



U.S. COMMODITY FUTURES TRADING COMMISSION

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Market Participants
Division

Joshua B. Sterling
Director

Re: CFTC Regulation 1.25 – Investment of Customer Funds – Time-Limited No-Action Position for Investments in Securities with an Adjustable Rate of Interest Benchmarked to the Secured Overnight Financing Rate

Ladies and Gentlemen:

This letter is in response to requests received by the Market Participants Division (“MPD”) of the Commodity Futures Trading Commission (“CFTC” or “Commission”) for confirmation that MPD will not recommend an enforcement action to the Commission if futures commission merchants (“FCMs”) invest customer funds pursuant to Commission Regulation 1.25 (“Regulation 1.25”) in certain securities that contain an adjustable rate of interest that is benchmarked to the Secured Overnight Financing Rate (“SOFR”).¹

MPD received two separate requests for relief. One request was submitted by R.J. O’Brien & Associates LLC (“RJO”), a registered FCM.² A second request was submitted by the Futures Industry Association (“FIA”) on behalf of its member FCMs and similarly situated FCMs.³

¹ Commission regulations are found at 17 CFR Ch. 1. The requests for no-action relief were submitted to the Division of Swap Dealer and Intermediary Oversight (“DSIO”). DSIO was renamed the MPD effective November 8, 2020 as part of a Commission reorganization.

² Letter from Eric Gurdian, Executive Director, Global Treasurer, 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 Act, or to issue such other relief as the Commission deems appropriate, to permit FCMs to: (i) invest customer funds in certain specified foreign sovereign debt; (ii) engage in repurchase transactions with certain specified foreign sovereign debt; (iii) engage in repurchase transactions on an internal basis or with affiliates; and, (iv) invest customer funds in certain securities that contain an adjustable rate of interest benchmarked to SOFR. Commission staff is currently considering FIA’s petition. However, due to the rapid changes developing with the use of SOFR as discussed in this letter and FIA’s general request for relief as the Commission deems appropriate in its petition, MPD is including

I. Background

Regulation 1.25(a) permits FCMs 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.⁴ Regulation 1.25(b)(2)(iv)(A) further provides that if an FCM 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 loans. LIBOR is administered by the ICE Benchmark Administration Limited, and is published each business day. In July 2017, the U.K. Financial Conduct Authority (“FCA”), which regulates ICE Benchmark Administration Limited, announced that it has 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 will not use its powers to compel or persuade contributions beyond such date.⁵ Therefore, LIBOR may be phased-out as a published benchmark rate in 2021.

II. Request for Relief

FIA and RJO requested relief to permit FCMs to invest customer funds in investments that otherwise qualify as permitted investments under Regulation 1.25, with the exception that the investments contain an adjustable rate of interest that is benchmarked to SOFR. SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities

FIA’s request for relief for FCMs to invest customer funds in securities that contain an adjustable rate of interest benchmarked to SOFR in this no-action letter.

⁴ The list of permitted investments set forth in Regulation 1.25(a) is applicable to funds deposited by customers with an FCM to trade futures and options on futures. The Commission also has extended the list of permitted investments to funds deposited by customers with FCMs to margin foreign futures and Cleared Swaps positions. *See*, Regulations 30.7(h) and 22.2(e)(1), respectively.

In addition, 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.

⁵ *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>.

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in the repo markets used by financial institutions, governments, and corporations.⁶ 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.⁷ The Federal Reserve Bank of New York, in cooperation with the U.S. Office of Financial Research, publishes SOFR by 8:00 am each business day.⁸

RJO and FIA stated that SOFR is becoming more widely accepted and used as a benchmark rate. RJO stated that since 2018, SOFR-linked securities have grown to approximately \$900 billion, with more than \$600 billion issued in 2020 alone. RJO also represented that U.S. Government-sponsored enterprises that issue U.S. agency obligations, such as the Federal National Mortgage Association (“Fannie Mae”) and Federal Home Loan Mortgage Corporation (“Freddie Mac”), will cease issuing debt linked to LIBOR beyond December 31, 2020⁹ and June 30, 2021,¹⁰ respectively. RJO further represented that Federal Housing Finance Agency (“FHFA”) has instructed all Federal Home Loan Banks to no longer enter into new financial assets, liabilities, and derivatives that reference LIBOR and mature after December 31, 2021.¹¹

RJO asserted that investing customer funds in permitted investments that contain an adjustable rate of interest benchmarked to SOFR is not contrary to the regulatory protections that Regulation 1.25 affords such funds. RJO stated that the liquidity of SOFR linked securities and its industry-wide acceptance, including by government-sponsored enterprises issuing debt utilizing SOFR as a reference rate, demonstrate that an investment of customer funds in such securities is consistent with Regulation 1.25’s principles of “preserving principal and maintaining liquidity”.¹² As such, RJO requested that MPD staff provide no-action relief to permit RJO to invest customer funds in permitted investments that pay interest based on an adjustable rate that uses SOFR as the benchmark rate.

⁶ See Secured Overnight Financing Rate Data, published by the Federal Reserve Bank of New York (“FRBNY”) and available at <https://apps.newyorkfed.org/markets/autorates/sofr>.

⁷ *Id.*

⁸ See Additional Information about the Treasury Repo Reference Rates, published by the FRBNY and available at <https://www.newyorkfed.org/markets/treasury-repo-reference-rates-information>.

⁹ See Fannie Mae LIBOR Transition Timeline, FANNIE MAE, available at <https://capmkt.fanniemae.com/resources/file/fundmarket/pdf/libor-transition-timeline.pdf>.

¹⁰ See Key LIBOR Transition Milestones, FREDDIE MAC, available at http://www.freddiemac.com/about/pdf/key_LIBOR_transition_milestones.pdf.

¹¹ See Memo from Andre D. Galeano, Deputy Director of the Division of Federal Home Loan Bank Regulation to Federal Home Loan Bank Presidents and Chief Executive Officers, FHFA (Sep. 27, 2019) at 5, available at https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Supervisory-Letter_Planning-for-LIBOR-Phase-Out.pdf. See also, FHFA News Release issued on September 27, 2019 and available at <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Instructs-FHLBanks-to-Begin-Transitioning-Away-from-LIBOR.aspx>.

¹² 17 CFR § 1.25(b).

III. Analysis of Request for Relief

Regulation 1.25 authorizes FCMs to invest customer funds in defined permitted investments, including investments that contain an adjustable rate of interest benchmarked to specified interest rates, including LIBOR. In response to significant concerns regarding the reliability and robustness of the interbank offered rates (“IBORs”), including LIBOR, the Financial Stability Board (“FSB”) called for the identification of alternative benchmarks to the IBORs and transition plans to support the implementation of such benchmarks.¹³ The U.S. Financial Stability Oversight Council (“FSOC”) also has made calls for member agencies to work closely with market participants to identify and mitigate risks that may arise during an IBOR transition process.¹⁴ In response to ongoing efforts such as these, central banks in various jurisdictions, including the United States, United Kingdom, Japan, Switzerland, and European Union, have convened working groups of official sector representatives and market participants.

In June 2017, the Alternative Rates Reference 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.¹⁵ As noted above, SOFR is based on the cost of borrowing cash

¹³ 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>.

¹⁴ 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>.

¹⁵ 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. AARC 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.

overnight collateralized by U.S. Treasury securities, and is calculated and published by the FRBNY.

As noted above, U.S. Government-sponsored enterprises, which issue U.S. agency obligations that are permitted investments, are currently issuing debt linked to SOFR. In this regard, Fannie Mae and Freddie Mac have issued collectively approximately \$173 billion in debt securities using SOFR as the benchmark interest rate.¹⁶ We understand reliance on SOFR for issuing these kinds of debt-linked securities will continue.

Based upon the above, MPD does not believe that the investment of customer funds in investments that meet the criteria of “permitted investments” under Regulation 1.25 except for an adjustable rate of interest that is benchmarked to SOFR is contrary to objectives of Regulation 1.25, including the requirement in Regulation 1.25(b) to manage investments consistent with the objectives of preserving principal and maintaining liquidity. In this regard, the use of an interest rate benchmarked to SOFR in an adjustable rate debt security that otherwise meets the criteria of Regulation 1.25 should have minimal, if any, impact on the credit risk of the permitted investments.

IV. Conclusion

Based on the facts and representations set forth in the submissions and staff’s analysis of the information, MPD staff will not recommend enforcement action to the Commission if an FCM invests customer funds (*i.e.*, funds deposited by customers trading futures, foreign futures, or 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 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 otherwise complying with all relevant terms and conditions of Regulation 1.25, including the requirement in Regulation 1.25(a) that the adjustable rate security is one of the enumerated permitted investments. An FCM 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 Regulation 1.25(b). Furthermore, as required by 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.

MPD also notes that Regulation 1.29 provides that an FCM is solely responsible for any losses resulting from the investment of customer funds under Regulation 1.25, and may not allocate any losses to its customers. 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 no-action letter does not relieve an FCM from compliance with Regulations 1.29 and 1.17(c)(5)(v)

¹⁶ Information obtained by accessing Bloomberg Terminal on August 7, 2020.

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with respect to an investment in a permitted security that contains an adjustable rate of interest benchmarked to SOFR.

This letter, and the position taken herein, are based upon the representations made to us and are subject to compliance with the conditions stated above. Any different, changed or omitted material facts or circumstances might require MPD to reach a different conclusion and render this letter void. You must notify MPD immediately in the event there is any change to the facts presented to MPD. This letter does not provide no-action relief from any provision of Commission Regulation 1.25 except as specifically noted above, or from any other applicable requirements in the Commodity Exchange Act or in the Regulations issued thereunder. This letter represents the position of MPD only and does not necessarily represent the views of the Commission or of any other division or office of the Commission. Further, this letter does not create or confer any rights for or obligations on any person or persons subject to compliance with the Commodity Exchange Act that bind the Commission or any of its other offices or divisions. Finally, this letter shall expire no later than December 31, 2022.¹⁷

If you have any questions concerning this correspondence, please contact Mark Bretscher, Special Counsel at (312) 596-0529 or mbretscher@cftc.gov, or Thomas Smith, Deputy Director, at (202) 418-5495 or tsmith@cftc.gov.

Sincerely,

Joshua B. Sterling
Director

¹⁷ As noted above, MPD staff is currently reviewing a petition submitted by FIA to amend Regulation 1.25. A two-year period will provide staff with adequate time to include the relief provided in this letter as part of its ongoing review of the FIA petition.