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By Electronic Submission

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RIN 3038–AF07	RIN 3235-AM64; File Number S7–15–20

Re: Request for Comment on Portfolio Margining of Uncleared Swaps and Non-Cleared Security-Based Swaps (RIN 3038-AF07; RIN 3235-AM64).

Ladies and gentlemen,

Better Markets, Inc.[1] appreciates the opportunity to comment on the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission's ("CFTC") (together, the "Commissions") request for comment on portfolio margining of uncleared swaps ("Swaps") and non-cleared security-based swaps ("SB-Swaps").[2] We commend the Commissions for responsibly seeking public comment through a request-for-comment release and not issuing a premature portfolio margining proposal.

There are substantial legal complexities associated with portfolio margining of uncleared SEC and CFTC-jurisdictional derivatives (and related instruments) across multiple account types at SEC and CFTC registrants. Inconsistent elements of margin, segregation, capital, and bankruptcy frameworks across broker-dealers ("BDs"), OTC derivatives dealers ("OTC-DDs"), SB-swap dealers ("SBSDs"), and swap dealers ("SDs") would raise a number of intractable conflict-of-laws issues. Furthermore, these frameworks likely would not be harmonized for portfolio margining purposes without the Commissions deferring on (effectively waiving) otherwise irreconcilable elements of statutory and regulatory requirements and instead applying requirements designed to address risks of *other* types of derivatives in *other* types of accounts maintained by registrant categories.

Thus, although an SEC and CFTC portfolio margining framework for uncleared SB-swaps and Swaps conceptually *could* be risk-reducing for intermediaries and the U.S. financial system, **<u>it also could incentivize market participants to migrate derivatives activities into the most permissive account and registrant categories and open avenues for regulatory arbitrage of margin and capital requirements.</u>**

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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, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 Portfolio Margining of Uncleared Swaps and Non-Cleared Security-Based Swaps, 85 Fed. Reg. 70536 (Nov. 5, 2020), available at https://www.cftc.gov/sites/default/files/2020/11/2020-23928a.pdf.

A portfolio margining framework, by its nature, would broadly reduce derivatives-related margin and capital levels across SEC and CFTC registrant categories. If a framework facilitates the introduction of new derivatives-related risks into account and registrant categories *without otherwise applicable requirements*, benignly described efforts to merely "harmonize" SEC and CFTC requirements and recognize legitimate risk offsets in practice could—and likely would—increase certain types of risks to intermediaries and/or the U.S. financial system relative to the current separately margined account framework.

I. The U.S. regulatory structure divides derivatives oversight responsibilities between multiple regulators, including the SEC and CFTC. Portfolio margining raises practical concerns about regulatory arbitrage and the application of reforms to appropriate derivatives categories.

In the aftermath of the 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act")[3] was adopted to address deficiencies in the regulation, oversight, and management of financial markets and institutions. In Title VII of the Dodd-Frank Act, Congress established a comprehensive regulatory framework to address these issues in the over-the-counter ("OTC") derivatives markets. The Title VII framework institutes, among other things, substantial reforms to risk management practices, including through a statutory framework for the exchange of initial margin ("IM") and variation margin ("VM") on uncleared SB-swaps and Swaps, the segregation of IM in a manner that insulates dealers and their counterparties from most plausible default risks, and the establishment of capital requirements that account for residual credit and other risks arising from uncleared derivatives portfolios.

The Dodd-Frank Act divides responsibilities for implementing these risk management reforms between the SEC, the CFTC, and the prudential regulators.[4] The SEC is responsible for oversight of SB-Swaps markets and key related intermediaries, which include SBSDs in addition to other categories of registrants involved in OTC derivatives activities. The CFTC is responsible for oversight of Swaps markets and key related intermediaries, including SDs.[5] The Dodd-Frank Act complicates this division of responsibilities by providing prudential regulators—including the Board of Governors of the Federal Reserve System ("Federal Reserve") and the Office of the Comptroller of the Currency ("OCC")—responsibilities to establish margin and capital requirements for SEC-registered SBSDs and CFTC-registered SDs that are primarily regulated by prudential regulators. Because SBSDs and SDs may be legal entities involved in other securities and derivatives activities requiring registrations (e.g., BDs), SEC, CFTC, and self-regulatory organization rules and restrictions on SB-swaps and Swaps activities often arise under parallel frameworks as well.

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[3] Pub. L. 111-203, 124 Stat. 1376 (2010).

[4] See 7 U.S.C. § 1a(39) (defining the term "prudential regulator" for purposes of the margin requirements applicable to certain regulated entities).

[5] The CFTC has regulatory authority with respect to derivatives falling within the definition of "swap," as defined in the Commodity Exchange Act ("CEA") (7 U.S.C. § 1 et seq.). See 7 U.S.C. § 1a(47) (providing the statutory definition of "swap"). The SEC has authority with respect to derivatives falling within the definition of "security-based swap," as defined in the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. § 78a et seq.). See 15 U.S.C. § 78c(a)(68) (providing the statutory definition of "security-based swap"). The SEC and the CFTC jointly adopted regulations defining those terms. See Further Definition of "Swap," "Security-Based Swap," and "Security- Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208 (Aug. 13, 2012); Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596 (May 23, 2012).

Under this Byzantine structure, any uncleared SB-swaps and Swaps portfolio margining framework would have to reconcile conflict-of-laws issues and address incentives arising from multiple regulatory frameworks applicable to multiple categories of eligible contracts held within multiple account types at multiple categories of securities and derivatives intermediaries. These intermediaries may hold multiple combinations of SEC and CFTC registrations based on their varied activities in the securities and derivatives markets. For such dual registrants, the SEC and/or CFTC would be required to address irreconcilable margin, segregation, and other customer protection and capital-related provisions, including self-regulatory rules. That means the Commissions would be required to reconsider policy determinations and add further complexity to frameworks adopted or sanctioned by the Commissions after considerable deliberation.

For these reasons, we recommend that the Commissions adopt a *most-restrictive-of-applicable-requirements* approach to applying SEC and CFTC requirements. Under that approach, the Commissions would treat SB-swaps and Swaps held in a portfolio margining account as if they were a single regulatory class of derivatives subject to the strictest of applicable requirements in key areas (e.g., IM posting, prohibited rehypothecation, third-party segregation). Other approaches to resolving conflict-of-laws issues—like providing a choice-of-law mechanism that would drive markets to the least restrictive account classes and registrant categories—almost certainly would sabotage the post-crisis movement of OTC derivatives markets towards standardization, central clearing, multilateral execution, and electronic trading. In fact, such other approaches would incentivize precisely the opposite: The trading of uncleared OTC derivatives through—and continued concentration of risks in—a handful of dealers within four U.S. bank holding companies.[6]

II. Portfolio margining of uncleared derivatives would broadly reduce required IM and enable dealers (and others) to redeploy collateral and capital capacity presently used to mitigate credit and other risks.

The 2008 financial crisis revealed systematic risk management failures at Wall Street's largest financial institutions, especially failures to manage counterparty credit risks in the OTC derivatives markets. The consequence was exemplified by the near-failure of American International Group, Inc., where spillover effects on other financial institutions—including every remaining systemically important investment bank—essentially extorted agencies of the U.S. government, U.S. policymakers, and U.S. taxpayers to directly and indirectly spend, lend, commit, guarantee, pledge, assume, or otherwise put at risk tens of trillions of dollars in bailouts, facilities, and other extraordinary programs to benefit the very institutions that precipitated the worst economic downturn in generations.[7] Counterparty credit risk

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[6] Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, Third Quarter 2019 (Dec. 2019), available at https://www.occ.gov/publications-and-resources/publications/quarterly-report-on-bank-trading-and-derivatives-activities/files/pub-derivatives-quarterly-qtr3-2019.pdf (noting that "[a] small group of large financial institutions continues to dominate trading and derivatives activity in the U.S. commercial banking system" and that "four large commercial banks represented 87.2 percent of the total banking industry notional amounts and 83.2 percent of industry net current credit exposure").

[7] For an overview of interventions, see, e.g., J. Felkerson, A Detailed Look at the Fed's Crisis Response by Funding Facility and Recipient, Public Policy Brief, Levy Economics Institute of Bard College, No. 123 (2012), available at https://www.econstor.eu/bitstream/10419/121982/1/689983247.pdf (calculating "the total amount of loans and asset purchases made . . . from January 2007 to March 2012" and determining that the Federal Reserve's cumulative 2008 financial crisis interventions were "over $29 trillion"). With respect to long-term effects of the crisis, see, e.g., R. Barnichon et. al, Federal Reserve Bank of San Francisco, Economic Letter 2018-19, The Financial Crisis at 10: Will We Ever Recover?, available at https://www.frbsf.org/economic-research/files/el2018-19.pdf (finding "a large fraction of the gap between current GDP and its pre-crisis trend level is associated with the 2007–08 financial crisis" and concluding that "GDP is unlikely to revert to the level implied by its trend before the crisis"). For another study of the effects of the 2008 financial crisis, see T. Atkinson et. al, Federal Reserve

management has since become one of the most critical concerns of global regulators, motivating the 2009 G20 commitments to encourage and mandate central clearing of standardized derivatives and impose higher capital requirements on non-cleared derivatives.[8]

In 2011, the G20 added margin requirements for non-centrally cleared derivatives as a third pillar for managing counterparty credit risk.[9] By then, the Dodd-Frank Act had implemented that commitment by requiring the Commissions and prudential regulators to adopt initial margin ("IM") and variation margin ("VM") requirements for all SB-swaps and Swaps booked into SBSDs and SDs (and less relevant registrants) if they are not cleared by a derivatives clearing organization or a clearing agency.[10] The Commissions and prudential regulators implemented those mandates by adopting margin frameworks for uncleared derivatives. These critical counterparty-specific margin requirements supplement capital requirements based on market and credit risk measures across all of an SBSD or SD's derivatives counterparties.

Portfolio margining generally refers to the cross margining of related but differently regulated positions in a single regulatory account class. In theory, portfolio margining permits market participants to net inversely related risk exposures that otherwise would be separately margined and subject to conflicting statutory and regulatory requirements. It carries the potential to "align margining and other costs more closely with overall risks presented by a customer's portfolio" and "reduce the aggregate amount of collateral required to meet margin requirements."[11] In turn, portfolio margining may permit dealers and others to redeploy collateral and capital capacity, facilitate collateral risk management, reduce operational

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Bank of Dallas, Staff Paper No. 20, How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis (July 2013), available at https://www.dallasfed.org/~/media/documents/research/staff/staff1301.pdf.

[8] See G20 Declaration of the Summit on Financial Markets and the World Economy, The White House President George W. Bush, (November 15, 2008), available at http://www.fsb.org/wp-content/uploads/pr_151108.pdf (stating that prudential regulators must "[s]trengthen[] the resilience and transparency of credit derivatives markets and reduc[e] their systemic risks"); See also 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").

[9] See G20 Cannes Summit Final Declaration—Building Our Common Future: Renewed Collective Action for the Benefit of All (Nov. 4, 2011), available at http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html ("We call on the Basel Committee on Banking Supervision (BCBS), the International Organization for Securities Commission (IOSCO) together with other relevant organizations to develop . . . consultation standards on margining for non-centrally cleared OTC derivatives . . . ."). The Basel Committee on Banking Supervision ("BCBS") and the Board of the International Organization of Securities Commissions ("IOSCO") issued an international framework for margin requirements on Non-Cleared Derivatives in 2013. See BCBS and IOSCO Margin requirements for non-centrally cleared derivatives (March 2015), available at https://www.bis.org/bcbs/publ/d317.pdf. See also BCBS and IOSCO Margin requirements for non-centrally cleared derivatives (September 2013), available at https://bis.org/publ/bcbs261.pdf.

[10] The Dodd-Frank Act's VM and IM requirements address fundamentally different risks in derivatives portfolios. VM is a risk management tool designed to reduce market risks by requiring collateralization of a counterparty's daily change in mark-to-market or mark-to-model exposures within an eligible derivatives portfolio. IM, on the other hand, is a risk management tool designed to reduce credit risks in the event of a counterparty's default by requiring collateralization of defaulting counterparty's potential future exposure, which may be based, in part, on a derivatives portfolio's assumed liquidation and hedging time horizon. Better Markets is especially concerned about the potential for systematic underestimation of credit risks under any future portfolio margining framework. For more detail on margin requirements, see, e.g., Better Markets, Comment Letter on Margin and Capital Requirements for Covered Swap Entities, 84 Fed. Reg. 59970 (Dec. 9, 2019), available at https://bettermarkets.com/sites/default/files/Better_Markets_Inc_Letter_on_Margin_and_Capital_Requirements_for_Covered_Swap_Entities_12-9-2019.pdf.

[11] Portfolio Margining of Uncleared Swaps and Non-Cleared Security-Based Swaps, 85 Fed. Reg. 70536. 70537 (Nov. 5, 2020).

risks, and limit liquidity constraints and other adverse market effects associated with separate but related margin calls.

However, the Commissions must consider significant risks attendant to portfolio margining as well. In addition to the regulatory arbitrage concern we emphasize above, any portfolio margining framework would broadly reduce derivatives-related margin and capital across SEC and CFTC registrant categories. Model review and approval and model risk management program requirements therefore must be carefully considered elements of any portfolio margining framework. Such requirements must provide reasonable confidence, for example, that reductions in required IM would be commensurate with reductions in credit risk for subject portfolios.

However, even with intense scrutiny of models and model risk management programs, the Commissions must remain cognizant of the fact that models, while useful, too often fail to perform as expected in extreme but plausible market conditions (and often, are not designed to address such conditions). Yet, that may be precisely when (1) it is the most critical for models to perform as expected, (2) inverse correlations, volatilities, and other data-based measures relevant to risk components may deviate from prior and expected relationships, (3) IM may be most needed to prevent losses upon a default, and (4) pressures on risk management personnel to approve risk exceptions or deviate from policies and procedures may be significant. If models do not perform as intended, financial institutions will manage derivatives positions with false confidence that they remain within risk tolerances and may under-margin and mask risks within derivatives portfolios.

III. The reduced IM associated with portfolio margining of swaps and SB-swaps would have significant capital implications.

The 2008 financial crisis also demonstrated that U.S. regulators had for too long permitted financial intermediaries either to remain dramatically undercapitalized or to structure legal entities and/or activities to avoid application of capital requirements. Congress therefore[12] enacted Exchange Act section 15F(e)[13] and CEA section 4s(e)[14] to mandate that the SEC and CFTC impose capital requirements on SBSDs and SDs (among others) without a prudential regulator. Exchange Act section 15F(e)(3) and CEA section 4s(e)(3) each specify that one statutory objective of imposing capital requirements is **"[t]o offset the greater risk to the [SBSD and SD] . . . and the financial system arising from the use of [SB-swaps and Swaps] that are not cleared"** and in this regard, require capital levels that (1) "help to ensure the safety and soundness of the [SBSD and SD];"[15] and (2) are **"appropriate for the risk associated with the non-**

12 See Statement of Sen. Christopher Dodd, Cong. Rec., Vol. 156, Issue 104, S5828, S5832 (July 14, 2010) ("Derivatives are vitally important if utilized properly in terms of wealth creation and growing an economy. But what was once a way for companies to hedge against sudden price shocks has become a profit center in and of itself, and it can be a dangerous one as well, when dealers and other large market participants don't hold enough capital to back up their risky bets and regulators don't have information about where the risks lie."), available at https://www.congress.gov/111/crec/2010/07/14/CREC-2010-07-14-pt1-PgS5828.pdf. See also Statement of Sen. Carl Levin, Id at S5842 ("[The Dodd-Frank Act] will bring new transparency and accountability to the shadowy market in derivatives . . . It empowers regulators to establish tough new capital requirements that make it harder for firms to become so big they endanger the stability of the system.").

13 15 U.S.C. § 78o-10(e)(2)(B)(i) (providing that "[t]he [SEC] shall adopt rules for [SBSDs] . . . with respect to their activities as a [SBSD] . . ., for which there is not a prudential regulator imposing—capital requirements"). See also 15 U.S.C. § 78o-10(e)(1)(B) (requiring SBSDs and MSBSPs to comply with such requirements).

14 7 U.S.C. § 6s(e)(2)(B)(i) (providing that "[t]he [CFTC] shall adopt rules for [SDs] . . . with respect to their activities as a [SD] . . ., for which there is not a prudential regulator imposing—capital requirements"). See also 7 U.S.C. § 6s(e)(1)(B) (requiring SDs and MSPs to comply with such requirements).

15 15 U.S.C. § 78o-10(e)(3)(A)(i). 7 U.S.C. § 6s(e)(3)(A)(i).

cleared **[SB-swaps and Swaps]."**[16] Thus, the SEC and CFTC must give special attention to this statutory objective prior to proposing any portfolio margining framework substantially affecting the safety and soundness of SBSDs and SDs and the stability of the U.S. financial system.

The aims of SBSD and SD capital regulations should be uncontroversial. To "help to ensure the safety and soundness" of SBSDs and SDs, the SEC and CFTC's capital requirements must protect SBSD and SD legal entities as going concerns by requiring minimum levels of entity-level financial resiliency to ensure SBSDs and SDs can meet obligations to counterparties and creditors in most extreme but plausible market conditions, while accounting for risk mitigants (e.g., IM). These capital requirements must provide a loss absorbing buffer that is reasonably tailored to the residual risks *across* SBSD or SD lines-of-business and that reasonably ensures, in actual effect, that SBSDs and SDs can perform on derivatives (and other contracts) and maintain critical functions in the event of a broad deterioration of assets. This, in turn, prevents disruptions to SBSD and SD market-making, liquidity, and other functions, limits contagion that otherwise would be attendant to an SBSD or SD's failure or near-failure, and protects funds and/or securities in the control or custody of the SBSD or SD legal entity.

For these purposes, the SEC and CFTC have been given independent prudential mandates under the Dodd-Frank Act. Congress recognized that capital regulation and related supervisory safeguards proved remarkably inadequate during the 2008 financial crisis, most apparently with respect to investment banks and other non-bank financial intermediaries. However, prudential regulators have acknowledged that they, too, failed to address bank capital inadequacies, contributing to the failure and near-failure (and hundreds of billions of dollars in U.S. taxpayer bailouts) of numerous banking entities, including Citigroup as a notable example.[17]

The problem was not merely technical; it was philosophical. For years, in the lead-up to the 2008 financial crisis, prominent bank regulators did not even agree that capital regulations should aim to mitigate systemic risk. Federal Reserve Chairman Alan Greenspan, for example, expressed a view that the "management of systemic risk is properly the job of the central banks" alone and that "banks should not be required to hold capital against the possibility of overall financial breakdown,"[18] presumably even if the banks' trading and other activities greatly increase the likelihood of that overall "breakdown" occurring. That view reflected prevailing group think. Daniel Tarullo, the former Federal Reserve Governor, has noted in this regard that "the extensive official Basel committee commentary on the Basel II process" did not cite "prevention of systemic risk as either a rationale for the existence of capital adequacy requirements or as a factor in setting them."[19]

Unsurprisingly, by 2010, Congress thoroughly disagreed with the Greenspan proposition and provided the SEC and CFTC mandates to establish capital regulations not just to limit but "[t]o ***offset*** the greater risk to the [SBSD and SD] . . . ***and the financial system*** arising from the use of [SB-swaps and swaps] that are not cleared."[20] In other words, the Dodd-Frank Act not only discards the narrow conception

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16 15 U.S.C. § 78o-10(e)(3)(A)(ii). 7 U.S.C. § 6s(e)(3)(A)(ii).

17 For additional information, see Special Inspector General for the Troubled Asset Relief Program, Extraordinary Financial Assistance Provided to Citigroup, Inc. (SIGTARP 11-002) (Jan. 13, 2011), available at https://www.sigtarp.gov/Audit%20Reports/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf.

18 D. Sicilia, J. Cruikshank, The Greenspan Effect: Words that Move the World's Markets, pg. 202 (2001).

19 D. Tarullo, Banking on Basel: The Future of International Financial Regulation, pg. 22 (2008). Then-Professor Tarullo rightly stated that "systemic [risk] concerns should perhaps not be dismissed so readily in framing capital adequacy requirements." Id.

20 15 U.S.C. § 78o-10(e)(3)(A) (emphasis added). 7 U.S.C. § 6s(e)(3)(A) (emphasis added).

of capital adequacy espoused prior to the financial crisis; it divides capital responsibilities between multiple regulators specifically to do the opposite: To protect SBSDs and SDs, as well as "the financial system," from risks associated with SBSD and SD activities, most especially with respect to uncleared derivatives. In the new framework, the SEC and CFTC have been provided clear, independent, and unequivocal mandates to establish capital requirements reasonably designed to achieve systemic risk and other public interest objectives. These capital requirements must be informed by the SEC and CFTC's unique understanding of the SB-swaps and swaps markets and the residual risks in the SBSDs and SDs under their oversight.

Before proposing a portfolio margining framework, then, the Commissions would have to reconsider whether capital requirements across SBSDs and SDs would be sufficiently attentive to the Dodd-Frank Act's directives to mitigate uncleared derivatives risks (unmargined credit risks in particular) both to SEC and CFTC registrants and to the U.S. financial system. Because these and other registrant categories have options to comply with capital components tied to IM exchanged in connection with uncleared derivatives, the Commissions also would have to reevaluate the adequacy of capital requirements at the same time that they consider the impact that the portfolio margining framework would have on IM and credit risk.

Either way, the reduced IM associated with portfolio margining of SB-swaps and Swaps would have significant capital implications. Therefore, the Commissions must consider those implications before proposing broad reductions of IM on portfolios. Permitting portfolio margining of positions that ultimately prove insufficiently related and do not, in practice, present a lower combined risk profile than portfolios considered independently would increase risks to financial institutions and the U.S. financial system in violation of statutory directives. For some SEC and CFTC registrants, the effects may manifest *both* in IM and capital shortfalls.[21]

IV. Conclusion

In the absence of a fulsome proposal explaining a proposed scope with respect to financial instruments, account types, and registrant categories and identifying determinations with respect to conflicts-of-law on key policy questions, it is all but impossible for the public to assess the full implications of a portfolio margining framework. Although offsetting positions can legitimately result in risk-reductions, the Commissions must remain mindful that some of the industry push for portfolio margining is centered around collateral management and capital relief, not necessarily reductions of risk that ostensibly would be associated with them. As such, the Commissions must assume that some in industry will exploit the portfolio margining framework to pull derivatives activities away from more restrictive safety and soundness and customer protection frameworks and towards less restrictive, more profitable—but higher risk—frameworks.

In addition, a portfolio margining framework would introduce bankruptcy complexities and uncertainties that could adversely affect U.S. customers and counterparties and perhaps disincentivize use of portfolio margining accounts. Clarifying the "customer" or "counterparty" status of the beneficial owners of accounts and the treatment of a portfolio margining account upon the bankruptcy of the SEC and/or CFTC registrant carrying that account would be necessary but likely insufficient. Given material statutory differences in the bankruptcy treatment of accounts at SEC and CFTC registrants, harmonizing bankruptcy frameworks for purposes of enabling portfolio margining may require unlikely legislative action.

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[21] Furthermore, the Commission must consider that capital requirements tied to IM apply differently to different categories of registrants and that certain capital requirements may be more sensitive to changes in regulatory IM than others.

Sincerely,

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