



December 23, 2019

Chris Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st St. NW
Washington, DC 20581

Submitted via electronic filing: <https://comments.cftc.gov>

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, RIN 3038-AE89

BlackRock, Inc. (together with its affiliates, “**BlackRock**”)¹ respectfully submits its comments to the Commodity Futures Trading Commission (“CFTC”) in response to the CFTC’s request for comment on a proposed amendment (“Proposal”) to the margin requirements for uncleared swaps for swap dealers and major swap participants for which there is no prudential regulator (the “Margin Rules”).

We appreciate the CFTC’s goal of mitigating potential market disruption that could result from such a large number of entities coming into the scope of initial margin requirements on September 1, 2020. We are supportive of the Proposal to extend the compliance schedule to September 1, 2021 for entities with smaller average daily aggregate notional amounts of swaps and certain other financial products.

In order to further mitigate potential market disruption, we believe the CFTC should clarify that certain exchange-traded funds would qualify as eligible collateral under the Margin Rules. Specifically, the CFTC should clarify that shares of an exchange-traded fund that is an open-end management investment company (an “ETF”) should be considered “redeemable securities” and that shares of such an ETF would qualify as eligible collateral under the Margin Rules where the ETF invests in qualifying assets and satisfies certain other relevant investment conditions, as further outlined below (a “qualifying ETF”).

Without such clarification, we believe that some swap dealers will continue to be deterred from accepting qualifying ETF shares as eligible collateral, thus narrowing the universe of liquid assets that can be posted as margin. A clarification from the CFTC that ETF shares should be treated as redeemable securities and that shares of qualifying ETFs are eligible collateral under the Margin Rules would avoid this result, while remaining consistent with the policy rationale of the Margin Rules and recent actions by the Securities and Exchange Commission (“SEC”).

¹ BlackRock is one of the world’s leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed-income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers, and other financial institutions, as well as individuals around the world.

1. Factual Background

a. The Margin Rules and Eligible Collateral

The Margin Rules provide a list of financial instruments that may be used as eligible collateral. Among other instruments, securities issued by pooled investment funds that meet specific requirements are included in the list of eligible collateral.² These securities of pooled investment funds must:

- be in the form of redeemable securities in a pooled investment fund representing the security holder's proportional interest in the pooled investment fund's net assets; and
- be issued and redeemed only on the basis of the market value of the pooled investment fund's net assets prepared each business day after the security holder makes its investment commitment or redemption request to the fund (collectively, the "Redeemability Requirements").

In addition, the pooled investment fund's assets must generally be limited to securities that are issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, the U.S. Department of the Treasury, and immediately-available cash funds denominated in U.S. dollars ("qualifying assets").³ As an additional requirement, assets of the fund may not be transferred through securities lending, securities borrowing, repurchase agreements, reverse repurchase agreements, or other means that involve the fund having rights to acquire the same or similar assets from the transferee. Taken together, these criteria are meant to "provide flexibility while maintaining a level of safety"⁴ and to "facilitate liquidity of the redeemable securities while still protecting holders of the fund's securities from dilution."⁵ Thus securities issued by an open-end management investment company that holds qualifying assets and that operates as a traditional mutual fund—that is, it directly issues shares to and redeems shares from investors on a daily basis—are eligible collateral under the Margin Rules.

There is a lack of clarity in the market, however, as to whether an ETF that holds qualifying assets would be viewed as issuing "redeemable securities" – a term which is not defined in the Margin Rules – and whether the redemption mechanics of ETFs would in all cases technically comply with the other Redeemability Requirements, thus creating a potential question as to whether the shares of such an ETF would be eligible collateral under the Margin Rules.

² 17 C.F.R. § 23.156(a)(ix).

³ Qualifying assets also include securities denominated in a common currency and issued by, or fully guaranteed as to the payment of principal and interest by, the European Central Bank or a sovereign entity that is assigned no higher than a 20 percent risk weight under the capital rules applicable to swap dealers subject to regulation by a prudential regulator, and immediately-available cash funds denominated in the same currency. § 23.156(a)(ix)(B).

⁴ 81 Fed. Reg. at 666.

⁵ Id.

2. **ETFs and ETF Liquidity**

a. **ETF Mechanics**

ETFs are publicly offered investment funds whose shares, unlike those of a traditional open-end mutual fund, are listed and traded on an exchange. They provide investors with similar liquidity characteristics as open-end mutual funds, though through different mechanics.

Under the Investment Company Act of 1940, as amended (the “’40 Act”), traditional open-end mutual funds are required by law to issue and redeem securities on a daily basis directly to and from investors. These shares must be issued and redeemed at net asset value (“NAV”) per share. ETFs, in contrast, do not issue and redeem shares to and from end investors. ETFs instead issue (or “create”) and redeem their shares at NAV in large blocks of shares known as “creation units” only with institutional trading firms (“Authorized Participants”) that enter into contracts with the ETF or its affiliate that allow them to create and redeem shares on an ongoing basis. Creation and redemption transactions may occur on a daily basis or less frequently, depending on demand for purchases and redemptions of an ETF’s shares.

ETF end investors, in turn, can purchase or sell ETF shares from or to the Authorized Participants, usually as part of over-the-counter (“OTC”) block transactions. They are also able to buy and sell ETF shares using a broker in transactions on securities exchanges, on which ETF shares are listed and traded like ordinary stocks of public companies. Market makers, many of whom are also Authorized Participants, regularly transact in ETF shares through both of these mechanisms, providing liquidity for transactions on securities exchanges or as OTC block transactions with end investors. The ability for end investors to transact in ETF shares either on an OTC basis or in the secondary market, coupled with the creation and redemption activities of Authorized Participants (either for their own books or as agent for other market participants), helps to ensure that the secondary market ETF share price tracks the NAV per fund.⁶

b. **ETFs Provide Multiple Layers of Liquidity**

An ETF shareholder may convert ETF shares into cash in multiple ways. First, the ETF shareholder may liquidate the position on a securities exchange. Second, the ETF shareholder may liquidate the position through a block trade with a broker-dealer in an OTC transaction. Third, the ETF shareholder may liquidate the position by taking advantage of the ETF redemption mechanism by requesting that an Authorized Participant redeem the shares.

With respect to this third liquidity mechanism, an Authorized Participant in turn has several ways to effect such a redemption order. First, an Authorized Participant may in some cases offer a cash price and simply purchase the ETF shares from an investor as part of the Authorized Participant’s normal course securities dealing activities. At other times

⁶ See, e.g., Investment Company Institute, *The Role and Activities of Authorized Participants of Exchange-Traded Funds* (Mar. 2015), https://www.ici.org/pdf/ppr_15_aps_etfs.pdf (explaining the role of Authorized Participants and other entities that provide liquidity in ETF shares).

and as a separate alternative, an Authorized Participant may act as agent for the investor and arrange a redemption in kind. In those cases, the ETF shareholder will deliver its ETF shares to the Authorized Participant, who will submit a redemption request to the ETF and receive from the ETF a designated portfolio of securities and a specified amount of cash. The Authorized Participant will then deliver the securities and cash to the investor.⁷ In the case of qualifying ETFs, the securities delivered to the Authorized Participant to be liquidated are highly liquid and are themselves eligible collateral under the Margin Rules.

As a contractual matter, Authorized Participants are not obligated to redeem ETF shares, but for multiple reasons it is highly unlikely that an Authorized Participant would refuse to do so. First, effecting such transactions is part of the normal course of business of Authorized Participants, through which they earn commissions and fees for their services. Second, and particularly where an ETF's underlying assets are qualifying assets and thus highly liquid, the transactions are akin to agency transactions in which the Authorized Participant is not exposed to market risk. Thus, even in a scenario where an investor holding an ETF share as collateral for a swap does not have access to secondary-market liquidity, the shareholder should be able to receive in kind their proportionate share of the ETF's assets, which assets would themselves be eligible collateral under the Margin Rules. As a result, the holder is in essentially the same position as if it was directly holding such assets that qualify as eligible collateral.

For these reasons, while ETF shares cannot be converted to cash by every end investor through a *direct* transaction with the ETF, they are issued to and redeemable by Authorized Participants on a daily basis and end investors enjoy daily liquidity in ETF shares through transactions (i) in the exchange-traded market, (ii) in the OTC market via block transactions with broker-dealers and (iii) that leverage Authorized Participants to either purchase their ETF shares or to act as their agent to redeem their ETF shares in kind. Holders of collateral in the form of ETFs would be expected to have access to the same or greater liquidity as compared to a market participant who holds an open-end mutual fund that invests in similar qualifying assets.

c. Data on ETF Liquidity

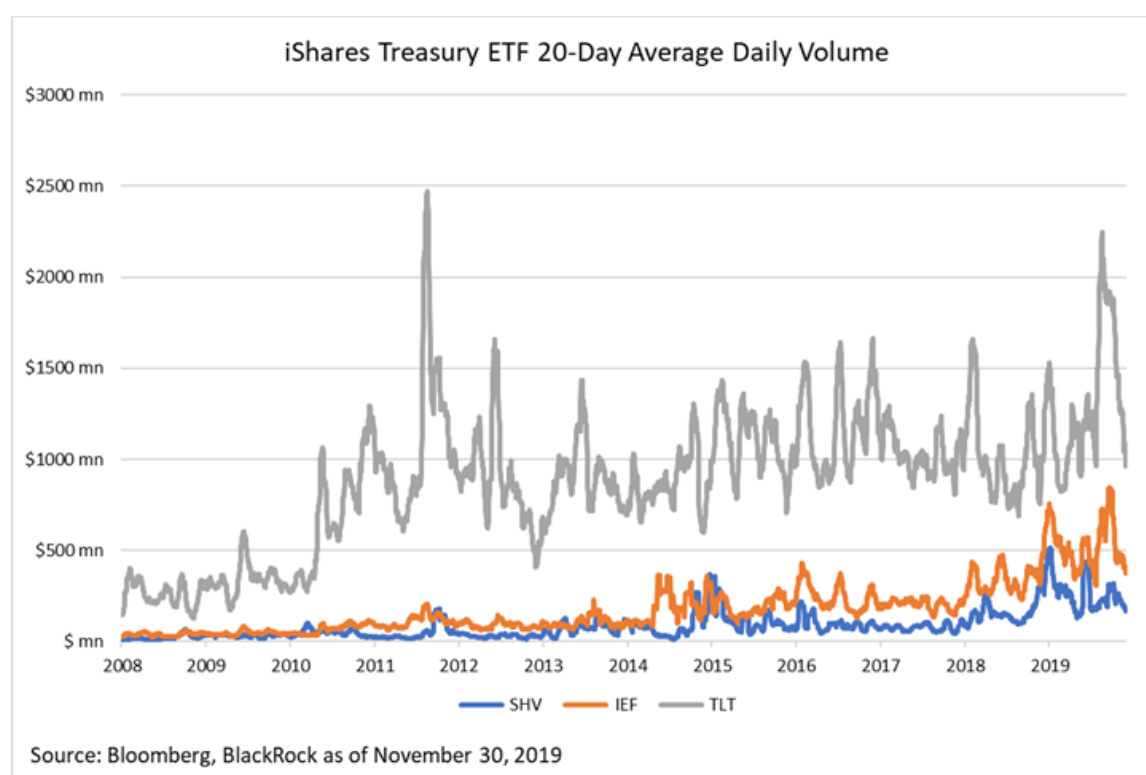
The eligible collateral provisions of the Margin Rules recognize that highly liquid categories of eligible collateral are more desirable,⁸ as such collateral types are more likely to remain liquid and retain value during an economic downturn. As demonstrated by a review of liquidity data for qualifying ETFs, discussed in more detail below, qualifying ETFs have significant liquidity. As discussed above, ETF liquidity relates both to the ability of an investor to trade shares of the ETF in the market as well as how quickly the ETF shares can be converted to cash, either through cash redemptions or in-kind redemptions with a subsequent sale of the underlying asset. On this second avenue of liquidity, because a qualifying ETF's underlying assets are U.S. Treasuries, the liquidity of the Treasury market itself dictates how quickly the ETF's shares could be converted to cash. The U.S. Treasuries

⁷ An Authorized Participant may also, as a service, liquidate the securities and provide cash to the ETF shareholder based on the value of those securities.

⁸ 81 Fed. Reg. at 686.

market is among the most liquid in the world, and qualifying ETF shares can be converted into cash through the multiple methods discussed above.

With respect to liquidity through trading ETF shares in the secondary market, we have provided below several examples that are illustrative of the significant liquidity available through secondary market trading. The below chart depicts 20-day average daily volume for three illustrative BlackRock ETFs.⁹ iShares 20+ Year Treasury Bond ETF (ticker: TLT) invests in U.S. Treasury bonds with remaining maturities greater than 20 years, iShares 7-10 Year Treasury Bond ETF (ticker: IEF) invests in U.S. Treasury bonds with remaining maturities between seven and 10 years, and iShares Short Treasury Bond ETF (ticker: SHV) invests in U.S. Treasury bonds with remaining maturities between one month and one year. In each case, the below chart illustrates that investors in each BlackRock ETF have access to significant liquidity in the secondary market.



The average daily volumes shown above reflect historical demand, which should not be viewed as a ceiling on qualifying ETF liquidity through transactions in ETF shares. If investor demand for shares of qualifying ETFs were to increase, the depth of the primary

⁹ Note that, as a technical matter, these funds may not currently be qualifying ETFs, as described in this document, because currently they may engage from time to time in securities lending or repurchase transaction activity. In order to satisfy the conditions to be a qualifying ETF, we understand that an ETF would need to cease such activities. Whether or not an ETF engages in securities lending or repurchase transactions would not be expected to impact the liquidity of the ETF's shares.

market in U.S. Treasuries means that TLT, IEF and SHV could comfortably accommodate that increased demand.¹⁰

3. The CFTC Should Clarify that ETF Shares satisfy the Redeemability Requirements for Purposes of the Margin Rules

We request that the CFTC clarify that ETF shares are “redeemable securities” that can, assuming the investment eligibility criteria are met, be treated as eligible collateral for purposes of the Margin Rules. As described below, doing so would be (1) consistent with the policy rationale for limiting eligible collateral to those securities that are sufficiently liquid; (2) consistent with the treatment of ETF shares as redeemable securities in other regulatory contexts; and (3) beneficial to market participants, including end users, by providing an additional set of liquid assets that could be posted as margin.

a. The clarification would be consistent with the purposes of the eligible collateral list under the Margin Rules.

As noted above, the Margin Rules’ eligible collateral list is designed to limit collateral posted to satisfy the Margin Rules to collateral that is highly liquid and resilient in times of stress.¹¹ Despite the technical differences between open-end mutual funds and ETFs described above, ETF shares, like shares in open-end mutual funds, clearly satisfy this policy purpose.

As discussed above, through the operations of ETFs and their Authorized Participants, end investors in ETFs enjoy daily liquidity in ETF shares both through transactions in the exchange-traded and OTC markets, and through the additional layers of liquidity provided by the ETF creation and redemption process. Authorized Participants and market makers provide liquidity and ensure appropriate pricing of those shares against the fund’s NAV, and both Authorized Participants and other broker-dealers make markets in these ETF shares.

b. The clarification would be consistent with the treatment of ETF shares as redeemable securities in other regulatory contexts.

The SEC has recently provided guidance in multiple contexts supporting the view that ETF shares are to be treated as “redeemable securities” for regulatory purposes.¹² Because the Margin Rules did not adopt a definition of “redeemable securities,” it is reasonable to look to how the SEC has interpreted or intends to interpret this term in those contexts. It is also worth noting that the SEC’s definition of redeemable security incorporates other critical aspects of the Redeemability Requirements (i.e., the ability of a

¹⁰ This is true, of course, not just for the BlackRock ETFs for which we include data here, but also for any other ETF that invests in U.S. Treasuries and otherwise meets the prudential regulators’ criteria as a qualifying ETF.

¹¹ 81 Fed. Reg. at 669.

¹² The definition of “redeemable security” under Section 2(a)(32) of the ’40 Act, is “any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof”.

holder to exchange the security for the holder's proportional interest in the fund's current net assets).

i. 2019 Final ETF Rule

In September 2019, the SEC adopted Rule 6c-11 under the '40 Act, which establishes a new regulatory framework for ETFs and clarifies that ETFs relying on Rule 6c-11 are considered to issue redeemable securities under section 2(a)(32) of the '40 Act (the "ETF Rule").¹³ In the rule release, the SEC explained that "ETFs have features that distinguish them from both traditional open-end and closed-end funds. A defining feature of open-end funds is that they offer redeemable securities, which allow the holder to receive his or her proportionate share of the fund's NAV per share upon presentation of the security to the issuer."¹⁴ The SEC indicated that they believe "that ETF shares are most appropriately classified under the final rule as redeemable securities within the meaning of section 2(a)(32) of the '40 Act, and that ETFs should be regulated as open-end funds within the meaning of section 5(a)(1) of the Act."¹⁵

The SEC also noted that "Commenters also supported our view that the arbitrage mechanism that is central to the operation of an ETF (and the conditions in the final rule designed to facilitate an effective arbitrage mechanism) serves to keep the market price of ETF shares at or close to the ETF's NAV per share. As a result, even though only authorized participants may redeem creation units at NAV per share, commenters agreed that investors are able to sell their ETF shares on the secondary market at or close to NAV, similar to investors in an open-end fund that redeem their shares at NAV per share."¹⁶

ii. SEC Broker-Dealer No-Action Relief

The ETF Rule is consistent with no-action relief that the SEC granted in 2018 to broker-dealers with respect to the capital treatment of their positions in ETFs that were not less than a minimum creation/redemption unit size.¹⁷ Under this no-action relief, broker-dealers holding such positions may assess capital charges with respect to ETF shares as if those shares were redeemable securities under section 2(a)(32) of the '40 Act.

Clarification that ETF shares are redeemable securities in the context of the Margin Rules would be consistent with the SEC's view that ETF shares are redeemable securities for purposes of the '40 Act and for broker-dealer capital purposes.

¹³ Securities and Exchange Commission Final Rule, Exchange Traded Funds, 84 Fed. Reg. 57162.

¹⁴ 84 Fed. Reg. at 57171.

¹⁵ Id.

¹⁶ Id.

¹⁷ SEC, Re: Invesco PowerShares Capital Management LLC – Net Capital Treatment of PowerShares Treasury Collateral Portfolio (Mar. 6, 2018), <https://www.sec.gov/divisions/marketreg/mr-noaction/2018/invesco-treatment-of-collateral-portfolio-15c3-1.pdf>.

- c. **The clarification would benefit swap market participants, including end users, by providing an additional set of liquid assets that could efficiently be posted as margin.**

As the CFTC rightly recognized, it is of critical importance for the Margin Rules to limit eligible collateral to assets with sufficient liquidity. Technical points of interpretive uncertainty that may unnecessarily limit the types of instruments that may be posted, however, have created difficulties for end users who must rely upon a more limited set of instruments to meet margin requirements.¹⁸ For many market participants posting shares of ETFs that hold qualifying assets like U.S. Treasuries as eligible collateral may be easier and more cost effective than posting U.S. Treasuries themselves, particularly in cases where the amount of margin required to be posted is sizeable and posting U.S. Treasuries may involve multiple CUSIPs. Furthermore, without clarification, these difficulties are only likely to become more pronounced in the future as more non-swap dealers are required to post initial margin to dealers as the final margin implementation phases take effect.

Given the liquidity profile and regulatory treatment more generally of ETF shares, we believe that permitting qualifying ETF shares to be posted as margin under the Margin Rules would provide a helpful way for end users and other swap market participants to hold an otherwise desirable asset while satisfying the Margin Rules. Moreover, this clarification would provide swap market participants with a class of liquid assets that may be transferred and pledged more easily and efficiently than could an interest in an open-end mutual fund, the pledging of which presents comparatively greater operational difficulties.

We thank the CFTC for providing BlackRock with the opportunity to comment on the Proposal. Please contact the undersigned if you have any questions or comments regarding BlackRock's views.

Sincerely,

Samara Cohen
Managing Director, Co-Head of ETF and Index Investing (EII) Markets and Investments

Richard Ostrander
Managing Director, Legal & Compliance

Samantha DeZur
Director, Global Public Policy

¹⁸ The need for additional qualifying assets is particularly acute given that the Margin Rules generally do not permit cash to be held as collateral for initial margin purposes for other than short periods of time.