January 23, 2020

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RE: Margin and Capital Requirements for Covered Swaps Entities (OCC Docket ID OCC–2019–0023; Federal Reserve Docket No. R–1682; FDIC RIN 3064-AF08)

To Whom It May Concern:

The Americans for Financial Reform Education Fund (AFR) appreciates the opportunity to comment on the above referenced Proposed Rule (the "Proposal") concerning margin and capital requirements for Covered Swaps Entities (CSEs) by the various prudential regulators (the "Agencies"). Members of the AFR Education Fund include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

This is AFR's second comment on this Proposal, as we submitted a comment in December, 2019 strongly opposing the Agencies' intent to eliminate initial margin protections for swaps between CSEs and their affiliated entities.[2] Beyond the points made in that comment concerning the lack of any justification for eliminating these important prudential protections, we now offer comment on several points made in other comments to the Agencies.

Expanding permissible use of registered funds as collateral: We oppose requests made by ISDA, the Managed Fund Association, and Blackrock to expand the permissible use of registered funds such as Money Market Funds (MMFs) and Exchange Traded Funds (ETFs) as initial margin for derivatives transactions. We are particularly concerned regarding Blackrock's request that shares of ETFs be counted as redeemable and therefore as permissible collateral for derivatives transactions, and strongly oppose this request.

[1] A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/
[2] Americans for Financial Reform Education Fund Letter, December 9, 2019, available at https://bit.ly/2GjwBwm

The Agencies currently restrict the use of MMFs as collateral by requiring that eligible funds do not engage in repos, reverse repos, or securities lending. Several commenters requested that this restriction be eliminated.[3] The effect of eliminating this restriction would be to lengthen financial intermediation chains and make the quality of the MMF collateral depend not only on the assets of the MMF itself, but the solvency of the MMF's counterparty in a repo or securities lending transaction. Unless the Agencies are certain of their ability to identify such counterparties and ensure their solvency in stressed market conditions, we do not believe that restrictions on the use of securities lending and repo by collateral MMFs should be eliminated. In this context, it should be recalled that initial margin will likely only be drawn upon in stressed market conditions.

Blackrock's request that all ETF shares be counted as eligible derivatives collateral is even more concerning.[4] We urge the Agencies not to grant it. ETF shares are by definition not "redeemable securities" for end investors, since only Authorized Participants of the ETF can directly redeem shares for the underlying assets of the fund. Blackrock appears to argue that since ETF market values are reasonably close to underlying asset prices in normal market conditions, the Agencies should declare such shares to be the equivalent of redeemable securities. However, initial margin is intended as a protection against stressed market conditions, and the ETF mechanism has never fully been tested under conditions of extreme market stress.

Furthermore, even under current market conditions researchers have observed that ETF market prices can have significant tracking errors as compared to the index they purport to track, that large-scale ETF ownership of securities can be associated with increased price volatility of the underlying securities, and that ETFs can be highly vulnerable to operational risk on the part of a few large ETF managers. These issues have led to concerns about ETF contributions to systemic risk.[5] These considerations all argue against the use of ETF shares as low risk derivatives collateral that must be drawn on in stressed market conditions.

Blackrock also cites a Securities and Exchange Commission (SEC) no-action letter with respect to Invesco Powershares in support of its position that ETF shares should be counted as redeemable securities.[6] However, in that case the SEC only granted the relevant relief to shares of the ETF that were held by Authorized Participants and eligible for direct redemption in exchange for the underlying fund assets, not to all ETF shares held by end investors.[7]

Finally, the Agencies should consider that the performance of ETF shares depends critically on the details of SEC regulation of the ETF arbitrage mechanism, which is not under the direct control of the Agencies. If the Agencies permit ETF shares to be used as collateral the prudential

[3] See Managed Funds Association Letter, December 7, 2019, available at https://bit.ly/36fL72M and ISDA Letter, December 9, 2019, available at https://bit.ly/2NU7q7A

[4] Blackrock Letter, December 9, 2019, available at https://bit.ly/2uvVx1a

[5] For a review of concerns regarding ETF tracking error, liquidity risks, operational risks, and potential performance in stressed market conditions, see Pagano, Marco, Antonio Sanchez Serrano, and Josef Zechner, "Can ETFs Contribute to Systemic Risk?", Reports of the Scientific Advisory Committee No. 9, European Systemic Risk Board, European System of Financial Supervision, June, 2019, available at https://bit.ly/2tO7bnP

[6] See Blackrock Letter, Footnote 18

[7] See SEC Letter Re Invesco Powershares Capital Management, March 6, 2018, available at https://bit.ly/2GfqtFv

regulatory framework would become significantly dependent on SEC regulations not controlled by the Agencies. In the case of MMFs, the relative simplicity of the fund structure meant that the Agencies could specify detailed requirements for a MMF share to qualify as collateral that were independent of SEC rules. But the ETF arbitrage mechanism is more complex.

The Associations' justification for eliminating initial margin protections for inter-affiliate swaps: In our December, 2019 comment we stated that the Agencies did not offer any adequate justification for elimination initial margin protections for inter-affiliate swaps. This is also true of the joint comment letter from the Associations.[8] The only policy justification offered in that letter for eliminating initial margin protections reads, in full:

> "Swap Entities use inter-affiliate swaps for centralized risk management, which promotes safety and soundness and reduces systemic risk by decreasing group-wide liability exposures to third parties. Providing an exemption from IM requirements for inter-affiliate swaps would foster such systemic risk mitigation. It also would allow Swap Entities to allocate liquid collateral more efficiently internally."

As we pointed out in our previous comment, it is completely inadequate to simply gesture to a purported risk management benefit of inter-affiliate swaps as a justification for eliminating initial margin risk protections for such swaps. Instead, an analysis must be undertaken that balances any social benefits of improved risk management due to a lower cost of engaging in inter-affiliate swaps (if indeed such benefits exist) against the risk management benefits of providing initial margin protections to CSEs. Initial margin clearly protects CSEs, which are generally U.S. government insured depository institutions, against the risk of default by affiliated entities that are not publicly insured and may be operating in different markets under different regulations. Initial margin also creates related social benefits by properly pricing the public guarantee provided specifically to insured depository institutions and preventing non-insured affiliates from taking advantage of the subsidy at no cost, against the intent of Congress.

No such balancing analysis was performed in the Agencies' Proposal, and no such analysis was provided by the large banks seeking to take advantage of the initial margin exemption.

The Agencies must respond to Better Markets points concerning the lack of statutory justification for an initial margin exemption: The comment submitted by Better Markets includes a strong argument that the Dodd-Frank Act does not permit the Agencies to simply exempt non-cleared derivatives from mandated margin requirements.[9] The Proposal appears to simply assume that the Agencies have statutory authority to exempt an entire significant class of non-cleared derivatives from key margin requirements such as initial margin. It is incumbent on the Agencies to provide a clear legal argument as to how the statute permits them to provide such

[8] Associations (ABA, IIB, Bank Policy Institute, SIFMA, Chamber of Commerce) Joint Letter, December 9, 2019, available at https://bit.ly/2up97Ds
[9] Better Markets Letter, December 9, 2019, available at https://bit.ly/3ay4Yh3

a sweeping exemption on a discretionary basis. If such an argument cannot be provided, the exemption must not be granted.

Thank you for the opportunity to comment on this Proposal. If you have questions, contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org

Sincerely,
Americans for Financial Reform Education Fund