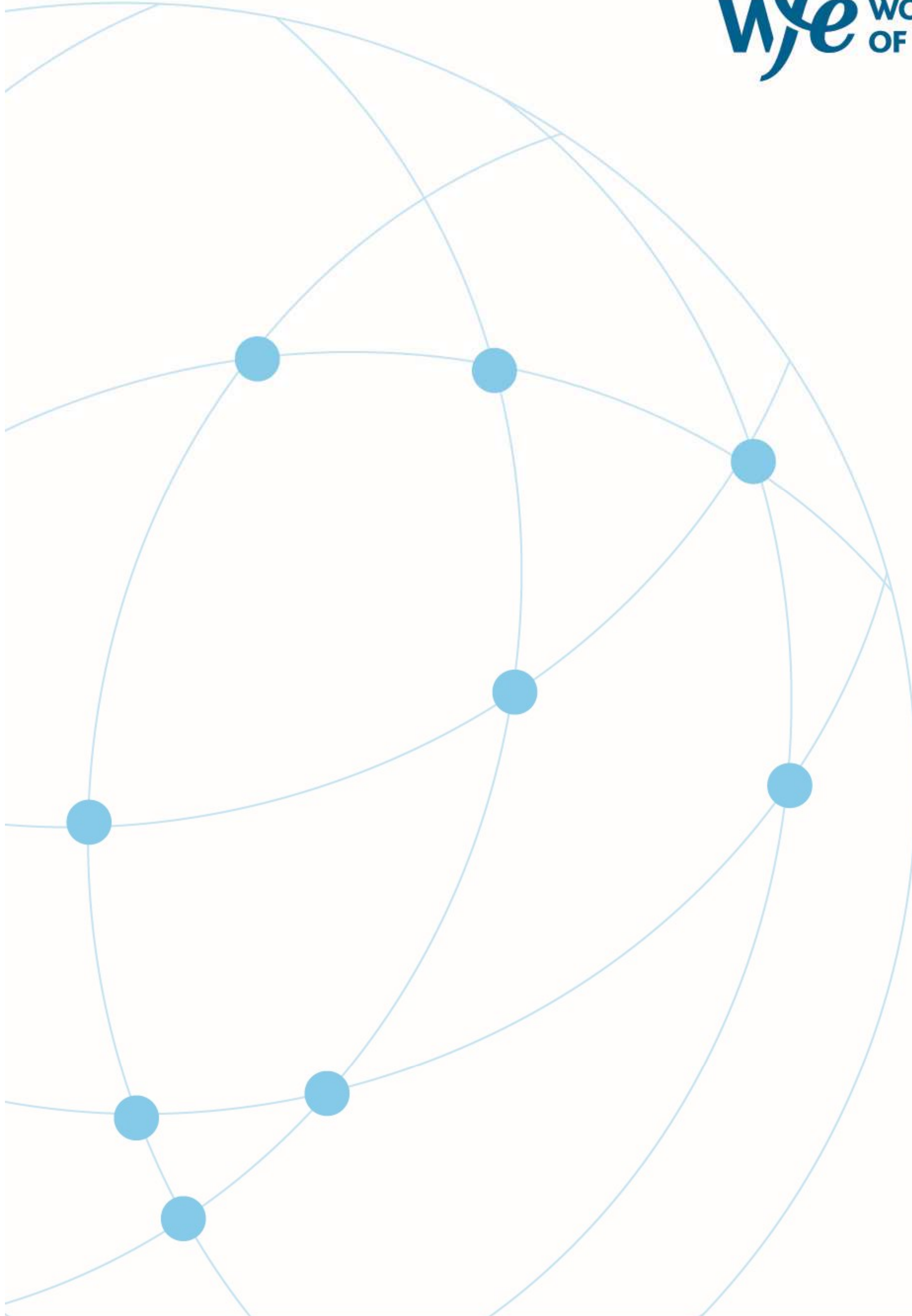

WORLD FEDERATION OF EXCHANGES

Response: The CFTC's Proposed Rulemaking Regarding Investment of Customer Funds by Futures Commission Merchants and Derivatives Clearing Organisations

Background

Established in 1961, the World Federation of Exchanges (WFE) is the global industry association for exchanges and clearing houses (CCPs). Headquartered in London, it represents over 250 market infrastructure providers, including standalone CCPs that are not part of exchange groups. Of our members, 34% are in Asia-Pacific, 45% in EMEA, and 21% in the Americas.

The WFE's 90 member CCPs and clearing services collectively ensure that risk takers post some $1.3 trillion (equivalent) of resources to back their positions, in the form of initial margin (IM) and default fund requirements. WFE exchanges, together with other exchanges feeding into our database, are home to over 50,000 listed companies, and the market capitalisation of these entities is over $100 trillion; around $140 trillion (EOB) in trading annually passes through WFE members (at end 2022).

The WFE is the definitive source for exchange-traded statistics and publishes over 350 market data indicators. Its free statistics database stretches back more than 40 years and provides information and insight into developments on global exchanges. The WFE works with standard-setters, policy makers, regulators, and government organisations around the world to support and promote the development of fair, transparent, stable and efficient markets. The WFE shares regulatory authorities' goals of ensuring the safety and soundness of the global financial system.

With extensive experience of developing and enforcing high standards of conduct, the WFE and its members support an orderly, secure, fair, and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence, and economic growth, and we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in a globally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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Introduction

The WFE appreciates the opportunity to comment on the Commodity Futures Trading Commission (CFTC or the Commission) Notice of Proposed Rulemaking Regarding Investment of Customer Funds by Futures Commission Merchants and Derivatives Clearing Organizations. The WFE and its members share the CFTC's goals of supporting the safety and soundness of the broader financial system, which is critical to enhancing investor and consumer confidence. We therefore remain supportive of the broader effort to safeguard customer funds held by clearing members and clearinghouses.

The WFE has previously publicly expressed support for initiatives that support financial stability led by international standard setters and local regulatory agencies, and has sought to proactively contribute to the discussion on these matters. In doing so, its members have contributed significantly to the strengthening of the broader financial system through engagement with regulators and other stakeholders on the implementation of many post-crisis initiatives.

Response

The WFE supports the CFTC's proposal to amend its regulations governing the safeguarding and investment of customer funds by futures commission merchants (FCMs) and derivatives clearing organisations (DCOs) to authorise both DCOs and FCMs to invest customer funds across a new set of foreign sovereign debt instruments which like current permitted investments share a low risk of default and high level of liquidity.

The range of investible instruments under Regulation 1.25

The proposal would amend CFTC Regulation 1.25, which seeks to safeguard funds of customers engaging in CFTC-regulated derivative transactions, by permitting FCMs and DCOs to invest funds deposited by customers in additional investment types, subject to the proposed conditions. The regulation continues to affirm that customer funds are not the property of the FCM or DCO and that the FCM or DCO must segregate customer funds from its own funds by holding the funds in specially designated customer accounts. The segregation of customer funds from an FCM's or DCO's own funds is designed to ensure that customer funds are used only to support customer trading and transactions and to facilitate the return of the funds to customers should it be required.

Regulation 1.25(a)(1) currently lists seven types of investments that FCMs and DCOs make with customer funds:

- Obligations of the U.S. and obligations fully guaranteed as to principal and interest by the U.S. (i.e., US sovereign debt);
- General obligations of any State or political subdivision of a State (i.e., US state-level debt);
- Obligations of any U.S. government corporation or enterprise sponsored by the U.S (i.e., US SOE debt);
- Certificates of deposit issued by a bank (i.e., bank deposits)
- Commercial paper fully guaranteed by the U.S. under the Temporary Liquidity Guarantee Program (TLGP) as administered by the Federal Deposit Insurance Corporation (FDIC) (i.e., TLGP paper);
- Corporate notes and bonds fully guaranteed as to principal and interest by the US under the TLGP (i.e., TLGP Corporate notes and bonds); and
- Interests in money market funds (MMFs).

This list has been amended over time, but consistently held that the selection of permitted investment has been made in order to preserve principal and maintain sufficient liquidity so that investments can be converted into cash within one business day (and without a material discount in value).

On expanding the range of investible instruments to include additional foreign debt

The Commission is proposing to expand the list of permitted investments by permitting FCMs and DCOs to invest customer funds in sovereign debt instruments issued by Canada, France, Germany, Japan, and the United Kingdom, as long as:

- The FCM or DCO holds balances owed to customers denominated in the currency of the specified foreign sovereign debt;
- The two-year credit default spread of the issuing sovereign is 45 basis points or less; and
- The dollar-weighted average time-to-maturity of the portfolio of investments in the specified foreign sovereign debt does not exceed 60 calendar days and the remaining time-to-maturity of each individual instrument does not exceed 180 calendar days.

The sovereign debt of Canada would have no capital charge for instruments with a remaining time to maturity of less than 3 months and a capital charge of 0.5 percent of the market value for instruments with a remaining time to maturity of 3 to 6 months under SEC Rule 15c3–1. The capital charge for the sovereign debt of France, Germany, Japan, and the United Kingdom that have a remaining time to maturity of one year or less would be subject to a capital charge of 2 percent of the market value of the security under SEC Rule 15c3–1(c)(2)(F)(1). The Commission also proposes to expand the permissible counterparties and depositories to include foreign banks, brokers and dealers (subject to certain requirements), as well as the European Central Bank and the central banks of Canada, France, Germany, Japan, and the United Kingdom.

The WFE supports this proposed amendment, which would enhance the effectiveness of the management of foreign currencies that customers deposit to margin their trades. Notably, the proposed foreign sovereign debt instruments share comparable characteristics in terms of credit and liquidity in regards to the instruments that already qualify as permitted investments. Investments in the proposed additional foreign sovereign debt instruments do not raise any liquidity issues or concerns. The five jurisdictions are among the seven largest economies in the International Monetary Fund's classification of advanced economies, and each qualifies as a "money center country" as defined in Regulation 1.49(a)(1).[1]

The WFE wishes to emphasise the low risk of default among these additional instruments. The S&P credit rating for the US is AA, and this is shared by France and the United Kingdom and the S&P credit ratings for Canada and Germany are AAA and the S&P credit rating for Japan is A+.[2] These are comparable ratings which outline that each government has a similarly low risk of default to the US. This is further demonstrated by the narrow spreads in credit default swaps on each jurisdiction's sovereign bonds, which all sit within the 45 basis point limit that the Commission set in 2018 (with the spread of the sovereign issuer used as a proxy for default risk, so that the instrument is disqualified from future investment if the issuer's two-year spread exceeds 45 basis points).[3] The WFE also agrees that the markets for the proposed debt instruments are sufficiently liquid to permit DCOs and FCMs to liquidate them in a timely manner without substantial devaluation. Each instrument demonstrates high liquidity at various maturities[4], with active secondary and repo markets for each instrument[5], and tight bid-offer spreads among bills and short coupons.

The WFE also supports the proposal as it would aid in the hedging of foreign currency risk that currently exists in the system – a particularly important practice now that the amount of customer funds held by FCMs in foreign currency represents approximately 10 percent of the total segregated customer funds.[6] Without the ability to invest customer funds in identically-denominated sovereign debt securities, an FCM or a DCO seeking to invest customer foreign currency deposits must convert the currencies to a U.S. dollar-denominated asset, introducing potential foreign currency risk, or hold funds in unsecured bank demand deposit accounts.

The WFE supports the requirement for the two-year credit default spread of the issuing sovereign to be 45 basis points or less, as this condition is consistent with the limit specified by the Commission in the 2018 exception for French and German sovereign debt (which was based on a historical analysis of the US two-year credit default spread), and would not disqualify any of the listed instruments based on data from September 2018 to September 2023.[7] The WFE recommends that the CFTC consider a minimum period of time or number of times that this limit is breached before investment in the instrument is prohibited. The WFE finds the proposed

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[1] Commodity Futures Trading Commission (CFTC), Denomination of Customer Funds and Location of Depositories, 68 FR 5551, February 2003
[2] S&P Global, Credit Ratings, https://disclosure.spglobal.com/ratings/en/regulatory, 27 November 2023
[3] CME Group, FIA, "Petition for Order under Section 4(c) of the Commodity Exchange Act", 24 May 2023
[4] Bloomberg, Government Bonds, https://www.bloomberg.com/markets/rates-bonds/government-bond, 27 November 2023
[5] Repo market functioning, CGFS Papers, No. 59, Committee on the Global Financial System, Bank for International Settlements, April 2017.
[6] Commodity Futures Trading Commission (CFTC), "Fact Sheet and Q&A – Notice of Proposed Rulemaking Regarding Investment of Customer Funds by Futures Commission Merchants and Derivatives Clearing Organizations", 3 November 2023
[7] Commodity Futures Trading Commission (CFTC), "Notice of proposed rulemaking: Investment of Customer Funds by Futures Commission Merchants and Derivatives Clearing Organizations", https://www.federalregister.gov/documents/2023/11/21/2023-24774/investment-of-customer-funds-by-futures-commission-merchants-and-derivatives-clearing-organizations#footnote-128-p81245

requirement that FCMs and DCOs would not be required to immediately divest their investments if this limit were breached appropriate, given the risks associated with liquidating investment in potentially volatile markets.

The Commission is also proposing to limit the time-to-maturity of investments in the additional instruments proposed, so that the dollar-weighted average time-to-maturity of its portfolio of investments does not exceed 60 calendar days. The WFE believes that a six-month dollar-weighted average time-to-maturity for the portfolio of foreign sovereign debt and a maximum two-year remaining time-to-maturity for each foreign sovereign debt instrument would be more suitable, in order to assure a high level of liquidity, and meet the CFTC's own objectives as per Regulation 1.25.

The WFE supports the Commissions continued stance on not imposing asset-based or issuer-based concentration limits on sovereign debt instruments, given the relative strength and limited default risk of each jurisdiction, strict investment conditions for the permitted instruments, and consistency with the Commission's 2018 order which did not impose limits when exempting the debt of France and Germany. In addition, the WFE believe that concentration risk is mitigated by CFTC DCO Rule 39.13(g)(10), which outlines that DCOs are required to limit assets accepted as IM to those that have minimal credit, market, and liquidity risks, and (g)(13), which requires DCOs to apply appropriate limitations or charges on the concentration of assets posted as IM as necessary to ensure the ability to liquidate such assets quickly with minimal adverse price effects.

The WFE additionally supports the proposal to permit FCMs and DCOs to invest customer funds in the same set of foreign sovereign debt instruments, creating consistency across agency registrants that may invest customer funds.

On extending the list of instruments to include exchange-traded funds (ETFs)

The Commission's proposal also includes amendments to authorise FCMs and DCOs to invest customer funds in Short-Term US Treasury ETFs. Under the proposal, FCMs and DCOs would be able to invest customer funds in ETFs subject as long as:

- The ETF is a registered investment company under the Investment Company Act of 1940 with the SEC and holds itself out as an ETF under SEC Rule 6c-11;
- The ETF is passively managed and seeks to replicate the performance of a published short-term U.S. Treasury security index and for purposes of the proposal, 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 U.S. Department of the Treasury;
- The ETF invests at least 95 percent of its assets in securities comprising the U.S. Treasury securities index whose performance the fund seeks to replicate;
- The ETF's interests are redeemable in cash by an FCM or a DCO by the business day following a redemption request;
- The ETF's interests are acceptable as performance bond by a derivatives clearing organisation;
- The NAV for the ETF is computed by 9 a.m. of the business day following each business day and made available to FCMs or DCOs, as applicable, by that time;
- The FCM or a DCO is an authorised participant (AP) of the ETF (to redeem the shares without relying on a separate authorised participant); and
- The ETF is acceptable by the DCO as a performance bond from clearing members to margin customer trades.

The Proposal would also apply a 2% capital charge on the value of ETF shares.

The WFE supports the Commission's proposal to authorise FCMs and DCOs to invest customer funds in Short-Term US Treasury ETFs. These instruments share consistent characteristics with the already permitted investments - particularly in terms of liquidity, as ETFs continuously offer shares for sale. The proposed amendment would provide opportunities to further diversify the investments of customer funds.

However, the WFE strongly disagrees with the condition that the FCM or a DCO should be an AP of the ETF. This does not provide additional protections beyond those that could be received by using a third-party AP. Practically, this requirement would severely limit the parties that could invest in ETFs to those that are registered as broker-dealers and APs – DCOs are not APs.

In addition, the WFE recommends the removal of the condition that the ETF is acceptable by the DCO as a performance bond from clearing members to margin customer trades. DCOs have different criteria for the acceptance of collateral as margin than for investment, and each FCM and DCO should determine the appropriate permitted investments for them. Instead, this requirement could be misinterpreted to imply that one can rely on the DCOs acceptance of ETFs for investments, which should not be the case.

Furthermore, the limiting of redemptions to cash could have unintended consequences, as there could be instances where it may be more advantageous for the FCM or DCO to receive the underlying U.S. Treasuries, which are also very liquid.

Finally, the WFE recommends that the Commission do not include requirement that the ETF invests at least 95 percent of its assets in securities comprising the U.S. Treasury securities index whose performance the fund seeks to replicate, as this measure is too punitive, and could cause funds to deviate from their index. Instead, we suggest that the percentage requirement should be lowered, and that cash, repo, and U.S. Treasury MMFs should also be acceptable, to provide appropriate flexibility, while preserving the high quality and liquid nature of the ETF. The WFE also recommends that the CFTC clarify the steps that would be taken in the situation where a percentage requirement is breached and an FCM or DCO is expected to divest from the fund. This could consider steps such as progressively reducing the amount of funds invested in the ETF (instead of immediately divesting the investments in a potentially volatile market). These recommendations are consistent with industry practices.

On the elimination of transaction and account balance information requirements

Regulations 1.20 and 30.7 (and certain related appendices) currently require that FCMs deposit customer funds with depositories that agree to provide the CFTC with direct, read-only electronic access to accounts holding customer funds. The proposed amendments would eliminate these read-only access provisions and rely on the automated daily segregation confirmation system. The WFE supports this amendment, as the automated daily segregation confirmation system has since been proven to be an efficient and effective alternative means of obtaining account balance and transaction information and generating alerts for any discrepancies. There would be no need for new acknowledgment letters.

On the implementation of the Secured Overnight Financing Rate

Regulation 1.25(b)(2)(iv)(A) also states that investments may include variable or floating interest rate payments that correlate closely or are determined 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); and
- or the interest rate of any fixed rate instrument that is a listed permitted investment under Regulation 1.25.

The CFTC has proposed to replace LIBOR with the Secured Overnight Financing Rate (SOFR) as a permitted benchmark for the interest rate of adjustable rate securities that qualify as permitted investments. The WFE supports this move following the March 2021 announcement that LIBOR would cease to be published, and the Alternative Reference Rate Committee (ARRC) announcement that SOFR is the preferred alternative benchmark to USD LIBOR for various new USD derivatives and financial contracts.

Conclusion

The WFE supports the CFTC's work to create additional appropriate flexibility for DCOs and FCMs with respect to the investment of customer funds while retaining public and customer confidence in financial markets. The Commission's proposal would allow customer funds to be invested in a way that minimises exposure to credit, liquidity, and market risk, while also providing an appropriately wider range of alternatives in which to invest customer funds that will provide tangible benefits for DCOs, FCMs, and their customers.

The WFE recommends that the Commission engage industry further regarding certain aspects of the proposal, such as the time-to-maturity for foreign sovereign debt instruments, as well as certain aspects regarding ETF investment, such as the reconsideration of

requirements that the FCM or DCO should be an AP of the ETF, that the ETF is acceptable by the DCO as a performance bond from clearing members to margin customer trades, that redemptions should be limited to cash, and that the ETF invests at least 95 percent of its assets in in securities comprising the U.S. Treasury securities index whose performance the fund seeks to replicate. It is the WFE's belief that, once adjusted, these amendments will continue to safeguard customer funds and enable investments to be converted to cash in a timely manner at a predictable value, while allowing FCMs and DCOs to attain capital efficiency and foster market resilience.