRs is available at https://www.fsb.org/wp-content/uploads/r_140722.pdf. *See also* Statement on Communication and Outreach to Inform Relevant Stakeholders Regarding Benchmarks Transition by the Board of the International Organization of Securities Commissions (IOSCO), July 31, 2019, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD636.pdf.

[15] *See, e.g.*, FSOC 2018 Annual Report, pages 4-5, 8-9, 108-109 (Dec. 19, 2018), available at https://home.treasury.gov/system/files/261/FSOC2018AnnualReport.pdf. ("The uncertainty surrounding LIBOR's sustainability may threaten individual financial institutions and the U.S. financial system more broadly. Specifically, without advance preparation, a sudden cessation of such a heavily used reference rate could cause considerable disruptions to, and uncertainties around, the large flows of LIBOR-related payments. It could also impair the functioning of a variety of markets, including business and consumer lending. The Council recommends that member agencies work closely with market participants to identify and mitigate risks from potential dislocations during the transition process."); *see also* FSOC 2013 Annual Report, pages 6, 14-15, 137, 140142 (June 2013) available at https://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202013%20Annual%20Report.pdf.

jurisdictions, including the United States, United Kingdom, Japan, Switzerland, and European Union, convened working groups of official sector representatives and market participants.

In June 2017, the Alternative Reference Rates Committee ("ARRC") identified SOFR as the preferred alternative benchmark to U.S. dollar LIBOR for certain new U.S. dollar derivatives and other financial contracts.[16] SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities, and is calculated and published by the Federal Reserve Bank of New York ("FRBNY").[17] SOFR is calculated as a volume-weighted median of transaction-level triparty repo data collected from the Bank of New York Mellon as well as data on bilateral U.S. Treasury repo transactions cleared through the Fixed Income Clearing Corporation.[18] The FRBNY, in cooperation with the U.S. Office of Financial Research, publishes SOFR by 8:00 am each business day.[19]

In March 2021, the FCA confirmed that LIBOR would either cease to be provided by any administrator or would no longer be representative for the one-week and two-month U.S. dollar LIBOR settings, immediately after December 31, 2021, and for all other U.S. dollar LIBOR settings immediately after June 30, 2023.[20]

II. Extension of Time Limit for No-Action Position for FCMs and No-Action Position with Respect to DCOs

MPD previously stated in CFTC Staff Letter 21-02 that, based upon the reasons set forth in the letter, MPD did not believe that the investment of customer funds in instruments that meet the criteria of "permitted investments" under Commission regulation 1.25, except for an adjustable rate that is benchmarked to SOFR, is contrary to the objectives of Commission regulation 1.25. Specifically, Commission regulation 1.25(b) requires that the investment of customer funds be managed consistent with the objectives of preserving principal and maintaining liquidity. In this regard, MPD noted, in its analysis of the request for relief, that the use of an interest rate benchmarked to SOFR in an adjustable rate debt security that otherwise

[16] The ARRC is a group of private-market participants convened to help ensure a successful transition from U.S. dollar LIBOR to a more robust reference rate. ARRC is comprised of a diverse set of private-sector entities, each with an important presence in markets affected by U.S. dollar LIBOR, and a wide array of official-sector entities, including banking and financial sector regulators, as ex-officio members.

[17] *See* Secured Overnight Financing Rate Data, published by the FRBNY and available at https://www.newyorkfed.org/markets/reference-rates/sofr.

[18] *Id*.

[19] *See* Additional Information about the Treasury Repo Reference Rates, published by the FRBNY and available at https://www.newyorkfed.org/markets/reference-rates/additional-information-about-reference-rates#information_about_treasury_repo_reference_rates.

[20] *See* FCA Announcement on Future Cessation and Loss of Representativeness of the LIBOR Benchmarks, March 5, 2021, available at https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf.

meets the criteria of Commission regulation 1.25 should have minimal, if any, impact on the credit risk of the permitted investments.[21]

In reaching this conclusion, MPD considered, among other factors, the volume of SOFR-linked debt securities issued by U.S. Government-sponsored enterprises ("GSEs"), such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, which issue U.S. agency obligations that are permitted investments.[22] In this regard, MPD notes that the volume of GSE SOFR-linked debt securities issuance grew considerably in the past few years, from approximately $35.6 billion in 2020 to approximately $316.9.8 billion as of November 2022, indicating an increasing reliance on SOFR in the issuance of this type of securities.[23]

In light of these considerations, MPD hereby extends the expiration of CFTC Staff Letter 21-02 until the earlier of December 31, 2024, or the effective date of any final Commission action addressing the addition of SOFR as a permitted benchmark for investments of customer funds, subject to continued compliance with the conditions of CFTC Staff Letter 21-02. For the same reasons, the Divisions believe that extending the position taken in CFTC Staff Letter 21-02 to DCOs investing customer funds pursuant to Commission regulation 1.25 is appropriate. In this respect, the Divisions believe that the analysis regarding SOFR-benchmarked adjustable rate securities discussed above supports this position. The Divisions are therefore taking a no-action position with respect to DCOs, subject to the conditions set forth in CFTC Staff Letter 21-02, through the duration of the no-action position as extended pursuant to this letter.

III. No-Action Position

Based on the facts and representations set forth in the submission dated December 12, 2022, requesting action with respect to the position taken in CFTC Staff Letter 21-02, including the extension of the no-action position to DCOs consistent with the aforementioned staff letter, as well as the staff's analysis of the information in this submission, the Divisions will not recommend enforcement action to the Commission if an FCM or a DCO invests customer funds (*i.e.*, with respect to investments by FCMs, funds deposited by customers trading futures, foreign futures, and cleared swaps, and, with respect to investments by DCOs, funds deposited by customers trading futures and cleared swaps) in permitted investments that contain an adjustable rate of interest that is benchmarked to SOFR. This no-action position extends to both the direct investment of customer funds in permitted investments that contain an adjustable rate of interest

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[21] *See* CFTC Staff Letter 21-02 at 5.

[22] *Id*.

[23] The data includes issuances by various GSE and is based on information obtained by accessing Bloomberg Terminal on November 21, 2022. *See also* Year-end Progress Report: The Transition from U.S. Dollar LIBOR, ARRC, December 2021, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/20211216-usd-libor-year-end-transition-progress-report, indicating that the issuance of GSE SOFR-linked mortgage-backed securities grew considerably, from approximately $30 billion issued in the period between January 2020 and March 2021 to approximately $60 billion issued between April and December 2021.

benchmarked to SOFR and to the purchase of securities that contain an adjustable rate of interest benchmarked to SOFR under agreements to resell such securities.

This no-action position is conditioned upon the FCM or DCO otherwise complying with all relevant terms and conditions of Commission regulation 1.25, including the requirement in Commission regulation 1.25(a) that the adjustable rate security is one of the enumerated permitted investments. An FCM or a DCO is also required to manage the investment of customer funds in adjustable rate securities that are benchmarked to SOFR consistent with the objectives of preserving principal and maintaining liquidity as required by Commission regulation 1.25(b). Furthermore, as required by Commission regulation 1.25(b)(1), an investment with an adjustable rate of interest benchmarked to SOFR must be highly liquid such that the investment has the ability to be converted into cash within one business day without material discount in value.

The Divisions also note that Commission regulation 1.29(b) provides that an FCM or a DCO, as applicable, is solely responsible for any losses resulting from the investment of customer funds under Commission regulation 1.25, and may not allocate any such losses to its customers. Commission regulation 1.17(c)(5)(v) also requires an FCM, in computing its adjusted net capital, to take capital charges on all permitted investments. This letter does not relieve an FCM or a DCO from compliance with Commission regulations 1.29(b) and 1.17(c)(5)(v), as applicable, with respect to an investment in a permitted security that contains an adjustable rate of interest benchmarked to SOFR.

The position taken in this letter will expire the earlier of **December 31, 2024** or the effective date of any final Commission action addressing the addition of SOFR as a permitted benchmark for investments of customer funds.

This letter, and the position taken herein, represent the views of the Divisions only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. This letter and the no-action position taken herein are not binding on the Commission.[24] The no-action position taken in this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the Commodity Exchange Act or in the Commission Regulations. Further, this letter, and the position taken herein, are based upon the representations made to the Divisions. Any different, changed, or omitted material facts or circumstances might render this no-action position void.

Finally, as with all staff letters, the Divisions retain the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the position taken herein in their discretion. If you have any questions concerning this letter, please feel free to contact Thomas Smith, Deputy Director, at (202) 418-5495; Warren Gorlick, Associate Director, at (202) 418-5195; Carmen Moncada-Terry, Special Counsel, at (202) 418-5795; Lily Bozhanova, Special Counsel, at (202) 418-6232, MPD; or Parisa Nouri, Associate Director, at (202) 418-6620, DCR.

[24] *See* 17 CFR 140.99(a)(2) ("A no-action letter binds only the issuing Division […] and not the Commission or other Commission staff.").

Sincerely,

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Clark Hutchison
Director
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