By Electronic Submission

October 10, 2023

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (RIN 3038-AF36)

Dear Mr. Kirkpatrick:

Better Markets[1] appreciates the opportunity to comment on the proposed rule ("Proposed Rule") issued by the Commodity Futures Trading Commission ("CFTC" or "Commission"), which is proposing to amend the margin requirements for uncleared swaps applicable to swap dealers and major swap participants for which there is no prudential regulator.[2]

The Proposed Rule is proposing to revise the definition of ''margin affiliate'' so that certain collective investment vehicles that receive all of their start-up capital, or a portion thereof, from a sponsoring entity ("seeded funds") would be deemed not to have any margin affiliates for the purposes of calculating certain thresholds that trigger the requirement to exchange initial margin for uncleared swaps. This proposed amendment would allow swap dealers and major swap participants to circumvent the requirement to post and collect initial margin with certain eligible seeded funds for their uncleared swaps for a period of three years from the date on which the eligible seeded fund's asset manager first begins making investments on behalf of the fund.

The Commission is also proposing to eliminate a provision disqualifying the securities issued by certain pooled investment funds ("money market funds" or "MMFs") that transfer their assets through securities lending, securities borrowing, repurchase agreements, reverse repurchase agreements, and similar arrangements from being used as eligible initial margin collateral, thereby expanding the scope of assets that qualify as eligible collateral.

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; 88 Fed. Reg. 53,409 (August 8, 2023).

Better Markets opposes both of these proposals, as they conflict with the letter and spirit of the law and threaten to undermine systemic stability in the derivatives markets.

Initial Margin Requirements Are Essential Safeguards

Derivatives trading, as demonstrated by the 2008 financial crisis, carries significant risks that can lead to catastrophic financial and economic consequences.[3] These financial instruments not only possess inherent dangers themselves but also function as a pivotal transmission mechanism for the widespread distribution of risk. Often, they act like a conveyor belt, silently dispersing misunderstood and underestimated risks, akin to hidden time bombs, throughout the global financial system.

Margin, which can be likened to the down payment when purchasing a house, is the most fundamental risk management tool, representing a best practice and providing a solid foundation for systemic stability. Much like subprime mortgages with no down payments, the absence of initial margin in uncleared swaps creates a potential crisis in waiting.[4] Unfortunately, as history has shown, the errors and poor judgments underlying the Proposed Rule may remain hidden for years, only becoming apparent in the midst of the next financial crisis. The absence of initial margin translates to inadequate shock absorbers, once again exposing taxpayers to the grave risk of having to bail out the financial industry.

However, it's crucial to understand that margin is not an additional cost, just as a down payment on a house is not an extra expense when securing a mortgage. Instead, it serves as a critical buffer designed to safeguard both parties involved in the transaction and the overall stability of the financial system. As Better Markets has advocated, in response to the CFTC's relaxation of the Dodd-Frank margin requirements in 2016, margin should not be viewed as a dispensable feature to be waived for the sake of cost-cutting.[5] It should remain an ever-present requirement aimed at reducing risk and enhancing systemic stability.

Money Market Funds Remain Subject to Systemic Instability

The shortcomings in the regulation of MMFs were starkly revealed in 2008 when the collapse of Lehman Brothers precipitated a crisis in the MMF sector that resulted in a run on MMFs, which quickly had dire ripple effects throughout the financial system and in the real economy.[6] MMFs persistently exhibit elevated run risk, primarily attributable to a government-

3 Dennis Kelleher, Joseph Cisewski, Better Markets, *Don't mess with rules curbing derivatives risk*, American Banker (October 18, 2019), *available at* https://www.americanbanker.com/opinion/dont-mess-with-rules-curbing-derivatives-risk.

4 *See* Better Markets, *Statement Following CFTC Vote On Margin Rules* (December 16, 2015), *available at* https://bettermarkets.org/newsroom/statement-following-cftc-vote-margin-rules/.

5 *See* Better Markets' *Statement Following CFTC Vote On Margin Rules*.

6 Better Markets, The Increasing Dangers of the Unregulated "Shadow Banking" Financial Sector: Money Market Funds (August 11, 2022), available at https://bettermarkets.org/wp-

endorsed fiction that the net asset value always remains fixed, coupled with the lack of capital buffers that could absorb redemption demands without sparking asset fire sales.[7] These features have led to a de facto government subsidy, allowing MMF sponsors to capitalize on profits during favorable market conditions while externalizing losses to the public when the market undergoes stress. Put simply, the MMF industry avoids footing the bill for its own risks, preferring to lean on government support, leaving taxpayers to pick up the tab. The reality is that MMF net asset values ("NAV") do not always remain stable, especially but not only during periods of market stress. Nevertheless, most MMFs are still permitted by the government to maintain a fixed NAV, giving market participants false comfort that their money is protected from loss.[8] And while the liquidity requirements applicable to MMFs have been strengthened over time, no progress has been made to apply mandatory minimum capital buffers to MMFs.

However, the core problem is that contrary to the false comfort created by the NAV, MMFs remain subject to losses and run risks. We saw it in 2008 and yet again in March 2020 during the market turmoil triggered by the pandemic. As MMF shares lost value and edged toward breaking the buck, millions of investors sought to withdraw their funds. That started a vicious cycle in which the funds sold assets to pay redeeming investors, which drove asset prices down and put more stress on MMF share prices. This threat is compounded by the fact the MMFs don't carry any mandatory capital buffers or government insurance of the sort that protects bank deposits, so investors feel they have to fend for themselves.[9] Both in 2008 and 2020, the government had to intervene with trillions of dollars in taxpayer-funded guarantees and liquidity assistance to prevent MMFs from collapsing.

Over the years, the SEC has rightly seen the need for the industry to assume more responsibility for the risks associated with the highly profitable MMF product that they promote and sell. Unfortunately, over the years, the SEC has only been willing to go halfway, which remains true with its recent rule adoption.[10] It has long been known that only a full package of reforms, including the floating (and fully transparent) NAV, along with meaningful and mandatory capital buffers and liquidity management, will stop the runs, promote systemic stability, and protect taxpayers. Better Markets has advocated for additional MMF reforms for over a decade and will continue to do so.

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content/uploads/2022/08/BetterMarkets_Report_Dangers_of_the_Shadow_Banking_MMFs_August2022.pdf.

7 Better Markets, Money Market Fund Reforms (April 11, 2022), available at https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_SEC_MMF_Reforms.pdf.

8 *Id.*

9 *Id.*

10 *See* Better Markets, The Sec's Money Market Reforms Do Not Go Far Enough (July 12, 2023), available at https://bettermarkets.org/newsroom/the-secs-money-market-reforms-do-not-go-far-enough/.

The Proposed Rule Is Driven by Industry Self-Interest, Not the Public Interest

Against the backdrop of the financial risks associated with the absence of initial margins on swaps transactions and the challenges posed by MMFs, it is important to note that this Proposed Rule was instigated by a report issued by the Subcommittee on Margin Requirements within the CFTC's Global Markets Advisory Committee.[11] This subcommittee included a wide range of industry participants, including representatives of swap dealers, asset managers, and third-party service providers, which recommended that the CFTC repeal certain aspects of its margin rule for self-interested, profit-maximizing, and shortsighted commercial reasons. While this may not come as a surprise, given that this subcommittee consists of industry insiders focused on advancing their institutions' commercial interests, it raises significant concerns. Such recommendations, driven primarily by self-interest, should not serve as the basis for regulatory action by the CFTC, charged with the critical responsibility of safeguarding the safety and stability of registered entities and markets under its oversight.

In the complex world of financial regulations, it's crucial to remember that eroding Dodd-Frank is like playing a game of Jenga. Removing a single piece may appear inconsequential at first, but with each successive extraction, the entire structure becomes weaker and closer to collapse. Therefore, it is imperative that the CFTC remain steadfast in implementing Dodd-Frank. Doing so ensures that it fortifies the derivatives markets against crises and prioritizes the well-being of legitimate businesses that rely on those markets, ultimately for the public's benefit—much like skillfully maintaining the stability of a Jenga tower as it grows taller and more complex.

BACKGROUND

The 2008 financial crisis exposed the vulnerabilities of the opaque and unregulated derivatives market, where complex financial instruments were traded without proper oversight or transparency. These derivatives played a significant role in exacerbating the crisis by amplifying risks and facilitating the spread of contagion throughout the financial system. In direct response to the economic fallout caused by the crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") emerged as a comprehensive solution aimed at addressing systemic vulnerabilities that had pushed the financial system to the brink of collapse.[12] It set out to enact sweeping changes in the derivatives landscape to prevent a similar calamity from happening again.

One of the major failures revealed by the 2008 crisis was the inadequate management of counterparty credit risks in the over-the-counter derivatives markets by Wall Street's largest

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[11] Recommendations to Improve Scoping and Implementation of Initial Margin Requirements for Non-Cleared Swaps, Report to the CFTC's Global Markets Advisory Committee by the Subcommittee on Margin Requirements for Non-Cleared Swaps (May 2020), *available at* https://www.cftc.gov/media/3886/download?name=GMAC_051920MarginSubcommitteeReport.

[12] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

financial institutions.[13] This failure was exemplified by the near collapse of American International Group, Inc. (AIG), which had spillover effects on other financial institutions, including every systemically important investment bank. These events forced policymakers and U.S. taxpayers to provide massive bailouts, commitments, guarantees, and support to the very institutions that had caused the worst economic downturn in generations.[14] Consequently, global regulators have prioritized counterparty credit risk management, leading to the 2009 G20 commitments to encourage central clearing of standardized derivatives and impose higher capital requirements on non-cleared derivatives.[15]

In 2011, the G20 added margin requirements for non-centrally cleared derivatives as a third pillar for managing counterparty credit risk. By that time, Dodd-Frank had already implemented this commitment by requiring regulatory agencies to jointly adopt variation and initial margin requirements for all swaps booked by swap dealers and major swap participants, collectively known as "Covered Swap Entities," if these derivatives are not cleared by a clearing organization or agency, thus addressing the concerns raised by the 2008 crisis.

Furthermore, in addition to counterparty credit risk, the financial crisis made it painfully clear that MMFs present a serious risk of systemically significant runs and that those runs can cripple the short-term credit markets, potentially tipping the entire financial system into chaos. As MMFs faced waves of redemption requests in September of 2008, they were forced to engage in fire sales. Those sales in turn depressed asset values, further weakening the funds. The runs quickly spread throughout the entire prime MMF industry, and during the week of September 15, 2008, investors withdrew approximately $310 billion (or 15 percent) of prime MMF assets. This caused immediate havoc in the short-term funding markets, triggering a vicious cycle of asset fire sales, depressed prices, redemption requests, more asset fire sales, and rapidly evaporating liquidity. These events prompted the Treasury, on September 19, 2008, to establish the Temporary Guarantee Program for Money Market Funds, and it prompted the Federal Reserve to establish a variety of facilities to support the credit markets frozen by the MMF crisis.

Moreover, in March 2020, when it finally became clear that the United States and the rest of the world were facing a prolonged battle against the COVID-19 pandemic, including restrictive shutdowns of indefinite duration, the result was a sharp economic contraction, compounded by a significant amount of uncertainty. This represented the most significant test of the financial system

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13 *See* Better Markets, Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59970 (November 7, 2019), *available at* https://bettermarkets.org/sites/default/files/Better_Markets_Inc_Letter_on_Margin_and_Capital_Requirements_for_Covered_Swap_Entities_12-9-2019.pdf.

14 *See* Dennis M. Kelleher, Testimony to Senate Committee on Agriculture, Nutrition, and Forestry on "The State of the Derivatives Market and Perspectives for CFTC Reauthorization (June 25, 2019), *available at* https://www.agriculture.senate.gov/imo/media/doc/Testimony_Kelleher%2006.25.19.pdf.

15 *See* G20 Leaders' Statement, the Pittsburgh Summit (September 24-25, 2009), *available at* http://www.fsb.org/wp-content/uploads/g20_leaders_declaration_pittsburgh_2009.pdf (stating that "[a]ll standardized OTC derivative contracts should be . . . cleared through central counterparties" and that "[n]on-centrally cleared contracts should be subject to higher capital requirements").

since the 2008 crisis and, critically, the first major test of the Dodd-Frank reforms.[16] The financial system, by and large, performed well. It did not amplify the economic strains induced by the pandemic, and many larger banks in fact supported the economy in important respects.[17] However, it must be noted that substantial government actions were needed to stabilize financial markets and it is likely that without these major taxpayer-supported actions the outcome would have been far worse. In particular, the MMF market once again served as a source of significant contagion that imperiled the markets broadly and forced government intervention. For the second time in just a dozen years, taxpayer money had to be put at risk to support a backstop of MMFs.

COMMENTS

I. The Proposed Rule aims to continue chipping away at the Dodd-Frank margin requirements, incrementally eroding their effectiveness, akin to a "death by a thousand cuts" approach.

The Proposed Rule Conflicts with the Statutory Mandate.

The CFTC's 2016 final rule relaxed certain aspects of Dodd-Frank's margin requirements, chiefly through the introduction of exemptions that allowed affiliated entities to forego the collection of margin under certain circumstances.[18] Specifically, this rule exempted swap dealers from the obligation to collect margin when conducting transactions with a wide range of affiliated parties, encompassing under-capitalized affiliates, foreign affiliates, and even those that operated outside the bounds of regulation. These exemptions failed to meet the original statutory intent of Dodd-Frank, as they potentially exposed swap dealers to greater risks during times of financial distress. Now, the Proposed Rule attempts to further erode Dodd-Frank by further dismantling the margin requirements by allowing swap dealers and major swap participants to circumvent the requirement to post and collect initial margin with certain eligible seeded funds for their uncleared swaps.

However, the Dodd-Frank Act did not provide the CFTC discretionary authority to determine whether to impose, or not to impose, initial margin requirements. It amended the Commodity Exchange Act ("CEA") to mandate that the CFTC impose initial margin requirements on ***all*** non-cleared derivatives[19]:

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[16] Dennis Kelleher, Tim Clark, Better Markets, No Financial Crash Yet Thanks to Dodd-Frank and Banking Reforms (June 24, 2020), available at https://bettermarkets.com/sites/default/files/Better_Markets_White_Paper_Dodd-Frank_Banking_Reforms.pdf.

[17] *Id.*

[18] *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; 81 Fed. Reg. 636 (January 6, 2016).

[19] 7 U.S.C. 6s(e)(2)(B)(ii) (emphasis added).

> The Commission **shall adopt rules** for swap dealers and major swap participants, with respect to their activities as a swap dealer or major swap participant, for which there is not a prudential regulator imposing… (ii) both **initial** and variation **margin requirements** on **all swaps** that are not cleared by a registered derivatives clearing organization.

This statutory language is prescriptive, deliberate, and unequivocal. Congress adopted a statutory mandate ("shall") and used the word "both" to statutorily direct the agencies to "impose" initial margin ("IM") requirements, in addition to variation margin ("VM") requirements. The ordinary and dictionary meanings of the word "impose" are instructive: "[T]o establish or bring about as if by force,"[20] "to establish something as a rule to be obeyed,"[21] or "to officially force a rule, tax, punishment, etc. to be obeyed or received."[22] Congress's use of this statutory language yields the following inescapable conclusions:

> 1) The CFTC is required to impose IM requirements on "all" Non-Cleared Derivatives; and
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> 2) The CFTC in no way has been given discretionary authority to do otherwise.

Indeed, the interpretation of the term "all" precludes a reading of the statute that would allow exclusions from the mandatory initial margin requirement for "some" non-cleared derivatives. It is essential to emphasize that, for all the statutory reasons mentioned above, the CFTC lacks the authority to disregard the clear statutory mandates of the CEA. The Proposed Rule provides an exemption that would eliminate existing initial margin requirements for seeded funds, which is inconsistent with the CEA's directives.

<u>The Proposed Rule Is Not Aligned with the Prudential Regulators.</u>

The Proposed Rule suffers from another flaw as it fails to align with the broader regulatory landscape in the United States, specifically the U.S. prudential regulators' definitions of "margin affiliates" for swap dealers. In the context of a regulatory framework where multiple U.S. market and banking regulators share jurisdiction, it is important for the CFTC to prioritize regulatory harmonization with its domestic counterparts, to the extent possible under its mandate to follow the law and protect the public interest. Neglecting alignment runs the risk of fostering a detrimental "race to the bottom" scenario where entities may exploit regulatory disparities to seek arbitrage opportunities among less stringent regulators, thereby compromising the overall effectiveness of our regulatory framework.

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[20] Merriam-Webster.com Dictionary, "impose (vb.)," *available at* https://www.merriam-webster.com/dictionary/impose.

[21] Cambridge Dictionary.com, "impose (vb.)," *available at* https://dictionary.cambridge.org/us/dictionary/english/impose.

[22] *Id.*

While the Proposed Rule acknowledges the importance of harmonization with global regulations, it conspicuously overlooks alignment with U.S. banking regulations.[23] This omission results in a troubling disconnect within our regulatory framework, amplifying risks associated with uncleared swaps, including those related to financial stability. The proposal advocates adopting a definition that harmonizes with global standards but fails to even mention the need to harmonize with domestic banking regulation. This inconsistency introduces not only weakness into the regulatory framework but also uncertainty and complexity in determining the qualification of entities as "margin affiliates," potentially exacerbating risks linked to uncleared swaps.

Such misalignment carries the potential to sow confusion and operational difficulties for market participants. Counterparties engaged with both prudentially regulated Swap Dealers (SDs) and CFTC-regulated SDs may incur heightened costs associated with adapting their swap-related documentation and collateral management systems to accommodate varying margin requirements under the CFTC's and the prudential regulators' rules. This added complexity and expense might dissuade market participants from participating in uncleared swaps transactions, ultimately diminishing market liquidity.

In sum, Dodd-Frank does not provide the CFTC discretionary authority to determine whether to impose initial margin requirements for all uncleared swaps—it must do so under the law. Furthermore, the Proposed Rule would disrupt the alignment of the current margin requirements with those of the prudential regulators.

II. **The Commission should refrain from lifting the asset transfer restriction, a move that could significantly elevate the use of money market funds as eligible non-cash collateral for swap dealers for initial margin.**

The Proposed Rule would relax restrictions on the use of MMFs as collateral for initial margin. This is clearly unwise and it displays a stunning disregard for the glaring deficiencies in the regulation of MMFs, which were laid bare during the 2008 financial crisis and again during the 2020 market turmoil. As mentioned above, at the heart of the issue lies the persistent run risk associated with MMFs, primarily stemming from a government-sanctioned framework that preserves a distorted pricing mechanism and an inadequate set of safeguards.[24]

While some MMFs are now subject to a floating NAV, most are not. The reality is that MMF NAVs do not always remain stable, especially during periods of market turbulence. In short, they are more vulnerable than they appear.[25] The recent history, encompassing the tumultuous events of 2008 and the turbulence witnessed in March 2020 due to the COVID-19 pandemic, serves

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23 See Proposed Rule at 53412.

24 *See* Better Markets, The Increasing Dangers of the Unregulated "Shadow Banking" Financial Sector: Money Market Funds (August 11, 2022), available at https://bettermarkets.org/wp-content/uploads/2022/08/BetterMarkets_Report_Dangers_of_the_Shadow_Banking_MMFs_August2022.pdf.

25 *See* Better Markets, Money Market Fund Reforms (April 11, 2022), available at https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_SEC_MMF_Reforms.pdf.

as a stark reminder of the inherent risks deeply embedded in MMFs. As the value of MMF shares plummeted, approaching the precipice of breaking the buck, investors hurriedly sought to withdraw their funds.[26] This triggered a destructive cycle of asset liquidation to meet redemption demands, further driving down asset prices and intensifying stress on MMF share values. The fact that MMFs lack mandatory capital buffers or government insurance akin to that which shields bank deposits leaves investors exposed to these perils.[27] And it makes MMFs unsuitable as a form of margin collateral.

While Better Markets acknowledges the SEC's recognition of the challenges surrounding MMF risks, its actions thus far have been lackluster in comprehensively addressing these concerns. We maintain that a transparent and floating NAV, substantial capital buffers, and mandatory liquidity management measures constitute indispensable components of a comprehensive reform package necessary to mitigate runs, fortify systemic stability, and safeguard taxpayers.

The CFTC must reconsider its ill-advised intention to lift the asset transfer restriction that presently limits the use of most MMFs as eligible non-cash collateral for swap dealers for initial margin. Unless and until the SEC establishes additional requirements to make MMFs more transparent and stable, including the floating NAV and capital buffers, the proposed approach is indefensible. And even if the SEC were to make progress on those reforms, the CFTC must very carefully evaluate their adequacy and determine whether MMFs are then sufficiently reliable to serve the critically important role as margin collateral.

CONCLUSION

We hope these comments are helpful.

Sincerely,

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[26] *Id.*
[27] *Id.*