

Memorandum

CFTC GMAC Global Market Structure Subcommittee Recommendation

I. Objective:

Include U.S. Treasury exchange-traded funds (“ETFs”) as eligible initial margin (“IM”) collateral under the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (collectively, “Covered Swap Entities” or “CSEs”) (the “CFTC Margin Rules” or “Margin Rules”)¹ to enhance the robustness and resilience of the collateral pipeline. This enhancement, driven by factors such as diversification, liquidity, efficiency, and market stability, could prove beneficial for end-users seeking a wider range of eligible IM, CSEs and the broader financial markets.

II. Recommendation:

The Subcommittee is urging the Commodity Futures Trading Commission (“CFTC” or “Commission”) to expand the universe of liquid assets that can be posted as uncleared margin, specifically to include U.S. Treasury ETFs (hereafter, “UST ETFs”). This would involve the CFTC providing clarity that certain ETFs would qualify as eligible IM collateral under the Margin Rules. In particular, the CFTC should specify that shares of an ETF that is an open-end investment company registered with the U.S. Securities and Exchange Commission (the “SEC”) under the Investment Company Act of 1940 (the “40 Act”), should be considered “redeemable securities” in a pooled investment fund². Therefore, shares of an ETF that invests in qualifying assets and meets other relevant investment conditions (“Qualified ETF”), as detailed in the Margin Rules,³ would be considered eligible collateral under the Margin Rules.

In addition, the Subcommittee is requesting the Commission encourage the U.S. Prudential Regulators to acknowledge and align with this clarification to their Margin Rules, which would prevent inconsistent collateral standards and acceptance by swap dealers.

III. Key Advantages to Include UST ETFs as Eligible IM Collateral

1. UST ETFs provide a diversified exposure to a portfolio of U.S. Treasury securities in a single instrument, which can help mitigate the idiosyncratic risk associated with an individual bond.
2. Fixed Income ETFs, including UST ETFs, played a crucial role in transforming the Bond market by promoting electronification, algorithmic bond pricing and portfolio trading, Fixed income ETFs empower investors to gain instant access to hundreds of bond market

¹ 17 CFR Part 23

17 C.F.R. § 23.156(a)(1)(ix)

exposures at transparent prices with extra layers of liquidity from secondary on exchange trading.

3. During many historic volatile trading sessions, certain UST ETFs have acted globally as “shock absorbers,” providing real-time prices and liquidity. Most notably, during the bond market volatility in 2020, volatility increased in U.S. Treasury bonds as dealers’ balance sheets were constrained. During this time, many UST ETFs traded at tighter bid-ask spreads than their portfolio of underlying bonds. For example, dislocations in U.S. Treasuries caused the bid/ask spreads of “off-the-run” bonds with a maturity of 20+ years to widen to almost 20 times that of the iShares 20+ Year Treasury Bond ETF (TLT).
4. Allowing UST ETFs as collateral could increase the efficiency of the collateral management process. For a significant number of market participants or CSEs, it may be simpler and more cost-effective to post shares of ETFs that hold qualifying assets like U.S. Treasuries as eligible collateral, rather than posting U.S. Treasuries directly. This is particularly true in cases where the amount of margin required to be posted is substantial and posting U.S. Treasuries may involve multiple CUSIPs. Moreover, the ongoing management of cash flows in UST ETFs are performed by the ETF itself, including reinvestment, rebalancing, and performing collateral substitutions when a bond matures, offering operational ease relative to holding individual bonds.

For the reasons mentioned above, and in line with the Commission's intent, allowing UST ETFs as IM collateral could not only help safeguard CSEs from counterparty default, but also help reduce the overall risk in the financial system and limit the potential for contagion arising from uncleared swaps.

Moreover, the Commission should contemplate the principles established by BCBS-IOSCO to permit a broader range of eligible collateral and address the potential volatility of such assets through the implementation of suitable haircuts. By broadening the spectrum of liquid assets that can be posted as uncleared margin to include UST ETFs, the potential liquidity impact of margin requirements could be further diminished by enabling CSEs to utilize a wider array of eligible assets to fulfill margin requirements. This would also more closely align with central clearing practices, as CCPs are beginning to accept certain UST ETFs as IM collateral for cleared derivatives.

IV. Background and Current Issue:

1. *The Margin Rules and Eligible IM Collateral*

The Margin Rules provide a list of financial instruments that may be used as eligible IM collateral. Among other instruments, securities issued by pooled investment funds that meet specific requirements are included in the list of eligible collateral.⁴ 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 based on 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").

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"). These criteria are designed to provide flexibility while maintaining a level of safety and to facilitate liquidity of the redeemable securities while still protecting holders of the fund's securities from dilution. Securities issued by an open-end management investment company that holds qualifying assets and that operates as a traditional mutual fund, which directly issues shares to and redeems shares from investors on a daily basis, are eligible IM collateral under the Margin Rules.

2. *ETF Mechanics and ETF's Two Layers of Liquidity*

ETFs are investment funds that are publicly available, and unlike traditional open-end mutual funds, their shares are listed and traded on an exchange. While ETFs and mutual funds both offer investors liquidity, the way they issue and redeem shares differs. ETFs have a unique mechanism for this process, which sets them apart from open-end mutual funds.

Under the 40 Act, traditional open-end mutual funds are legally obligated to issue and redeem securities directly to and from investors on a daily basis. These shares must be issued and redeemed at the net asset value ("NAV") per share. In contrast, ETFs do not issue and redeem shares to and from individual investors. Instead, ETFs issue (or "create") and redeem their shares at NAV in large blocks known as "creation units" exclusively with institutional trading firms that have contracts with the ETF or its affiliate, enabling them to create and redeem shares continuously. These Authorized Participants ("APs") can engage in creation and redemption transactions daily or less frequently, depending on the demand for buying and selling an ETF's shares.

The SEC provided guidance as part of Rule 6c-11 under the 40 Act that it would treat ETF shares as redeemable securities under section 2(a)(32) of the 40 Act,⁵ which would allow ETFs to meet the 40 Act's definition of open-end company. The SEC explained that "the arbitrage mechanism central to the operation of an ETF serves to keep the market price of ETF shares at or close to the ETF's NAV per share. Even though only APs may redeem creation units directly from the ETF at NAV per share, 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 directly from the fund at NAV per share."⁶

End investors of ETFs have the option to buy or sell ETF shares to or from APs in over the counter ("OTC") block transactions or trade ETF shares on securities exchanges, as they would with stocks of public companies. Market makers, many of whom are also APs, frequently transact in ETF shares through both these methods, thereby providing liquidity for transactions on securities exchanges or as OTC block transactions with end investors. The ability of end investors to trade in ETF shares either on an OTC basis or in the secondary market, along with the creation and

redemption activities of APs (either for their own books or as agent for other market participants), helps to keep the secondary market ETF share price in-line with the NAV of the ETF.

ETFs have two layers of liquidity: primary market liquidity, provided by the underlying assets of the ETF, such as bonds, and secondary market liquidity, provided by the trading of ETF shares on exchanges. These two layers of liquidity mean that ETFs can be net contributors to market liquidity. In the primary market, the creation and redemption mechanism allow the ETF to absorb or supply the underlying assets to the market. In the secondary market, the trading of ETF shares provides additional liquidity. This structure generally allows investors to transact in large volumes without significantly impacting the price of the ETF or its underlying assets.

3. *The lack of clarity in the market results in swap dealers continuing to be deterred from accepting qualifying ETF shares as eligible IM collateral.*

The market is unclear 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 technically comply with the other Redeemability Requirements. This creates a potential question as to whether the shares of such an ETF would be eligible IM collateral under the Margin Rules.

A clarification from the CFTC that ETF shares should be treated as redeemable securities and that shares of qualifying ETFs are eligible IM collateral under the Margin Rules would avoid narrowing the universe of liquid assets that can be posted as margin, while remaining consistent with the policy rationale of the Margin Rules.

V. Supporting Rationale for Recommendation:

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

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. Despite the technical differences between open-end mutual funds and ETFs, we believe that ETF shares, like shares of open-end mutual funds, clearly satisfy this policy purpose.

Through the operations of ETFs and their APs, 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. APs and market makers provide liquidity and ensure appropriate pricing of those shares against the fund’s NAV, and both APs and other broker-dealers make markets in these ETF shares.

2. *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.*

While it is critical for the Margin Rules to limit eligible collateral to sufficiently liquid assets, certain technical interpretive ambiguities may unnecessarily constrain the types of instruments

that can be posted. This has posed challenges for end users who are forced to depend on a narrower set of instruments to fulfill margin requirements. For a significant number of market participants or CSEs, it may be simpler and more cost-effective to post shares of ETFs that hold qualifying assets like U.S. Treasuries as eligible collateral, rather than posting U.S. Treasuries directly. This is particularly true in cases where the amount of margin required to be posted is substantial and posting U.S. Treasuries may involve multiple CUSIPs. Furthermore, without the clarification, these challenges are likely to further intensify as more and more market participants (including a significant number of end-users) have come into scope following the completion of the IM phase in periods.

Given the liquidity profile and regulatory treatment more generally of ETF shares, we believe that permitting Qualified UST ETF shares to be posted as IM collateral under the Margin Rules would offer a beneficial means for end users and other swap market participants to retain an otherwise desirable asset while satisfying the Margin Rules. Moreover, this clarification would provide swap market participants with a class of liquid assets that can be transferred and pledged with greater ease and efficiency than an interest in an open-end mutual fund, which comparatively presents more operational challenges.

Moreover, this recommendation is in line with the rationale and benefits recognized by the CFTC in proposing to allow customer funds under Reg 1.25 to be reinvested by FCMs and DCOs in certain qualified short-term UST ETFs.

⁴ 17 C.F.R. § 23.156(a)(1)(ix)

⁵ SEC, Proposed Rule, Exchanged-Traded Funds, 83 Fed. Reg. 37332 (July 31, 2018)

⁶ 83 Fed. Reg. at 37341.