January 16, 2024

Chief Counsel's Office
Attn: Comment Processing, Office of the Comptroller of the Currency, Docket ID OCC–2023–0008 (RIN 1557-AE78)
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Secretary, Board of Governors of the Federal Reserve System
Attn: Comments, Docket No. R–1813 (RIN 7100-AG64); Docket No. R–1814 (RIN 7100–AG65)
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Submitted via email to: regs.comments@federalreserve.gov

Re: Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and Banking Organizations with Significant Trading Activity (RINs 1557-AE78, 7100-AG64, 3064-AF29); and, Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies, Systemic Risk Report (FR Y-15) (RIN 7100-AG65)

BlackRock, Inc. (together with its affiliates, "BlackRock")[1] respectfully submits its comments to the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve" or "Board"), and the Federal Deposit Insurance Corporation (the "FDIC", together with the OCC and Federal Reserve, the "Agencies") in response to the Agencies' proposals to modify the regulatory capital requirements applicable to large banking organizations and banking organizations with significant trading activity,[2] which would implement the final components of the

[1] BlackRock is one of the world's leading asset management firms. We manage assets on behalf of individual and institutional clients across equity, fixed-income, liquidity, real estate, alternatives and multi-asset strategies. We manage retirement funds on behalf of millions of Americans, including public pension funds in 47 of the 50 states.
[2] 12 CFR Parts 3 (OCC), 217 (Federal Reserve) and 324 (FDIC) (collectively, as used in this letter, the "capital rules"). For convenience, citations in this letter to the currently effective capital rules reflect

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Basel III capital standards known as the Basel III Endgame (the "Basel Proposal").[3] This letter also includes our comments on the Board's proposal (the "GSIB Surcharge Proposal," together with the Basel Proposal the "Proposals") to make certain adjustments to the calculation of the capital surcharge (the "GSIB Surcharge") for the U.S. global systemically important bank holding companies ("U.S. GSIBs").[4]

As a matter of both regulatory and fiduciary obligations, asset managers like BlackRock—and by extension their clients—regularly rely upon banking organizations to enable access to financial markets allowing asset managers to buy or sell products that can achieve their clients' investment objectives. Therefore, changes that would impact the ability or willingness of banking organizations to serve their traditional roles in financial markets, or to do so at a price point that is untenable to their clients, will have direct impacts on a wide range of market participants and investors. As an asset manager to millions of Americans charged with meeting numerous investment objectives for our diverse client base, BlackRock shares the Agencies' goal of protecting the interests of investors by facilitating the resiliency and stability of the U.S. banking system that we and our clients rely upon to meet those financial goals.

BlackRock, however, believes that the Proposals may cause a material contraction in U.S. banking organization participation in financial markets and thereby may adversely impact the ability of asset managers to implement the investment strategies chosen by their clients or substantially increase the cost of doing so. BlackRock anticipates that the Proposals would likely result in a reduction in the provision of services made available to asset managers for the benefit of their clients, higher costs of capital for borrowers, lower liquidity in certain markets, exacerbated financial stability risks, diminished investor returns and investor choice, increased operational risks from new processes and structures designed to offset the increased capital burden and further concentration of counterparty risk.

We therefore urge the Agencies to consider amendments and clarifications to the Proposals, and to certain other existing rules, to more effectively meet the aim of "strengthen[ing] risk-based capital requirements for large banking organizations by improving their comprehensiveness and risk sensitivity"[5] without unduly imposing costs and burdens on investors. As discussed in more detail below, BlackRock recommends:

With respect to the Basel Proposal:

- Expanding the availability of the 65% risk weighting for corporate exposures under the expanded risk-based approach ("ERBA") to other corporate entities and not just those that have publicly listed securities.

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the Federal Reserve's capital rules. To distinguish the currently effective capital rules from the Proposed Rule, citations to sections of the proposed rule are formatted as in the following example: Proposed Rule § _.[XXX].

[3] *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*, 88 Fed. Reg. 64028 (Sept. 18, 2023), *available at* https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf.

[4] Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15), 88 Fed. Reg. 60385 (Sept. 1, 2023), https://www.govinfo.gov/content/pkg/FR-2023-09-01/pdf/2023-16896.pdf.

[5] Basel Proposal at 88 FR 64030.

- Regarding the imposition of mandatory minimum haircut floors for securities financing transactions, decline adoption of the requirements at this time. Alternatively, if the Agencies decide to proceed with the imposition of the requirements:
    - Modifying the scope of the definition of "unregulated financial institution" to include only entities that employ significant leverage and engage in maturity transformation.
    - Broadening the cash reinvestment exemption to exclude transactions that do not impose material liquidity risk.
    - Clarify that collective investment funds ("CIFs"), as Regulated Investment Funds (as defined below), are excluded from the definition of "unregulated financial institution" because they are subject to significant regulatory oversight.
    - Explicitly state that the exclusion from the definition of "unregulated financial institution" applies to any unregulated financial institution that holds qualifying ERISA plan assets or otherwise serves as the investment vehicle for a pension fund (as described below).
    - In response to the question posed by the Agencies in the proposal, continuing to exclude security financing transactions referencing sovereign issued securities from the minimum haircut requirements.
    - Applying a look-through approach (as described below) when determining minimum haircuts for exchange traded funds (ETFs) and applying haircuts based on the characteristics of the fund's underlying securities.
- Amending the proposed definition of "subordinated debt" under the ERBA to exclude preferred stock in closed-end funds.

With respect to the GSIB Surcharge Proposal

- Amending the current scoring calculation of the GSIB Surcharge rule to align the treatment of ETFs with the credit quality of their underlying assets.
- Excluding ETFs from the definition of "financial institution."
- Removing the requirement that all client clearing of Over-the-Counter ("OTC") derivatives be included into the interconnectedness and complexity indicators.

Parts I through V describe these recommendations in further detail. BlackRock appreciates the opportunity to share our views and we look forward to engaging with the Agencies on the Proposals.

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I. Risk Weighting for Investment Grade Corporate Exposures

BlackRock recommends extending the 65% risk weighting category to include exposures to certain investment funds and institutional investors.

Currently, U.S. capital rules generally require a banking organization to assign a risk weighting of 100% to its corporate exposures under the standardized approach to credit risk (the "Standardized Approach"), with no differentiation between such exposures based on the creditworthiness of the obligor.[6] The Basel Proposal takes a more nuanced approach in an effort to better differentiate the credit quality of corporate obligors, reducing the risk weighting for certain investment grade corporate exposures from 100% to 65%.[7] We support the Agencies' intent to better account for and differentiate credit risk through the expanded risk-based approach (the "ERBA"). However, we believe there are some structural flaws to the proposed framework. Specifically, linking the reduced 65% risk weight to the issuance of public securities, either by the obligor or its parent, removes many investment funds from consideration for the reduced risk weight, which will result in either higher costs of services or even restrict investment funds from obtaining services. While we appreciate that having public securities outstanding may correlate with enhanced transparency and market discipline and is indeed a simple differentiator, it fails to recognize the transparency provided by investment funds through public disclosures required under applicable law or through direct communication of financial information to credit departments of banking organizations that provide discipline on their risk management. We believe the regulatory regimes applicable to these investment funds—in addition to established market practices—achieve a similar, if not superior, level of transparency and discipline. Importantly, not only do the regulatory structures that govern many investment funds require meaningful public disclosure, but these structures also serve as a basis for bank credit departments to categorize those investment funds as investment grade credit risk.

For example, investment funds registered under the Investment Company Act of 1940 (the "40 Act") ("RICs") and business development companies—which elect to be subject to many of the regulations applicable to RICs—("BDCs," and together with "RICs," "U.S. registered funds") that are advised by investment advisers registered under the Investment Advisers Act of 1940 (the "Advisers Act"), are required to provide public reporting on fund financials and portfolio holdings, institute and adhere to corporate governance requirements, complete regular fund audits that are reviewed by the fund board, and are subject to limitations on the use of leverage.[8] Registered open-end mutual funds also are required to publish their net asset values for each business day and report a complete list of their holdings on a quarterly basis.[9] We believe that obligations like these, which also exist under comparable regulatory regimes for retail investment funds in other non-U.S. jurisdictions, already provide significant transparency into the financial state of the foreign equivalents (*e.g.* UCITS) of U.S. registered funds (such foreign funds together with U.S. registered funds, "Registered Funds") and impose considerable levels of

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[6] *See* 12 CFR § 217.32(f)(1).
[7] Proposed Rule § _.111(h). Under the Basel Proposal, corporate exposures are exposures to a company which do not fall under any other exposure category.
[8] *See*, *e.g.*, 17 CFR § § 210, 239, 249, 270, and 274.
[9] 17 C.F.R. § 270.22c-1(b)(1); 17 C.F.R. § 274.150.

discipline on their prudent management of risk. We would also note that the need to properly align the risk weighting of these funds with their actual credit risk profile is particularly acute for open-end mutual funds because these funds regularly maintain credit facilities to meet redemptions.

Likewise, collective investment funds ("CIFs") administered by national banks, while being exempt from registration under the 40 Act, are nonetheless highly regulated (CIFs, together with Registered Funds, "Regulated Investment Funds"). CIFs are subject to specific regulations adopted by the OCC.[10] In addition, nationally chartered banks that act as trustees of CIFs are subject to close and continuous supervision by the OCC. This is an ongoing process that includes monitoring of the bank's activities including real-time assessments of asset and liability management, assessing risks, completing core assessments and communicating with bank management and directors.[11] The supervision of asset management activities is an important component of the OCC's safety and soundness supervisory framework. In addition, to the extent that CIFs are managing the assets of employee benefit plans subject to Employee Retirement Income Act of 1974 ("ERISA"), the CIF is also subject to ERISA. Further, CIFs are formed as state trusts and are subject to applicable state fiduciary regulations.[12] Complying with the applicable rules and regulations imposed by the OCC, the Department of Labor (the "DOL") and state fiduciary regulators requires CIFs to be managed in a risk sensitive way consistent with the investment program agreed with the investors of the CIF. The CIFs are subject to regular audits and produce their own annual audited financial statements and statements of holdings, both of which are available to their investors and to banking organizations that transact with the CIFs.

Analogously to CIFS and U.S. registered funds, pension funds[13] are subject to statutory and or regulatory regimes that impose comparably prescriptive disclosure, supervision and administrative requirements. Many pension funds are subject to open meeting laws, requirements concerning access to public records, and/or direct oversight by governmental bodies and appointed boards. Further, much like entities that issue public securities, pension funds are often required to publicly publish audited financial statements and provide certain material performance metrics like funded status, returns on investments, plan liabilities, risk management and plan governance.

Similarly, insurance companies are regulated to ensure that they have sufficient capital and liquidity to meet their obligations. For example, in the United States, insurance companies are regulated by state insurance departments, who coordinate via the National Association of Insurance Commissioners ("NAIC"). The NAIC also evaluates insurance

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[10] 12 CFR § 9.18.

[11] OCC, Fiscal Year 2024 Bank Supervisory Operating Plan Office of the Comptroller of the Currency Committee on Bank Supervision (News Release 2023-109, September 28, 2023).

[12] For example, BlackRock's CIFs are formed as California trusts, and BlackRock management of the CIFs is consistent with 12 Cal. Code Regs. 10 § 104.512.

[13] For purposes of this comment letter "pension funds" means any plan, fund, or program providing pension, retirement, or similar benefits that is a broad-based plan for employees or individuals that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered, and would include non-U.S. plans subject to substantially similar regulatory requirements.

regulations in non-U.S. jurisdictions for the purposes of reinsurance.[14] In addition to oversight aimed at ensuring the insurance companies' solvency, regulations also require insurance companies to publish financial information at a similar or greater level of transparency than is required for issuers of public securities.[15]

For those entities not subject to statutory or regulatory transparency obligations like Regulated Investment Funds, such as private funds and certain institutional investors, other market standard mechanisms exist to provide banking organizations with comparable levels of transparency. Banks require regular financial reporting that substantially resembles the contents of financial reporting required of publicly traded entities. Further still, many credit arrangements between banking organizations and their counterparties require notices of material financial events, such as new or drawn commitments or a material deterioration in the value of assets. While different in form, we believe the Agencies should consider the substantive similarity between the transparency provided through these contractual requirements and those imposed by regulation.

Fundamentally, we believe many investment funds and institutional investors are highly creditworthy and would rationally be classified as 'investment grade' under any reasonable credit-risk assessment model. If the Basel Proposal is adopted, these entities would face higher costs to engage in services relative to less punitively risk weighted, though similarly creditworthy, entities. This may impact a banking organization's willingness to provide existing banking services, which these entities rely upon on a daily basis. Banking services that could be impacted by the relatively punitive risk weighting include:

- Liquidity facilities and overdraft protection that fund share redemptions and manage day-to-day liquidity needs.
- Bilateral and cleared derivatives that may be used to hedge risks or to obtain exposure to particular investments or markets more efficiently than may be possible through direct investments.
- Securities financing transactions, such as securities lending or repurchase transactions where investment funds lend securities or cash to banks, ultimately increasing liquidity of the securities and funding markets, and producing revenue for fund investors.
- Credit facilities to allow timely fund investments in portfolio companies.

To avoid distortions in the pricing and provision of banking services to investment funds, BlackRock recommends modifying the Basel Proposal to extend the 65% risk weighting category under the ERBA to apply to each of the following categories of corporate exposures: (i) investment grade exposures to corporates with (or that is a subsidiary of a parent company with) publicly traded securities outstanding; (ii) investment grade exposures to Regulated Investment Funds, pension funds and insurance companies; and, (iii) investment grade exposures to other investment funds and

[14] The NAIC also has reciprocal agreements imposing regulation on insurance companies with various jurisdictions globally.

[15] In the U.S., the NAIC requires statutory filings containing similar information to public companies' quarterly reports, and also requires insurance companies to disclose their holdings at a line-item level on a lagged basis.

other institutional investors that are contractually obligated to provide regular, audited financial disclosure to credit providers.

BlackRock believes that this recommended approach is consistent with the Agencies' stated rationale for the proposed publicly traded securities requirement and furthers its objective of applying tailored risk weights to foster the safety and soundness of banking organizations. Further, our proposed recommendation would spare millions of investors unnecessary costs that would ultimately function as a punitive headwind to achieving their long- and short-term financial objectives.

II. Minimum Haircut Floors for Securities Financing Transactions

a. Scope of "Unregulated Financial Institutions"

BlackRock recommends that the Agencies not adopt the minimum haircut floor requirements at this time. Alternatively, if the Agencies decide to proceed with adopting the proposed requirements, we recommend modifying them to (i) apply only to unregulated financial institutions that are significantly levered and engage in maturity transformation; (ii) broaden the cash reinvestment exemption to a wider set of transactions in liquid assets; and (iii) clarify that CIFs and investment funds holding ERISA plan assets (or their non-U.S. equivalents) are excluded from the definition of "unregulated financial institution."

The Basel Proposal would impose minimum haircuts floors on banking organizations for certain non-centrally cleared securities financing transactions ("SFTs"), [16] and netting sets of SFTs, with "unregulated financial institutions" ("In-scope SFTs").[17] Banking organizations would be required to treat In-scope SFTs that do not meet the minimum haircut floors as uncollateralized transactions for capital purposes,[18] effectively forcing the application of the minimum haircut floors for In-scope SFTs. The minimum haircut floors, absent an exemption, would generally apply to any non-centrally cleared SFT between a banking organization and an "unregulated financial institution" (i) where the banking organization lends cash to the unregulated financial institution in exchange for securities, unless all of the securities are non-defaulted sovereign exposures or (ii) that are collateral upgrade transactions. Consistent with the definition in § __.2 of the current capital rules, the Basel Proposal would define "unregulated financial institution" as a financial institution that is not a regulated financial institution, including any financial institution that would meet the definition of "financial institution" under § __.2 of the current capital rules. The Basel Proposal states that the definition is intended to "capture non-bank financial entities that employ leverage and engage in maturity transformation but that are not subject to prudential regulation."[19] Further, the proposal would exempt certain transactions and netting sets of those transactions with unregulated financial institutions from the minimum haircut floor requirements. One of those exemptions is

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[16] In this letter, an "SFT" refers to a transaction that meets the definitional and operational requirements to be treated as a "repo-style transaction" or "eligible margin loan" under the capital rules. Under the capital rules, a repo-style transaction is a securities borrowing or securities lending transaction or a repurchase agreement or reverse repurchase agreement transaction, whether cleared or uncleared, that involves liquid and readily marketable securities, cash or gold, provided that certain criteria are satisfied. 12 CFR § 217.2 (definition of "repo-style transaction").

[17] Basel Proposal at 88 FR 64064.

[18] *Id.*

[19] *Id.*

defined as transactions in which an unregulated financial institution lends, sells subject to repurchase, or posts as collateral securities to a banking organization in exchange for cash and the unregulated financial institution reinvests the cash at the same or a shorter maturity than the original transaction with the banking organization.

BlackRock believes that these proposed changes would have a number of negative effects on investors, including (i) imposing substantial new costs on In-Scope SFTs due to the increased capital requirements for such transactions; (ii) unnecessarily discriminating against certain types of investment funds that are similarly situated to other investment funds exempted from the minimum haircut requirement; (iii) further solidifying a jurisdictional regulatory asymmetry that disadvantages U.S. GSIBs and, (iv) assigning collateral haircuts that do not appropriately recognize or account for the risk and volatility attributes of underlying assets. The net results of these externalities, we believe, are increased costs and more limited access to the banking organization services and products that investors rely on to effectively manage risk and meet their investment objectives. The proposed amendment may also reduce investors' ability to use SFTs, thereby denying them valuable lending revenue from their long-term securities holdings and impair the price discovery and risk hedging opportunities related to short selling. For these reasons, BlackRock recommends that the Agencies decline to adopt the proposed minimum haircut floors for SFTs until more insight into their potential effects are known and analyzed.

However, if the Agencies determine to move forward with requiring minimum haircut floors, BlackRock believes the Agencies should modify the proposed requirements in the following manner:

- Modify the definition of "unregulated financial institution" for the purpose of the minimum haircut floors to apply only to unregulated financial institutions that have significant leverage and engage in maturity transformation.
- Broaden the cash reinvestment exemption to encompass instances when an unregulated financial institution reinvests cash collateral in such a way that it retains sufficient liquidity across its collateral pool to satisfy transaction unwinds including investments in cash or liquid and readily marketable securities.
- Clarify that CIFs, as Regulated Investment Funds, are excluded from the definition of "unregulated financial institution" because they are subject to significant regulatory oversight (as articulated in Part I of this letter).
- Make explicit that the exclusion from the definition of "unregulated financial institution" applies to any unregulated financial institution that holds qualifying ERISA plan assets or otherwise serves as the investment vehicle for a pension fund (as described above).

Relatedly, the Basel Proposal would apply a collateral haircut to shares of ETFs that is equal to that applied to any other publicly traded equity security, regardless of the nature of the underlying securities of the ETF.[20] In instances where an ETF invests primarily in debt securities, this treatment would result in a substantially higher collateral haircut despite the ETF having a substantially similar economic exposure and risk profile to a portfolio of individual debt securities. To avoid these otherwise punitive collateral

[20] Basel Proposal at 64060-61 & 63.

haircuts that would impose unnecessary costs on investors, BlackRock recommends that the Agencies amend the proposal to permit a banking organization to apply a collateral haircut based on the characteristics of the underlying assets of the ETF when it has knowledge of the composition of all of the underlying exposures (referred to as a look-through approach).

SFTs serve an important role in the efficient functioning of the securities trading market in the U.S. by bolstering market liquidity, promoting expeditious settlement of trades, and facilitating efficient and effective hedging strategies and price discovery. BlackRock urges the Agencies to consider the aforementioned recommendations to ensure the continued efficiency of U.S. markets. We would also note that the United Kingdom[21] and the European Union[22] have decided to postpone the implementation of the Basel III standards with respect to SFTs until such time that they have sufficient information and insight into the potential effects on market functioning. A similar pause, we believe, is warranted in the United States to (i) ensure the prudence of the proposed amendments and (ii) ensure global consistency that would not unfairly benefit one jurisdiction's banking organizations over another.

b. Inclusion of Sovereign Exposures in the Definition of "In-Scope Transactions"

BlackRock recommends continuing to exclude security financing transactions on sovereign issued securities from the minimum haircut requirements of the capital rules.

The Basel Proposal requests feedback on the definition of "in-scope transactions" for purposes of applying the minimum haircut floors.[23] In particular, the Agencies inquire

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[21] Bank of England, *Consultation Paper 16/22 – Implementation of the Basel 3.1 Standards*, Nov. 30, 2022, https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards ("Note that the [Prudential Regulation Authority] is not consulting in this [consultation paper] on the implementation of minimum haircut floors for securities financing transactions (SFTs) in the capital framework [...]. The PRA will consider whether implementation in the capital framework is appropriate in due course, taking into account data available under SFT reporting.").

[22] Council of the European Union, *General Approach on Regulation (EU) No. 575/2013 As Regards Requirement for Credit Risk, Credit Valuation Adjustment Risk, Operational Risk, Market Risk and the Output Floor*, "The lack of clarity of certain aspects of the minimum haircut floors framework for [SFTs], developed by the BCBS in 2017 as part of the final Basel III reforms, as well as reservations about the economic justification of applying it to certain types of SFTs have raised the question of whether the prudential objectives of this framework could be attained without creating undesirable consequences. The Commission should therefore reassess the implementation of the minimum haircut floors framework for SFTs in Union law [in approximately two years].")

[23] *See* Question 55 of the Basel Proposal, asking "What alternative definitions of "in-scope transactions" should the agencies consider? For example, what would be the pros and cons of an expanded definition of "in-scope transactions" to include all eligible margin loan or repo-style transactions in which a banking organization lends cash, including those involving sovereign exposures as collateral? How would the inclusion of sovereign exposures affect the market for those securities? What, if any, additional factors should the agencies consider concerning this alternative definition?" Basel Proposal at 64064.

as to the merits of expanding the definition to include sovereign exposures and the potential effects of such as expansion on the market for those securities.[24]

BlackRock recommends not expanding the definition of "in-scope transactions" to include sovereign securities in the manner contemplated by the Basel Proposal until further transparency into the marketplace of sovereign securities can be obtained and studied to determine the potential impact on the markets for such exposures. Furthermore, we believe that the Agencies also should first assess the impact of the recently adopted Securities and Exchange Commission ("SEC") rules that require central clearing of certain U.S. Treasury securities transaction as such rules are likely to have a substantial impact on the structure and functioning of those markets and may in fact mitigate some of the system risk related to SFTs of U.S. Treasuries.[25] Any application of minimum haircuts on sovereign securities could have material—and at this time, unknown—impacts on the liquidity, depth and resiliency of markets for those securities. In a recent paper published by the Federal Reserve, the Board acknowledged that requiring haircuts on U.S. Treasury repo transactions could have material impacts on the volatility of spreads in that market but that more information and analysis is needed to determine the net effects and estimating how a floor on repo haircuts might affect (either positively or negatively) the Treasury markets.[26] Given that increases in borrowing costs to governments through these markets are directly borne by taxpayers, we would urge the Agencies to take a methodical, incremental and data-driven inquiry and analysis, subject to full public notice and comment, prior to considering the imposition of any type of haircut on sovereign securities.

III. Risk Weight Treatment of Closed-End Fund Preferred Stock

BlackRock recommends exempting preferred stock in 40 Act closed-end funds from the proposed definition of "subordinated debt."

The Basel Proposal, under the ERBA, would introduce a definition and an explicit risk weight treatment for exposures in the form of subordinated debt instruments.[27] The proposed definition of a "subordinated debt" instrument would capture exposures that are financial instruments and, in the view of the Agencies, present heightened credit risk but are not equity exposures and would include "preferred stock that is not an equity exposure."[28] This proposed definition would result in further heightening the incongruous treatment of these securities relative to other types of similarly situated senior securities and could inadvertently eliminate an efficient and prudent form of leverage to certain 40 Act registered closed-end funds that investors in those funds depend upon to meet their investment objectives.

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[24] *Id*.
[25] SEC, *Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule with Respect to U.S. Treasury Securities*, Release No. 34-99149 (Dec. 13, 2023).
[26] Board Governors of the Federal Reserve System, *Hedge Fund Treasury Exposures, Repo, and Margining*, (September 8, 2023) *available at* https://www.federalreserve.gov/econres/notes/feds-notes/hedge-fund-treasury-exposures-repo-and-margining-20230908.html.
[27] Basel Proposal at 64042-43.
[28] *Id*.

Preferred stocks issued by closed-end funds are considered senior securities under the 40 Act and are structured to serve as the most senior form of leverage in a closed-end fund's capital structure.[29] These securities often contain contractual provisions that prohibit a fund from issuing any debt senior to such shares and are subject to a 200% asset coverage requirement immediately following issuance.[30] U.S. GAAP, generally, classifies preferred stock such as these to be "debt securities" rather than equities.[31] These securities are frequently used by 40 Act closed-end funds, particularly municipal bond closed-end funds, to employ modest leverage—subject to strict statutory limits—to efficiently enhance the returns of their higher-yielding long-term bond positions. Under the current standardized approach, preferred stock issued by closed-end funds can receive a standard corporate risk weight of 100%.[32] This is despite the fact that an equity exposure, in the form of common stock ownership, of the fund can be subject to a look-through approach that renders the risk weighting to be a function of the underlying securities.[33] In the case of municipal bond closed-end funds, the resultant risk weighting would be a blended risk weight of constituent securities that have risk weightings somewhere between 20% (general obligation bonds) and 50% (revenue obligation bonds).[34] The effective result of the current approach can be that a subordinate claim on the assets of the fund receives vastly superior risk weighting treatment compared to a senior claim.

Under the Basel Proposal, this confounding result is further compounded by including preferred stock in the definition of "subordinated debt" under the ERBA. This classification could increase the risk weighting of preferred stock to 150%.[35] While the Basel Proposal somewhat tempers the ratio of disparity between preferred stock and the common stock of municipal bond closed-end funds by also amending the look-through approach applicable to the common stock to require that that leverage levels of the fund be reflected (*i.e.*, total assets / equity) in the risk weighting calculation (which is not currently required),[36] it is unclear what the impetus is for such a material increase in capital requirements for such a low risk asset. The likely result of a considerable increase in capital requirements for preferred stock of 40 Act closed-end funds is a substantial reduction in their demand and or a sharp rise in their issuance cost to funds. In either scenario, the impact will likely be borne directly by investors in these funds and, perhaps, indirectly by the municipalities that depend on these investment funds to provide capital for their public projects and budget.

To better align the risk profile of preferred stock with the analogous risk weightings for similarly situated securities, BlackRock recommends that the definition of "subordinated debt" exclude preferred stock in 40 Act closed-end funds because such securities are subject to regulatory oversight and stringent limitations on leverage. This

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[29] 15 USC § 80a-18(g).
[30] 15 USC § 80a–18(a)(2)(A).
[31] *See* ASC 320-10-20.
[32] 12 CFR § 217.32(f)(1).
[33] 12 CFR § 217.53.
[34] 12 CFR § 217.32(e)(i) and (ii).
[35] Proposed Rule §_.111(h)(4).
[36] Proposed Rule §_.142(b).

interpretation would ensure that preferred stocks receive risk weighting of at least 100% but also remain eligible for a 65% risk weighting if the issuing entity qualifies.

IV. Treatment of ETFs under GSIB Surcharge Rule

BlackRock recommends amending the GSIB Surcharge Proposal to exclude ETFs from the definition of "financial institutions" and to further reduce the scoring weight of ETFs to more closely align with the credit risk of the fund's underlying securities.

ETFs provide investors with a convenient, cost-effective way to access markets, and investors of all types have increasingly turned to ETFs to allocate capital and manage risk. Increased capital surcharges for ETFs could diminish liquidity in these products, ultimately increasing the cost of using ETFs for investors.

Under the current GSIB Surcharge rules, ETFs are scored more punitively than (i) the constituent securities that compose the funds' holdings and (ii) other securities that provide comparable economic exposures (*e.g.*, index futures).[37] In some cases, this punitive treatment has impacted the trading behavior of U.S. GSIBs over scoring periods, including how they manage capital to meet quarter-end targets, their appetite to provide liquidity to ETFs, and ability to recognize the benefits of using ETFs as hedging vehicles to reduce risk (*e.g.*, liquidity at a generally low cost).

The GSIB Surcharge Proposal would eliminate the current 'point in time' measurement period and instead require that the GSIB Surcharge measure average holdings of assets (including ETFs) over the entire period for which the calculation is being made (daily or monthly). While we agree with the Board that an average holding period may provide a more accurate measurement of GSIBs' holdings, this change, absent any modifications to the current weighting parameters for ETFs, will make holding ETFs even more costly for U.S. GSIBs.

In addition to the amplifying effects that the proposed new measurement period would have on the already punitive treatment of ETFs, the GSIB Surcharge Proposal also would amend the FR Y-15 instructions by expanding the definition of "financial institution" to include ETFs (alongside adding savings and loan holding companies, private equity funds, and asset management companies).[38] This expanded definition would further increase the GSIB score for ETFs.

As described in the GSIB Surcharge Proposal, banking organizations often enter into transactions with other financial sector entities, giving rise to a range of obligations that, in the view of the Board, can also serve as transmission channels for stresses to financial stability.[39] The GSIB Surcharge rule currently measures interconnectedness using three systemic indicators: intra-financial system assets, intra-financial system liabilities, and securities outstanding.[40] For purpose of these indicators, the FR Y–15

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[37] 12 CFR Part 217, Subpart H.
[38] Board of Governors of the Federal Reserve System, "Banking Organization Systemic Risk Report" at B-2.
[39] GSIB Surcharge Proposal at 60391-2.
[40] *Id*.

instructions currently define "financial institutions" as depository institutions, bank holding companies, securities brokers, securities dealers, insurance companies, mutual funds, hedge funds, pension funds, investment banks, and central counterparties.[41] The GSIB Surcharge Proposal, however, acknowledges that "the redemption structures for shares of exchange-traded funds generally differ from the structure of an open-ended mutual fund..." but states that asset management entities, like ETFs, can have "a variety of redemption structures and still act a source of financial sector interconnectedness."[42]

BlackRock believes that the unique structural attributes of ETFs acknowledged by the Board, combined with certain regulatory obligations imposed on the funds, sufficiently mitigate the interconnectedness concerns expressed in the proposal and warrant an exclusion from the definition of "financial institution."

First, unlike other investment funds included in the definition, ETF investors do not interact directly with the fund provider when buying or selling fund shares. Instead, ETF investors generally trade existing ETF shares with each other during market hours, on an exchange, just like trading stocks. Market makers—key liquidity providers in the ETF ecosystem that ensure continuous and efficient ETF trading in the secondary market—regularly provide two-sided (buy and sell) quotes to clients on the exchange.[43] Most ETF trading happens in this "secondary" market, which means that ETFs are generally not required to sell assets when ETF investors sell their shares.[44] When demand cannot be met in the secondary market, a separate, "primary" market exists where large institutions (authorized participants, "APs") can transact with ETF issuers to create or redeem ETF

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[41] *Id*.

[42] GSIB Surcharge Proposal at 60392.

[43] Authorized Participants ("APs") and market makers have an economic incentive to take advantage of arbitrage opportunities in the market. This involves trading the ETF shares or underlying securities when there are small price differences between the two. A market maker may engage an AP to initiate a creation if the price of an ETF share is greater than the value of the underlying holdings (at a premium) or a redemption if the price of an ETF share falls below the value of the underlying holdings (at a discount). For example, assume that when the market opens, the price of an ETF and the value of its underlying securities are both $100. If the value of the underlying securities falls to $99 while the price of the ETF remains $100 (i.e., the fund is trading at a premium), an AP could profit by creating new ETF shares. Specifically, the AP could buy the underlying securities for $99, deliver them to the ETF issuer to create shares of the ETF and sell the ETF shares at the market price of $100. This results in a profit of $1 per share for the AP. Likewise, if the market price of the ETF falls to $99 while the value of underlying securities remains $100 (i.e., the fund is trading at a discount), an AP could buy shares of the ETF and redeem them with the issuer in exchange for the fund's underlying securities, resulting in a profit of $1 per share for the AP. The ability to exchange the ETFs for either cash or the underlying assets provides economic incentives for market makers to trade when the price deviates from the value of the underlying assets. This self-policing mechanism seeks to ensure that the exchange price does not materially deviate from the value of the funds' assets. Any drifting in the price of an ETF away from the current value of the ETF's portfolio of securities may economically incentivize market makers due to the fact that profit can be made by selling the higher-priced asset while simultaneously buying the lower-priced asset. We term this the "ETF arbitrage mechanism."

[44] In the third quarter of 2023, the ratio of secondary market activity to primary market activity in the U.S. was eight to one. This means that for every $8 of ETFs traded, only $1 resulted in trading activity in the underlying securities. Source: Bloomberg, BlackRock.

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shares based on market demand.[45] This process facilitates price discovery and maintains alignment between the price of the ETF share and the value of its underlying securities. The presence of multiple APs in the ETF primary market serves as a risk mitigating mechanism.[46] Additionally, many primary market transactions between an ETF and AP happen "in-kind." In an in-kind redemption, an AP receives a pre-specified bundle of securities representing the underlying index in exchange for ETF shares. In other words, the ETF oftentimes is not required to sell portfolio securities to satisfy investor redemptions. Historically, ETFs have served as a tool for investors to access liquidity and trade efficiently, even in times of heightened volatility.[47] The combination of robust primary and secondary markets and the availability of in-kind redemptions for ETF shares mitigates the risk that ETFs will become pro-cyclical contributors of systemic risk during times of market stress and, therefore, ETFs should not be viewed by the Board as propagating interconnectedness risk.

Second, ETFs are subject to regulations that impose a number of obligations that substantially mitigate their potential contribution as channels for the transmission of distress and financial instability. For example, the 40 Act and related guidance limits the amount of leverage[48] an ETF may incur, regulates how funds value assets, requires public disclosure of fund financials, and, along with the Internal Revenue Code, establishes minimum asset diversification requirements that could help mitigate the potential impact of any one fund holding.[49]

Together, these regulatory requirements, structural elements and trading mechanisms serve as important distinguishing characteristics from other types of entities included in the definition of "financial institution" that, in our view, warrant (i) a reconsideration by the Board of both the current scoring weight under the GSIB Surcharge rule that would reduce the scoring weight of ETFs to more closely align with the credit risk of the fund's underlying securities and (ii) an exclusion of ETFs from the expanded definition of "financial institutions" under the GSIB Surcharge Proposal.

Absent these changes, we believe that many banking organizations will have a materially diminished ability and risk appetite to serve as liquidity providers in the ETF market (both primary and secondary), which could lead to greater volatility and decreased liquidity in those markets. This would be detrimental to the 16.1 million American

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[45] Each AP has an agreement with an ETF issuer that gives it the right (but not the obligation) to create and redeem ETF shares. APs may act on their own behalf or on behalf of market participants and are not compensated by ETF issuers. Each ETF contracts with multiple APs.

[46] As of February 28, 2023, there were 59 "contracted" and 39 "active" APs for U.S.-listed ETFs. A contracted AP has an effective agreement in place with an ETF issuer that allows it to create or redeem ETF shares, even if the AP does not regularly do so. An active AP has created or redeemed shares of an ETF within the fund's most recent fiscal year. Source: BlackRock analysis of SEC Form N-CEN data.

[47] *See Lessons from Covid-19: ETFs as a Source of Stability*, BlackRock, *available at:* https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-lessons-from-covid-19-etfs-as-a-source-of-stability-july-2020.pdf.

[48] *See* Sections 18(f)(1) and 18(a) of the 1940 Act, and 17 CFR 270.18f-4.

[49] 15 USC 80a-1 et seq.

households who rely on ETFs to meet their financial goals.[50] Further, banking organizations may, as result of the increased costs associated with holding ETF positions, no longer be able to use ETFs as cost-efficient hedging mechanisms, removing an important tool that banking organizations currently use to effectively and efficiently mitigate risk.

V. GSIB Surcharge Proposal—OTC Derivatives

BlackRock recommends not amending the GSIB Surcharge to include agency model cleared OTC derivatives in the systemic indicators of the surcharge calculation.

In the GSIB Surcharge Proposal, the Board has proposed amending the complexity and interconnectedness indicators to include cleared OTC derivatives provided to clients under the agency model, where the GSIB guarantees its clients to the Central Counterparty. In the proposal, the Board states that these amendments are aimed at promoting consistent treatment between the principal and agency clearing models and to capture "a firm's guarantees of client performance to a CCP with respect to client cleared derivative positions." [51] While we appreciate the appeal of aligning the treatment across the two models, its enactment would negatively impact the availability and affordability of cleared derivatives for end users, particularly those clearing through U.S. GSIBs. We urge the Board to consider the following critical points.

a. The Board has not clearly articulated the financial or systemic risk reduction benefits of the GSIB Surcharge Proposal.

The current GSIB Surcharge Proposal mirrors one that was proposed and ultimately rejected by the Board in 2017. At that time, the Board cited industry comments that asserted, "the risk associated with client-cleared transactions would have been overstated under the proposal and that the risks associated with these transactions are already appropriately captured in total exposure (Schedule A, item 1(h)), intra-financial system assets (Schedule B, items 5(a) and 5(b)), and intra-financial system liabilities (Schedule B, items 11(a) and 11(b))."[52] The Board further concluded, "the Board does not believe it is appropriate at this time to treat the client leg of a cleared transaction in the agency model as more complex than a simple credit exposure, and therefore does not believe it is currently necessary to include these exposures in the complexity indicator."[53]

In addition, industry commenters to those previous proposals highlighted that central clearing reduces complexity, interconnectedness, overall systemic risk and

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[50] As of 2022. Source: Investment Company Institute available at https://www.ici.org/system/files/2023-05/2023-factbook.pdf.
[51] GSIB Surcharge Proposal at 60392.
[52] Board, *Agency Information Collection Activities: Announcement of Board Approval Under Delegated Authority and Submission to OMB*, 83 FR 31144 (Jun. 30, 2018).
[53] *Id.* at 31145. *See also* the Agencies liquidity rules: (1) Liquidity Coverage Ratio 79 FR 61440 at 61497-61498; and, (2) Net Stable Funding Ratio, 86 FR 9120 at 9188 "…if a covered company is engaged in clearing activities as an agent for a client, it may be that the covered company would record no balance sheet entries associated with such activities. Accordingly, there would be no RSF factor assigned to such activities. Under these circumstances, interdependent treatment would be unnecessary."

provides transparency by replacing the complex and interconnected web of bilateral ties between market participants. They also noted that interconnectedness is substantially curtailed in a central clearing model by a waterfall of risk mitigants that include robust amounts of initial margin, pre-funded default fund contributions, CCP capital and other safeguards.

In light of these prior conclusions, we believe that it would be instructive to the market if the Board were to provide its rationale for re-introducing the proposed requirements. Furthermore, we agree with the commenters' assessment of the initial proposal that central clearing ultimately reduces risk in these indicators.[54] Since 2017, cleared markets have proven to operate as they were designed, protecting broader market participants from contagion risk from small and large bank defaults in 2023. We ask that the Agencies give these previous conclusions and comments due consideration as they determine whether to move forward with the proposal.

b. Cleared OTC Derivatives are already accounted for under the GSIB Surcharge and the current capital rules.

Adding, as proposed, agency model cleared OTC derivatives transactions to the complexity and interconnectedness indicators would essentially "triple count" the exposures as they are already accounted for in the size indicator of the GSIB Surcharge. In addition, and aside from the GSIB Surcharge, the current capital rules impose a series of capital requirements that account for the risk exposure of OTC derivative transactions. These requirements include (i) the Standardized Approach to Counterparty Credit Risk ("SA-CCR") that assesses risk-based capital requirements for counterparty risk,[55] (ii) mandatory default fund contributions, (iii) mandatory initial and variation margin held on balance sheets[56]; and (iv) leverage capital requirements for certain derivatives exposures, including in the form of the Supplementary Leverage Ratio ("SLR")[57] and the "enhanced" Supplementary Leverage Ratio.[58] Given the ample recognition of the credit risk exposure of cleared OTC derivative transactions in the current calculation of capital requirements, we believe that also including such transactions into the complexity and interconnectedness indicators would be unnecessary and, in fact, result in overweighting of such risk exposures relative to the actual risk they pose.

c. The proposed change is expected to materially increase capital requirements for client trades as the vast majority of client cleared OTC derivatives are currently cleared under the agency model.

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[54] *See*, *e.g.*, Letter to the Board of Governors of the Federal Reserve System regarding Proposed Agency Information Collection Activities (FR Doc. 2017-17939) from the Futures Industry Association and the International Swaps and Derivatives Association, dated October 11, 2017.
[55] 85 FR 4362.
[56] *See* SR 17-7 "Regulatory Capital Treatment of Certain Centrally-Cleared Derivative Contracts Under Regulatory Capital Rules" (August 14, 2017).
[57] 79 FR 57725.
[58] *See* CFTC Research Paper "When the Leverage Ratio Meets Derivatives: Running Out of Options?" (April 2019) *available at* https://www.cftc.gov/sites/default/files/2019-05/oce_leverage_and_options_ada.pdf.

Notwithstanding the Board's rationale for re-instating the GSIB Surcharge Proposal with respect to client cleared OTC derivatives under the agency model, it is paramount that the repercussions of such a move be identified and analyzed to ensure the change is warranted. Given the dominance of the agency model in client cleared OTC derivatives markets, it is logical to expect this proposed change would increase capital charges for the provision of these services.[59] This will likely result in one or several of the following: (1) increased cost to end-users for cleared OTC derivatives; (2) reduced appetite to voluntarily clear non mandated derivatives; (3) reduction in banks willing to provide OTC clearing services and a concurrent increase in clearing member concentration; (4) reduced ability to effectively port positions to a non-defaulting clearing member; and (5) reduced end-user participation in derivatives that could include a reduction in hedging activity.

We urge the Board to fully analyze the microeconomic impact that the GSIB Surcharge Proposal could have on the provision and use of derivatives clearing services that could in turn increase systemic risk.

d. International Basel standards do not include these transactions in GSIB surcharge calculations, which would create a competitive disadvantage for U.S. GSIBs.

In the Basel Committee on Banking Supervision's latest reporting instructions, non-U.S. GSIBs are explicitly instructed to not include cleared OTC derivative transactions in the complexity indicator when the clearing non-U.S. GSIB, acting as agent, does not guarantee the performance of a CCP to its client.[60] In requiring U.S. GSIBs to include such transactions within the complexity indicator of the U.S. GSIB Surcharge, the Board would be inflicting a competitive disadvantage on U.S. GSIBs relative to their non-U.S. counterparts. This competitive asymmetry would then sit on top of the already more stringent capital requirements imposed by the current GSIB Surcharge through the use of the U.S.-specific methodology for calculating the GSIB Surcharge, also known as 'Method 2.'[61] In addition, client-cleared derivatives will be subject to new credit valuation adjustment ("CVA") risk requirement under the Basel Proposal, while non-U.S. GSIBs are exempted from this requirement. These competitive disadvantages could, assuming other non-U.S. clearing firms had available capacity, cause a flight of OTC derivatives clearing away from U.S. GSIBs to other less, or dissimilarly, regulated organizations and markets. BlackRock therefore urges the Board to not adopt these proposed changes as we believe they would further widen the disparate regulatory treatment between U.S. and non-U.S. GSIBs.

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[59] *See* BIS, FSB, OICV-IOSCO "Incentives to centrally clear OTC derivatives: a post-implementation evaluation of the effects of the G20 financial regulatory reforms – final report" (November 19, 2018) at 3.

[60] Basel Committee on Banking Supervision, Instructions for the end-2022 G-SIB assessment exercise, *available at* https://www.bis.org/bcbs/gsib/instr_end22_gsib.pdf.

[61] Method 2 measures a GSIB's systemic risk profile using the same systemic indicators as Method 1, except that the substitutability category is replaced with a measurement of reliance on short-term wholesale funding. Method 2 generally results in materially higher capital requirements than "Method 1" and is the standard adopted by the Basel Committee on Banking Supervision for identifying and setting the surcharge for GSIBs and is followed by non-U.S. GSIBs.

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VI. Support for other commenters

We also write to express our general support of many of the issues raised in the comment letters submitted, on or about January 16, 2024, by the Investment Company Institute (ICI) and the Securities Industry and Financial Markets Association Asset Management Group (SIFMA AMG) regarding the Proposals. We believe that Agencies should carefully consider the issues identified, and recommendations made, in each of these letters.

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There is a close, interdependent, relationship between asset managers, banking organizations and the millions of investors that are investing their hard-earned wages to meet their long and short-term financial objectives. We therefore hope that the Agencies appreciate that substantial modifications to the structure or workings of any one financial market or market participant will have direct and consequential effects on all of those investors hoping to achieve their financial goals. While we recognize and agree that regulation governing U.S. capital markets should be periodically reviewed and updated to keep pace with the evolution of market structure and market participants, we also believe that any change should be based on a holistic and pragmatic evaluation of how modifications may impact other parts of the financial ecosystem so that benefits to one part are not gained at the expense of another with little to no net gain to the greater whole. BlackRock therefore requests that the Agencies give due examination of the potential impacts of the Proposals to the market participants and investors that rely on banking organizations for efficient functioning of markets, effective risk and liquidity management strategies and the efficient provision of credit to meet their investment objectives. Also, in determining whether to proceed with any of the proposed amendments under consideration in the Proposals, we would also ask the Agencies to fully contemplate and acknowledge how other regulatory regimes have developed risk mitigating regulatory solutions that may currently address some of the same concerns prompting their current rulemaking action.

We thank the Agencies for providing BlackRock the opportunity to comment on the Proposals and other rules. Please contact the undersigned if you have any questions or comments regarding BlackRock's views or if we can be of any assistance as you develop your final position on the Proposals.

Sincerely,

Samara Cohen
Chief Investment Officer of ETF and Index Investments, BlackRock

John Kelly
Global Head of Corporate Affairs, BlackRock