sifma

asset management group

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Chief Counsel's Office
Attn: Comment Processing, Office of the Comptroller of the Currency
400 7th Street SW
Suite 3E–218
Washington, D.C. 20219

Ann E. Misback
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

James P. Sheesley
Assistant Executive Secretary
Attn: Comments/Legal OES (RIN 3064–AF29), Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429

Re: Regulatory Capital Rule: 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 (RIN 7100-AG65)

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association Asset Management Group (**SIFMA AMG**)[1] appreciates the opportunity to comment on the proposal of the Office of the Comptroller of the Currency (the **OCC**), the Board of Governors of the Federal Reserve System (the **Federal Reserve**), and the Federal Deposit Insurance Corporation (the **FDIC** and, collectively with the OCC and the Federal Reserve, the **Agencies**) to modify the regulatory capital requirements applicable to large banking organizations and banking organizations with significant

[1] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $62 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, undertakings for collective investment in transferable securities (**UCITS**) and private funds such as hedge funds and private equity funds.

trading activity,[2] which would implement the final components of the Basel III capital standards known as the Basel III endgame (the **Basel III Proposal**).[3] In addition, this letter includes SIFMA AMG's comments on the Federal Reserve's proposal (the **GSIB Surcharge Proposal,** and collectively with the Basel III 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]

I. Executive Summary

SIFMA AMG members support measures to ensure the resiliency and stability of the U.S. financial markets as they execute investment and hedging strategies in support of client goals including saving for college, buying a home and planning for retirement. Our members are concerned, however, with the potential far-reaching, adverse effects that the Proposals may have on pricing, transaction costs, the availability of services and market liquidity.[5]

We offer our comments to highlight the downstream effects the Proposals would have on ordinary investors and end-users, who are our members' clients. While we appreciate the Agencies' policy objectives to bolster the safety and soundness of the U.S. banking system, we do not believe the requirements under the Proposals strike the right balance and we are gravely concerned that their impacts would be disproportionate to the potential risk being addressed, erode the capacity for individual investors to achieve desired outcomes, and seriously compromise the buy-side's ability to hedge investment, market and counterparty risks – and thereby create the unintended consequence of a much more systemically risky environment within the U.S. capital markets.

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[2] 12 C.F.R. Parts 3 (OCC), 217 (Federal Reserve) and 324 (FDIC) (collectively, the "**capital rules**"). For convenience, citations in this letter to the currently effective capital rules reflect the Federal Reserve's capital rules (e.g., 12 C.F.R. § 217.2). 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 § _.110.

[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), *available at* https://www.govinfo.gov/content/pkg/FR-2023-09-01/pdf/2023-16896.pdf.

[5] MORGAN STANLEY RESEARCH & OLIVER WYMAN, INTO THE GREAT UNKNOWN 11 (2023) ("The significant divergence in impact on specific products could redefine who participates in certain wholesale banking activities and the cost and quality of capital, liquidity, and broader services that corporate and institutional clients receive.").

In particular, the Proposals could make it more difficult for asset managers to meet their clients' investment targets or mitigate risks in their portfolios, as banking organizations abandon or curtail their offerings in certain products or services, reduce their provision of liquidity in markets that are no longer commercially viable or become more selective as to their customers and counterparties.

For example, consider an exchange-traded fund (**ETF**) and a mutual fund that have similar investment strategies and that pose nearly identical credit risks to a banking organization. The Basel III Proposal would impose different capital requirements for liquidity facilities and other exposures to ETFs (which have publicly traded securities outstanding, a criterion for preferential capital treatment under the proposal) and mutual funds (which do not). The downstream effect of such disparate capital treatment would inevitably lead banking organizations to impose different terms, including credit extension and pricing, for transactions with an ETF compared to a similarly situated mutual fund notwithstanding nearly identical investment risks.

In addition to unjustified differences in credit and pricing, such capital treatment may also hinder the ability of investment advisers to efficiently trade on a block basis for ETFs and mutual funds (and other clients with a common strategy), thereby indirectly increasing transactions fees and costs for our members and their clients. Our members may also face concentration of risk and market volatility in the event that banking organizations consolidate and/or limit access to products as a result of the effects of the Proposals.

While SIFMA AMG members recognize that stability and resilience are the intended goals of the Proposals, any such potential benefits must be considered in the context of the significant regulatory reforms enacted since the Global Financial Crisis of 2007 – 2008 (**GFC**) addressing both prudential and market risks and enhancing the strength and resiliency of entities including banks, broker-dealers, fund managers and investment funds. In particular, regulators have implemented a series of reforms to improve the strength and resiliency of banking organizations, including strengthened capital requirements,[6] liquidity requirements,[7] stress testing requirements[8]

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[6] *See Regulatory Capital Rules*, 78 Fed. Reg. 62018 (Oct. 11, 2013), *available at* https://www.govinfo.gov/app/details/FR-2013-10-11/2013-21653.pdf.

[7] *See Liquidity Coverage Ratio*, 79 Fed. Reg. 61440 (Oct. 10, 2014), *available at* https://www.govinfo.gov/content/pkg/FR-2014-10-10/pdf/2014-22520.pdf; *Net Stable Funding Ratio*, 86 Fed. Reg. 9120 (Feb. 11, 2021), *available at* https://www.govinfo.gov/content/pkg/FR-2021-02-11/pdf/2020-26546.pdf.

[8] *See Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations*, 79 Fed. Reg. 17240 (Mar. 27, 2014), *available at* https://www.govinfo.gov/content/pkg/FR-2014-03-27/pdf/2014-05699.pdf.

and more. Meanwhile, other post-GFC regulatory reforms have transformed the functioning of U.S. capital markets, significantly improving both their transparency and resiliency.

Since the GFC, regulatory reforms have transformed the functioning of U.S. capital markets, significantly improving both their transparency and resiliency. Reforms enacted in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act have transformed derivatives markets through the mandated reporting, clearing, exchange trading, and margining of swaps and security-based swaps. With banks being the most significant liquidity provider for the derivatives market, these reforms have had a profound effect on mitigating market risk with respect to banks.

In addition, the Securities and Exchange Commission (**SEC**) has promulgated regulations to promote transparency (and thereby the ability to mitigate risks) to each of market participants, the public, and regulators including, but not limited to, (i) money market fund reforms requiring additional disclosure in each of 2010, 2014 and 2023;[9] (ii) shareholder reporting requirements for mutual funds and ETFs;[10] and (iii) additional disclosure related to the holdings of cash and cash equivalents to provide more comprehensive access into the liquidity risks of investment companies registered under the Investment Company Act of 1940 (the **'40 Act**) (registered investment companies or **RICs**).[11]

Moreover, the SEC has promulgated regulations to promote resiliency for both market participants and the market generally, such as (i) multiple reforms to generally increase liquidity and capital requirements for money market funds;[12] (ii) increased oversight of the use of

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[9] *See Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to N–CSR and Form N–1A*, 88 Fed. Reg. 51404 (Oct. 3, 2023), *available at* https://www.govinfo.gov/content/pkg/FR-2023-10-03/pdf/FR-2023-10-03.pdf; *Money Market Fund Reform; Amendments to Form PF*, 79 Fed. Reg. 47736 (Aug. 14, 2014), *available at* https://www.govinfo.gov/content/pkg/FR-2014-08-14/html/2014-17747 htm; *Money Market Fund Reform*, 75 Fed. Reg. 10060 (Mar. 4, 2010), *available at* https://www.govinfo.gov/link/fr/75/10117.

[10] *See Tailored Shareholder Reports for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements*, 87 Fed. Reg. 72758 (Nov. 25, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-11-25/pdf/2022-23756.pdf.

[11] *See Investment Company Liquidity Disclosure*, 83 Fed. Reg. 31859 (July 10, 2018), *available at* https://www.govinfo.gov/app/details/FR-2018-07-10/2018-14366.

[12] *See Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to N–CSR and Form N–1A*, 88 Fed. Reg. 51404 (Oct. 3, 2023), *available at*
(….continued)

derivatives by RICs;[13] and (iii) required liquidity risk management programs for open-ended funds.[14] In sum, securities markets have evolved considerably since the GFC through a wide range of regulatory reforms.

The collective existing reforms have significantly addressed market risks identified in the GFC and thereafter and should be recognized for the risk-mitigating effect they have had on all market participants, including banking organizations. Given the much more resilient market generally, we recommend that the Agencies should reconsider aspects of the Proposals given the limited incremental risk mitigation to be achieved against the significant downside risk of the compromised, if not frustrated, effect on investment options and the hedging of risk likely to be experienced by our members' clients – the investing public.

We encourage the Agencies to consider revisions to the Proposals in light of existing reforms that have been made to the U.S. financial system and broader goals related to systemic risk that some aspects of the Proposals may frustrate. For instance, financial regulators have consistently highlighted the policy benefits of encouraging central clearing, including decreasing the overall amount of counterparty credit risk and contagion risk, furtherance of the prompt and accurate clearance and settlement of transactions through increased multilateral netting, and enhanced regulatory visibility.[15] As discussed below, the Basel III Proposal's lack of a carve-out for cleared transactions from certain capital requirements would seem to run counter to the broader goal of encouraging central clearing.

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https://www.govinfo.gov/content/pkg/FR-2023-10-03/pdf/FR-2023-10-03.pdf; *Money Market Fund Reform; Amendments to Form PF*, 79 Fed. Reg. 47736 (Aug. 14, 2014), *available at* https://www.govinfo.gov/content/pkg/FR-2014-08-14/html/2014-17747 htm; *Money Market Fund Reform*, 75 Fed. Reg. 10060 (Mar. 4, 2010), *available at* https://www.govinfo.gov/link/fr/75/10117.

[13] *See Use of Derivatives by Registered Investment Companies and Business Development Companies*, 85 Fed. Reg. 83162 (December 21, 2020), *available at* https://www.govinfo.gov/app/details/FR-2020-12-21/2020-24781.

[14] *See Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting*, 87 Fed. Reg. 77172 (Dec. 16, 2022), *available at* https://www.govinfo.gov/app/details/FR-2022-12-16/2022-24376/summary.

[15] *See, e.g., Standards for Covered Clearing for U.S. Treasury Securities and Application of the Broker-Dealer Consumer Protection Rule with Respect to U.S. Treasury Securities*, at 15-19 (Dec. 13, 2023) (to be codified at 17 C.F.R. § 240), *available at* https://www.sec.gov/rules/2022/09/standards-covered-clearing-agencies-us-treasury-securities-and-application-broker#34-99149.

This letter identifies seven aspects of the Proposals that we think are most relevant to our concerns. They are:

A. the capital treatment of exposures to investment funds and other non-publicly traded companies;

B. the minimum haircut floors on certain securities financing transactions (**SFTs**);[16]

C. the capital requirement for credit valuation adjustment (**CVA**) risk;

D. the capital requirement for operational risk;

E. the capital requirement for market risk (also known as the fundamental review of the trading book or **FRTB**);

F. the capital requirement for certain equity exposures; and

G. the treatment of ETFs and client cleared derivatives transactions under the GSIB Surcharge Proposal.

Each of these issues is discussed in more detail below.

II. Discussion

A. Investors, including investment funds and their institutional and retail clients will be harmed by the limitation of preferential risk weights for investment grade corporate exposures to entities with publicly traded securities, which may limit access to liquidity and the ability to hedge risk.

Our members rely directly on banking organizations for the provision of credit to investment funds, which helps them manage liquidity for the benefit of their institutional and retail clients. For example, open-end mutual funds may use liquidity facilities as well as overdraft protection extended by their custodian banks to fund redemptions and otherwise manage their day-to-day liquidity needs. In addition, closed-end funds, including private funds, use capital calls or other secured credit facilities provided by banks to timely fund investments into portfolio companies without waiting for capital calls to be funded by their limited partners. These extensions of bank credit are important to the liquidity and functioning of the U.S. capital markets and enable our

[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 C.F.R. § 217.2 (definition of "repo-style transaction").

members and their clients to make timely investments in support of the economy, and, thus, for the expansion of businesses and increased employment.

i. **Proposed changes**.

Preferential Risk Weight for Investment Grade Corporate Exposures

The current U.S. capital rules provide that a banking organization must generally assign a 100% risk weight to its corporate exposures under the standardized approach to credit risk (the **Standardized Approach**), with no distinctions based on the credit quality of the obligor.[17] The expanded risk-based approach to credit risk under Basel III Proposal (the **ERB Approach**) would divide corporate exposures into two categories with the following risk weights:[18] (i) 65% for investment grade exposures issued by a corporate entity with (or that is controlled by an entity with) publicly traded securities outstanding and (ii) 100% for all other corporate exposures.

Although the ERB Approach would not generally increase capital requirements for corporate exposures, the ERB Approach would require banking organizations to assign relatively higher risk weights for corporate exposures to entities without publicly traded securities outstanding as compared to entities with publicly traded securities outstanding, even if the exposure is of high quality and otherwise satisfies the definition of investment grade.

The Basel III Proposal would similarly introduce a new criterion for the recognition of corporate debt securities as collateral. Banking organizations would be permitted to recognize the risk-mitigating benefits of corporate debt securities that meet the definition of financial collateral only "if the corporate issuer of the debt security has a publicly traded security outstanding or is controlled by a company that has a publicly traded security outstanding."[19]

Heightened Risk Weight for Exposures to Preferred Stock of Closed-End Funds

Separately, the definition of "subordinated debt instrument" in the Basel III Proposal would include preferred stock that is not treated by the banking organization as an equity exposure under the capital rules and subject those preferred stock exposures to a 150% risk weight.[20] Exposures to

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[17] 12 C.F.R. § 217.32(f)(1).

[18] Proposed Rule § _.111(h). Under the Proposed Rule, corporate exposures are exposures to a company which do not fall under any other exposure category. For instance, an exposure which qualifies as a real estate exposure would not be a corporate exposure for purposes of calculating capital risk weights.

[19] Proposed Rule § _.121(a)(3).

[20] Proposed Rule § _.102 (definition of "subordinated debt instrument"); § _.111(h)(4).

preferred stock issued by closed-end funds may not qualify as equity exposures to the extent any such preferred stock includes a contractual periodic payment obligation.[21] Because closed-end funds issue preferred stock as a financing instrument, those instruments often have contractual periodic payment obligations and, thus, would qualify as a subordinated debt instrument under the Basel III Proposal. Closed-end funds, however, often have no other debt outstanding, and, as a result, the preferred stock is functionally equivalent to senior debt in the fund and yet would be subject to this punitive capital treatment.

Preferred stock of closed-end funds, however, does not present the same type of risks as similarly structured preferred stock of operating companies. The '40 Act contains provisions that ensure a closed-end fund has sufficient assets to pay off its obligations and to protect its preferred shareholders.[22] In addition, closed-end funds, are limited by the '40 Act in the amount of senior debt they may incur.[23] In fact, closed-end funds that invest primarily in municipal securities often have no other material senior debt outstanding and, as a result, the preferred stock is functionally equivalent to senior debt in the fund. Finally, closed-end preferred shares are typically rated investment grade and most closed-end fund preferred stock held by banks have relative short, definitive "maturity tenors" that range from less than 90 days to three years. For these reasons, closed-end preferred stock should not be treated the same as preferred stock of operating companies for regulatory capital purposes.

ii. **Negative consequences to funds and their investors**.

The Agencies justify the public listing requirement based on its objectivity and the transparency and market discipline of corporate counterparties with publicly listed securities. The Agencies state that the requirement is a "simple, objective criterion that would provide a degree of consistency across banking organizations."[24] SIFMA AMG members respectfully submit that this reasoning does not appropriately reflect the attributes of most buy-side counterparties.

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[21] 12 C.F.R. § 217.2 (definition of "equity exposure").

[22] The '40 Act: (i) only permits a closed-end fund to issue one class of preferred stock (15 U.S.C. § 80a-18(a)(2)(E)); (ii) requires 200 percent asset coverage before issuing any preferred stock and before declaring any dividends (15 U.S.C. § 80a-18(a)(2)(A)); and (iii) gives preferred shareholder the right to elect at least two directors at all times and to elect a majority of directors if dividends on their stock are unpaid for two full years and until all dividends in arrears are paid (15 U.S.C. § 80a-18(a)(2)(C)).

[23] The '40 Act requires 300 percent asset coverage before issuing any "senior securities representing indebtedness" or other borrowings (15 U.S.C. § 80a-18(a)(1)(A)).

[24] 88 Fed. Reg. 64054.

Many investment funds and some end users of financial products are highly creditworthy but nevertheless do not have publicly traded securities outstanding. As a result, investment funds and other entities may face a reduced availability of credit compared to corporate entities that happen to have publicly traded securities outstanding, despite the creditworthiness of any particular fund.

For example, open-end mutual funds and their foreign equivalents generally employ little leverage and are among the most creditworthy borrowers and counterparties that banking organizations face, despite not issuing listed securities. To the extent that the Agencies believe that preferential risk weights should be subject to a standard for transparency as well as creditworthiness, we believe that the public listing requirement would impose an overly rigid standard that ignores other ways that borrowers and counterparties, including investment funds, can and do provide transparency to the market and to banking organizations.

RICs, business development companies, and their foreign equivalents (including, for example, UCITS) (collectively, **registered funds**) are subject to regulatory frameworks that provide for creditworthiness and transparency at least as rigorous as those that apply to publicly traded corporate entities and should be afforded similar capital treatment. For instance, registered open-end mutual funds are required to publish their net asset values for each business day and report a complete list of their holdings on a quarterly basis.[25] Additional transparency standards applicable to investment funds are discussed earlier in this letter.

In sum, the public listing requirement would significantly penalize exposures to highly creditworthy U.S. and global corporations, corporate pensions, mutual funds, and small and mid-sized businesses, among others, simply because they are not publicly listed. The requirement is misplaced and results in an improper allocation of capital because a public listing does not directly correspond to heightened creditworthiness nor does it reduce the risk of default vis-à-vis an unlisted commercial end-user. Removing the public listing requirement from the final rule would ensure greater consistency between the Basel III Endgame Proposal, as implemented, and the proposals in the European Union and United Kingdom, promote a level playing field among the jurisdictions and ensure that credit-risk-capital requirements are applied in a manner commensurate with a counterparty's actual credit risk and not assigned a higher or lower risk rating (and correspondingly lower or higher capital charge) based on a factor that is not solely determinative of creditworthiness.

[25] 17 C.F.R. § 270.22c-1(b)(1); 17 C.F.R. § 274.150.

Heightened Risk Weight for Exposures to Preferred Stock of Closed-End Funds

With respect to closed-end funds, the application of 150% risk weight to closed-end fund preferred stock would have significant negative market impacts. At this risk weight, the preferred stock of closed-end funds would be significantly less attractive to banking organizations. This would force such funds to seek alternative sources of capital (including alternative forms of leverage through exposure to derivatives), creating added refinancing risk to this market segment. The result would also substantially increase the costs of leverage for common shareholders of such closed-end funds, who are predominantly retail investors.

Such capital treatment for preferred stock of closed-end funds also results in an arbitrary outcome that does not reflect economic reality. Despite the liquidation preference of preferred stock relative to common stock, in some cases, the common stock of a closed-end fund could be subject to a lower risk weight than preferred stock in the same closed-end fund. For example, for a closed-end fund that invests solely in U.S. municipal general obligation bonds, with less than material leverage, the common equity of the fund would receive a 20% risk weight under the look-through approach, while the preferred stock would receive a 150% risk weight. We do not believe this result is consistent with the Agencies' goals, including making the capital rules more risk sensitive.

iii. **Recommended path forward**.

Preferential Risk Weight for Investment Grade Corporate Exposures

Because we do not believe the public listing requirement is indicative of creditworthiness of a borrower, we encourage the Agencies to eliminate it as a condition for investment grade corporate exposures to qualify for preferential capital treatment. This approach would be consistent with the implementation of the Basel Framework in the United Kingdom and European Union, neither of which impose a public listing requirement for investment grade corporate exposures.[26] Nevertheless, in the alternative, we offer several circumstances in which we believe the case for extending preferential capital treatment beyond the public listing requirement is especially compelling.

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[26] *See* Bank of England, *Consultation Paper 16/22 – Implementation of the Basel 3.1 Standards: Credit Risk – Standardised Approach*, Nov. 30, 2022, *available at* https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards/credit-risk-standardised-approach; Eur. Comm'n, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as Regards Requirements for Credit Risk, Credit Valuation Adjustment Risk, Operational Risk, Market Risk and the Output Floor 2021/0342* 13-14 (2021).

In the case of RICs, an alternative to the proposed listed security requirement is especially important, both because higher barriers to their participation in financial markets would not be cost-justified and because subjecting RICs to unfavorable capital treatment in this context may undermine other policy goals. For instance, the SEC requires open-end funds to maintain liquidity risk management programs, which help ensure funds are able to meet obligations to investors and their creditors.[27] Imposing unfavorable capital risk weights could result in open-end funds facing higher costs for access to credit and liquidity facilities provided by banking organizations, which ultimately could diminish returns for underlying investors. RICs also illustrate the arbitrary nature of the public listing requirement. As noted above, RICs and ETFs present similar risks, yet RICs are not publicly traded and, therefore, would not be eligible to be treated as an investment grade exposure.

For related reasons, the Agencies likewise should consider extending the same capital treatment to employee benefit plans as defined in 29 U.S.C. § 1002(3) and governmental plans as defined in 29 U.S.C. § 1002(32) that comply with the tax deferral qualification requirements provided in the Internal Revenue Code (**employee plans**). In addition, the Agencies should also extend the same capital treatment to collective investment funds or collective investment trusts (together, **CIFs**). CIFs are important mechanisms through which investors access financial markets, particularly with respect to retirement savings. Even though CIFs do not have publicly traded securities outstanding and are not RICs, they are subject to regulation and supervision under rules promulgated by banking regulators.

In addition, the Agencies should consider the same or similar capital treatment for certain private funds which can provide banking organizations with requisite information to make informed decisions about such funds' creditworthiness. Insofar as the Agencies justify favorable capital treatment to publicly listed corporate exposures based on the transparency that regular disclosure provides banking organizations, private funds in many circumstances are required to provide quarterly financial reporting to investors and creditors. Similarly, many private investment funds provide lenders with periodic financial statements and notice of material events such as new commitments, significant investor defaults or material changes in the value of a portfolio company.

Finally, the Agencies should consider the same or similar capital treatment for any corporate exposure in which any counterparty to a transaction with a banking organization can demonstrate, through ordinary course books and records, that an institutional investor with local statutory or regulatory reporting requirement is the end user of such transaction. Institutional investors,

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[27] *See* 12 C.F.R. § 270.22e-4(b).

including international institutional investors, with statutory or regulatory reporting requirements, such as pension plans, are highly creditworthy, do not have publicly listed securities outstanding, and are nevertheless both critical pools of capital for borrowers and entrepreneurs and necessary vehicles for helping to build retirement savings. Preferential risk weights for such investors, regardless of the vehicle through which they invest, would help mitigate the adverse effects of the Basel III Proposal otherwise could have.

In light of these considerations, registered funds, the employee plans noted above and CIFs (collectively, regulated investment vehicles or **RIVs**) and private funds should not be precluded from investment grade status due to the lack of having publicly traded securities outstanding. If the Agencies do not eliminate the public listing requirement, we recommend that the Agencies revise the 65% risk weight category under the ERB Approach 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 RIVs; and (iii) investment grade exposures to private funds that are subject to a contractual requirement to provide quarterly financial reporting to the banking organization; and (iv) investment grade exposures in which the end user is an institutional investor (including an international institutional investor) subject to a regulatory reporting requirement or a contractual reporting requirement to a banking organization.

This approach would appropriately achieve the Agencies' goals without applying punitive risk weights inconsistent with the actual risks such exposures pose to banking organizations. The second, third and fourth prongs of our recommended approach are consistent with the Agencies' intent to use publicly traded security status to require transparency into the nature of such corporate exposures. RICs and other registered funds are required to disclose detailed financial information to enable adequate review associated with the risks of such exposures. In the case of private funds, banking organizations can and often do obtain a similar degree of financial transparency through covenants that require the quarterly disclosure of financial statements.

Heightened Risk Weight for Exposures to Preferred Stock of Closed-End Funds

The application of a 150% risk weight to closed-end funds would not reflect the fact that closed-end funds often do not have other debt outstanding. In these circumstances, preferred stock would be functionally equivalent to senior debt exposures. Nevertheless, the Basel III Proposal would apply the 150% risk weight applicable to subordinated debt.

Accordingly, to reflect the economic reality that closed-end funds use preferred stock as a senior financing instrument, we recommend that the definition of subordinated debt instrument be modified to exclude preferred stock of closed-end funds. In the alternative, the definition of subordinated debt instrument could be amended to exclude preferred stock of a closed-end fund

when the preferred stock is the most senior source of leverage in a fund's capital structure (i.e., the fund has not issued any "senior securities representing indebtedness" as defined by the '40 Act). At the very least, the preferred stock of a closed-end fund should be treated no worse than the closed-end fund's common stock.[28]

B. Investors, including investment funds and their institutional and retail clients will be harmed through the proposed minimum haircut floors for SFTs which will likely reduce the provision of securities lending by imposing significantly higher capital requirements on in-scope SFTs unless such institutions satisfy the minimum haircut floors.

SFTs contribute to the healthy functioning of the U.S. securities markets by improving global market liquidity, helping to ensure prompt settlement of trades, and enabling the establishment of short positions and thereby facilitating price discovery and hedging activities.[29] The vehicles and accounts that our members advise use securities lending and borrowing transactions and other SFTs to generate returns or to cover short selling activity. These activities, in turn, facilitate well-functioning and liquid markets.

i. **Proposed changes**.

Under the Basel III Proposal, SFTs between a banking organization and an unregulated financial institution would be subject to minimum haircut floors. The term "unregulated financial institution" would be defined by reference to the term "financial institution," an existing defined term that excludes RICs, foreign equivalents to RICs and employee plans. Certain categories of SFTs would be exempt from this requirement. For instance, transactions where a banking organization borrows securities from an unregulated financial institution (from the financial institution's perspective, a securities lending transaction) would be exempt from the minimum haircut floors, provided the banking organization "maintain[s] sufficient written documentation that such transactions are for the purpose of meeting current or anticipated demand and not for providing financing to an unregulated financial institution."[30]

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[28] Under the Basel III Proposal, common stock of a closed-end fund would be treated as "equity exposures" which are permitted to be "looked through" to the underlying investments of the closed-end fund. "Look through" treatment would often result in risk weightings that are significantly below 150% for subordinated debt despite the fact that preferred stock of a closed-end fund is senior to its common stock. *See* Proposed Rule § _.142(b)-(c).

[29] *See* FINANCIAL STABILITY OVERSIGHT COUNCIL, 2020 ANNUAL REPORT 45, *available at* https://home.treasury.gov/system/files/261/FSOC2020AnnualReport.pdf.

[30] 88 Fed. Reg. 64064.

The Agencies explain the rationale for these provisions by indicating that such minimum haircut floors "would reflect the risk exposure of banking organizations to non-bank financial entities that employ leverage and engage in maturity transformation but that are not subject to prudential regulation."[31] We recognize that the minimum haircut floors would help limit the build-up of excessive leverage outside the banking system and reduce the procyclicality of that leverage. And we appreciate the Agencies' recognition that RICs, foreign equivalents to RICs and employee plans are distinguishable from other financial institutions and that under the Basel III Proposal, these entities would be excluded from the definition of a financial institution and, therefore, not be subject to the minimum haircut requirements. Nevertheless, in light of the overall purpose of this provision, we believe that the minimum haircut floor requirement should not apply to unlevered counterparties and that the exemption for securities lending transactions should be modified to make it workable.

ii. **Negative consequences to funds and their investors**.

We are concerned that the definition of unregulated financial institution and, therefore, the scope of SFTs subject to minimum haircut floors, is overbroad and would go beyond capturing the risks identified in the Agencies' above referenced statements. For example, neither the definition of "financial institution" nor "unregulated financial institution" would exclude forms of RIVs that are not RICs, foreign equivalents to RICs or employee plans. In addition, we believe that the scope of the exemption for transactions subject to minimum haircut floors is too narrow to be practicable.[32] The documentation requirements for the exemption for securities lending transactions are vague and may not be consistent with market practice. As such, our members' access to securities lending transactions could be severely disrupted, potentially denying investors the lending revenue from long-term securities holdings, and compromising the price discovery and hedging opportunities related to short selling. In turn, such a reduction in revenue could reduce returns for institutional and retail investors.

iii. **Recommended path forward**.

We recommend that the Agencies decline to adopt the proposed minimum haircut floors for SFTs until more information is available about the potential effects. Other jurisdictions have taken

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[31] 88 Fed. Reg. 64063.

[32] *See* Proposed Rule § _.121(d)(2)(ii).

a similar approach. For example, the United Kingdom[33] and the European Union[34] are deferring implementation of the Basel III standards with respect to SFTs out of a concern that they have insufficient information to meaningfully evaluate its effects on market functioning. We encourage the Agencies to consider the breadth of the Basel III Proposal in light of the considerable unknown effects on financial markets and the Agencies' financial stability goals. Such discretion is especially important alongside tremendous changes in U.S. and global capital markets as other regulatory changes occur concurrently, such as the recently adopted SEC rules highlighted in the Executive Summary, all of which have significant but uncertain effects on funding markets.

Alternatively, we recommend that the Agencies modify the scope of the minimum haircut floor requirement under the Basel III Proposal in five ways.

- First, to avoid the negative impacts noted above, and to preserve the price discovery and hedging benefits of short selling, we strongly encourage the Agencies to make explicit that, for analogous reasons and for the reasons set out in Part II.A of this comment letter, all RIVs are to be excluded from the definition of financial institution for purposes of minimum haircut floors for SFTs.

- Second, the definition of unregulated financial institution for the purpose of the minimum haircut floors should be modified to apply only to unregulated financial institutions that have significant leverage and engage in maturity transformation.

- Third, the Agencies should clarify that the documentation requirements for a banking organization to rely on the exemption for securities lending transactions can be satisfied by

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[33] 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.").

[34] Eur. Comm'n, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as Regards Requirements for Credit Risk, Credit Valuation Adjustment Risk, Operational Risk, Market Risk and the Output Floor 2021/0342* 43 (2021), "The lack of clarity of certain aspects of the minimum haircut floors framework for [SFTs], developed by the [Basel Committee] 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].").

ordinary course books and records that reflect that the purpose of the transaction is not for providing financing to an unregulated financial institution.

- Fourth, the Agencies should provide that the minimum haircut floor framework does not apply to repo-style transactions in which an unregulated financial institution reinvests cash collateral in such a way that it retains sufficient liquidity across its collateral pool to satisfy transaction unwinds. These uses should include investments in cash or liquid and readily marketable securities.

- Fifth, the Agencies should provide an explicit exemption from minimum haircut floors with respect to any type of repo-style transaction (including repurchase or reverse repurchase transactions and securities lending or securities borrowing transactions) and eligible margin loan to the extent that the securities the unregulated financial institution posts as collateral or sells subject to repurchase to a banking organization are debt securities issued by government-sponsored enterprises (e.g., Fannie Mae and Freddie Mac bonds or mortgage-backed securities). This exemption would be consistent with how debt securities issued by government-sponsored enterprises generally are viewed and would be consistent with, for example, Financial Industry Regulatory Authority (**FINRA**) Rule 4210, pursuant to which U.S. Treasury securities and government-sponsored enterprise debt securities are treated in the same manner for purposes of FINRA broker-dealer margin requirements.[35]

To the extent that the Agencies implement the minimum haircut requirements for SFTs, we strongly encourage the Agencies to incorporate views of our buy-side members and consider market practices, to mitigate adverse effects to market functioning which do not yield commensurate benefits to bank capital levels or financial stability.

C. Investors, including investment funds and their institutional and retail clients, will be harmed through the new and increased capital requirements for credit valuation adjustment (CVA) risk, which would increase hedging costs.

Investment funds rely on banking organizations as counterparties for derivatives transactions, which they generally use to hedge investment portfolio risks, such as foreign exchange risk, interest rate risk and credit risk, on behalf of their underlying institutional and retail investors.

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[35] FINRA, *4210. Margin Requirements, available at* https://www finra.org/rules-guidance/rulebooks/finra-rules/4210.

i. **Proposed changes**.

The Basel III Proposal would generally expand the requirement to hold capital in respect of CVA losses from Category I and II banking organizations to Category I – IV banking organizations and introduce two new approaches for calculating risk-weighted assets for CVA risk, neither of which provides for internal models-based calculation of CVA risk. Importantly, the Basel III Proposal would include risk-weighted assets for CVA risk in the capital measures that are subject to stress-based capital requirements, reflecting a change from the current capital rules.

The requirement to hold capital according to these calculation methods would apply to all derivatives contracts of a banking organization other than exposures to central counterparties and derivatives that are recognized by the banking organization as a credit risk mitigant. The Basel III Proposal would also introduce generally applicable risk management requirements for CVA risk, including (i) the requirement to identify certain transactions within the scope of CVA capital requirements; (ii) the requirement to maintain a hedging policy that quantifies CVA risk appetite and details hedging strategies; and (iii) documentation requirements for such calculations.

The implementation of CVA risk capital requirements under the Basel III Proposal would meaningfully increase capital requirements for CVA risk. By the Federal Reserve's own estimates, the impact of the Basel III Proposal would increase risk-weighted assets for CVA risk relative to the current U.S. capital rules by approximately 20% for Category I – IV banking organizations. Moreover, to the extent that capital charges for CVA risk are not part of the binding capital requirements on banking organizations today (*e.g.*, the stress-based capital standards), the effective increase likely would be much more significant.

ii. **Negative consequences to funds and their investors**.

Since investment funds do not fit into the category of derivatives counterparty excluded from such capital increases, it would be inevitable that the costs and accessibility for derivatives with investment funds would be seriously impacted. As such, asset managers would likely find it increasingly more expensive to execute investment strategies and hedge risk arising therefrom. As derivatives' liquidity providers would have to assess the continued viability or costs of derivatives with investment funds, concentration and volatility risk would undoubtedly increase as the field of liquidity providers shrank in size.

In addition, although "cleared transactions" would be excluded from the scope of CVA risk capital requirements under the Basel III Proposal, this defined term is limited to exposures of banking organizations to central counterparties and explicitly excludes the exposure of a banking

organization to its client in connection with a cleared derivative.[36] Banking organizations often clear derivatives transactions on behalf of investment funds and investors. Increasing capital requirements for cleared derivatives, via the new and expanded CVA risk capital requirements, could meaningfully impede market functioning, and would unduly burden banking organizations' cleared transaction clients, such as RICs and other funds.

iii. **Recommended path forward**.

We offer two recommendations with respect to the scope of the proposed CVA risk capital requirements.

First, we recommend that the Agencies exempt derivatives transactions with RIVs from the scope of CVA risk covered positions. The purpose of the CVA risk capital requirement is to address the risk that the CVA recognized under GAAP would increase as a result of increased credit spread risk and credit exposure risk. SIFMA AMG firmly believes that the many reforms to derivatives markets introduced since the GFC in terms of derivatives reporting, margining, clearing, and exchange trading; as well as reforms applicable to RIVs in terms of disclosure and creditworthiness, have served to mitigate perceived risks involving RIVs and derivatives usage. The possible benefits of increased CVA risk capital requirements cannot be justified given the otherwise significantly enhanced markets and the downside impact of reduced investment options and risk management capability.

It is important to note that authorities in the European Union have exempted pension funds from CVA risk capital requirements.[37] In the United States, defined contribution plans rather than pension plans constitute the largest pools of retirement and long-term savings. In order to preserve analogous capital treatment for a banking organization's exposures to retirees and similar individuals and in light of the regulatory framework that applies to RIVs, the Agencies should provide a similar exemption for RIVs (including international RIVs) through which defined contribution plans generally invest.

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[36] *See* 88 Fed. Reg. at 64150-51, n. 428 (providing that, "in a client-facing derivative contract, where a clearing member banking organization either is acting as a financial intermediary and enters into an offsetting transaction with a QCCP or where it provides a guarantee on the performance of its client to a QCCP, the exposures would be included in CVA risk covered positions").

[37] Eur. Comm'n, *Regulation (EU) No 648/2012 of the Eur. Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation (EU) No 648/2012* Art. 382 pt. 4(b) (exempting pension scheme arrangements from CVA risk capital calculations); *see also* Eur. Comm'n, *Regulation (EU) No 648/2012 of the Eur. Parliament and of the Council of 4 Jul. 2012 on OTC Derivatives, Central Counterparties and Trade Repositories*, Art. 2 pt. 10 (defining the scope of "pension scheme arrangement").

Second, we recommend that CVA risk capital requirements not apply to a banking organization's exposure to a client associated with a cleared derivative where the banking organization is acting as an agent on behalf of that client ("**client-facing cleared derivative agency exposures**"). CVA risk capital requirements for client-facing cleared derivative agency exposures would inappropriately require banking organizations to capitalize for a risk of loss they do not face and may adversely affect the sound public policy of incentivizing banking organizations and their clients to clear derivatives transactions.

When derivatives are cleared under an agency model, the clearing member banking organization does not recognize the derivative on its balance sheet and therefore does not recognize CVA for the resulting off-balance sheet exposure. Therefore, the CVA risk capital requirement, which capitalizes for potential changes in the amount of CVA recognized on the banking organization's balance sheet, is not appropriate or necessary for such exposures. This rationale is consistent with the exclusion of securities financing transactions from the scope of CVA risk covered positions under the Basel III Proposal, for which the Agencies recognized that CVA risk capital requirements are not appropriate because "a banking organization generally does not calculate CVA for ... securities financing transactions."[38]

The reduced provision of client-facing cleared derivative agency exposures may, in turn, concentrate markets for certain clearing transactions in fewer clearing member banks, increasing costs or reducing competition. The benefits of such concentration are not obvious and may increase systemic risk in the event of a failure of one such remaining clearing member bank.[39] We therefore encourage the Agencies to revise the Basel III Proposal according to this recommendation to better align the Agencies with both the economic reality of such transactions as well as other regulatory priorities.

D. Investors, including investment funds and their institutional and retail clients, will be harmed through the proposed capital requirements for operational risk which could increase costs of services provided by banking organizations to investors, including investment funds.

SIFMA AMG members' clients rely on banking organizations for the provision of various low-risk, fee-based services, including custody services. The efficient provision of these services

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[38] 88 Fed. Reg. 64151.

[39] Commodity Futures Trading Comm'n, Comment Letter on the Proposed Rule Regarding the Standardized Approach for Calculating the Exposure Amount of Derivatives Contracts (Feb. 15, 2019), *available at* https://www.cftc.gov/sites/default/files/2019-02/SA-CCRCommentLetter021519.pdf ("Further contraction of clearing members could increase systemic risk, and the associated reduction in the provision of clearing services is inconsistent with the fundamental reforms in Dodd-Frank.").

materially depends on the ability of banking organizations to do so with appropriately calibrated operational risk capital requirements. In addition, some SIFMA AMG members are subsidiaries of banking organizations that themselves offer asset management services. Fee-based services such as asset management activities help diversify banking organizations' revenues and expose them to relatively low risk.

i. **Proposed changes**.

Under the Basel III Proposal, all Category I – IV banking organizations would be required to recognize risk-weighted assets for operational risk as part of the new standardized measure of credit risk, which is very likely to be the measure of risk-weighted assets driving the binding capital ratios for most banking organizations.

Specifically, the Basel III Proposal would introduce a new standardized measurement approach for operational risk. Under the standardized measurement approach for operational risk, all revenue sources are treated as giving rise to operational risk, including fee-based revenue sources such as custody services and management and performance fees associated with asset management activities.

Furthermore, fee-based revenue services do not benefit in the standardized measurement approach for operational risk from provisions which apply to interest related income; specifically, the ability to net revenue and expenses and the use of a cap to limit the capital impact of services related income relative to total assets.

ii. **Negative consequences to funds and their investors**.

Investment funds and their clients would be seriously harmed as the costs of many fee-based services would likely increase significantly. RICs, in particular, are required to custody client assets to mitigate the risk of loss due to a fund managers' fraud or malfeasance. The custody requirement has been hard-wired into the rules for decades to mitigate risk and it is therefore incompatible for the Agencies to effectively penalize the fee-based provision of such services. For asset management firms that are subsidiaries of a banking organization, the proposed operational risk capital requirements would also increase capital requirements for asset management activities, creating disincentives for an important source of revenue diversification.

iii. **Recommended path forward**.

To address these issues, we encourage the Agencies to consider the recommendations specified in comments submitted by the Bank Policy Institute, American Bankers Association and the Securities Industry and Financial Markets Association, with which we agree.

E. Investment funds and their institutional and retail clients will be harmed from the increased bid-ask spreads and reduced liquidity of traded securities arising from the Fundamental Review of the Trading Book.

Banking organizations act as important trading counterparties to investment funds, including and especially for individualized investment and hedging products that would be subject to market risk-based capital requirements under the Basel III Proposal.

i. **Proposed changes**.

Current U.S. capital rules only apply to banking organizations whose trading activities exceed $1 billion of trading assets plus trading liabilities, or 10% of a banking organization's total consolidated assets. The Basel III Proposal would largely rewrite capital requirements for banking organizations engaging in market-making activity. Under the Basel III Proposal, banking organizations' capital requirements for market risk would be based on either standardized risk weights or expected shortfall methodologies, replacing value-at-risk-based internal modeling under current U.S. capital rules.

The Basel III Proposal would apply market risk-based capital requirements to (i) all Category I – IV banking organizations, regardless of trading activity; (ii) any banking organization with more than $5 billion of trading assets plus trading liabilities on average (a five-fold increase from the relevant current threshold) or (iii) trading activity which constitutes more than 10% of the banking organization's total consolidated assets. The Basel III Proposal would also extend the applicability of market risk-based capital requirements to positions currently excluded under the U.S. capital rules, including certain equity investments in funds and some hedges.

ii. **Negative consequences to funds and their investors**.

The implementation of the FRTB under the Basel III Proposal would significantly increase capital requirements for market risk. Based on the Federal Reserve's own estimates, the impact of the Basel III Proposal would increase risk-weighted assets for market risk relative to the current U.S. capital rules by approximately 75% for Category I and II banking organizations.[40]

As a first order effect, investment funds and their clients could face higher costs arising from such increased capital requirements, significantly increasing bid-ask spreads in trading markets. As a second order effect, client investment goals for college, a home, and a comfortable retirement could be seriously compromised, and risk-hedging tools limited.

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[40] *See* 88 Fed. Reg. at 64168 (Table 11).

iii. **Recommended path forward**.

We do not believe these costs are likely to be sufficiently justified by the prospective effects on bank capital levels. However, we acknowledge that it is difficult to know with precision how these rules will affect financial markets—to that end, we encourage the Agencies to carefully consider the results and limitations of the data collection related to the Basel III Proposal and the recommendations specified in comments submitted by the International Swaps and Derivatives Association and the Securities Industry and Financial Markets Association, calibrating FRTB accordingly.

F. Investors, including investment funds and their institutional and retail clients, will be harmed from the proposed treatment of equity exposures which would increase the costs of seed investments and other investments permitted under the Volcker Rule.

While banking organizations do not generally invest in investment funds, they do so in limited circumstances, including when providing seed capital and when making investments in sponsored registered and private funds as permitted under section 13 of the Bank Holding Company Act and regulations promulgated thereunder (collectively, the **Volcker Rule**).

i. **Proposed changes**.

The current U.S. capital rules provide that equity exposures, other than certain excluded exposures, are risk weighted at 100%, provided the aggregate amount of such investments is no more than 10% of the banking organization's total capital.[41] The Basel III Proposal would remove this 100% risk weight treatment for a limited quantity of certain equity exposures. It would instead require banking organizations to apply generally higher risk weights to such equity exposures, with applicable risk weights of up to 400% for an equity exposure to a company that is not publicly traded. In addition, equity exposures to seed investments also would constitute market risk covered positions, and banking organizations would be limited in their ability to make use of banking book rules for the measurement of their exposures as under the current rules. This can result in highly disproportionate capital outcomes, especially for non-dealer banks that do not have expansive and highly sophisticated trading operations.

ii. **Negative consequences to funds and their investors**.

The Basel III Proposal would impede the ability of and/or increase the cost for banking organizations to provide seed capital and when making investments in sponsored registered and

[41] 12 C.F.R. § 217.52(b)(3)(iii).

private funds as permitted under the Volcker Rule. As investment funds seeded by banking organizations attract third-party capital, such exposures may become eligible for the 100% risk weight noted above.

Instead of permitting a 100% risk weight to apply to such exposures, up to a limit of 10% of the banking organization's total capital, such exposures would be subject to potentially higher market risk capital requirements. The punitive risk weight treatment of such exposures under the Basel III Proposal would undermine an important, initial source of capital for investment funds which provide competition, diversity, and specialization to the asset manager landscape, better enabling our members to serve investors consistent with their individual goals.

In addition, and as detailed in Part II.D of this comment letter about capital requirements for operational risk, asset management businesses provide an important way for banking organizations to diversify sources of revenue. Existing policy frameworks, such as the Volcker Rule, have accommodated, and put guardrails around, banking organizations' participation as seed investors in registered and private investment funds.

These investments allow asset managers to develop new products and investment strategies, attract unaffiliated investors for those products and strategies and, thereby, to earn management fees. The Basel III Proposal would add friction to this business and product development process.

iii. **Recommended path forward**.

SIFMA AMG therefore encourages the Agencies to consider two changes relative to this aspect of the Basel III Proposal.

First, we believe the Agencies should maintain the existing favorable risk weight for equity exposures as described above. Removing the favorable risk weight treatment would meaningfully affect the economics for seed investments. This change could undermine competition, increasing costs and reducing the provision of asset management services for investors.

Second, if the Agencies finalize the rule as proposed and eliminate the favorable risk weight for equity investments in general, it should preserve a reduced risk weight for seed investment activity specifically.

G. Investment funds and their institutional and retail clients will be harmed by the GSIB Surcharge Proposal's treatment of holdings of ETFs by banking organizations and OTC client cleared derivatives transactions as systemically risky activities.

Large banking organizations play an important role in the price discovery process for ETFs. The fundamental value of an ETF share theoretically should reflect a proportionate share of the

value of its underlying exposures. Large banking organizations help intermediate this price discovery process by purchasing ETF shares and hedging their exposure by shorting positions reflecting the underlying investments of the ETF. ETFs also typically have a redemption process by which financial intermediaries may exchange a sufficient number of ETF shares for a proportionate basket of securities with equivalent value, which further supports the price discovery process. While other market participants also intermediate this price discovery process, large banking organizations play an important role.

Large banking organizations also play an important role as clearing members of cleared OTC derivatives. OTC derivatives help end users achieve cost-effective risk management. Since the GFC, many OTC derivatives are subject to central clearing requirements. The market structure for cleared derivatives generally requires end users to clear derivatives through intermediaries (i.e., clearing members), many of which are affiliates of large banking organizations. Central counterparties in the United States generally follow an agency model for clearing, whereby the client and the central counterparty face each other directly as principals to the OTC derivative transaction, and the clearing member provides a guarantee to the central counterparty of its client's performance.

i. **Proposed changes**.

Inclusion of ETFs in the Y-15 Interconnectedness Indicators

The FR Y-15 interconnectedness indicators are intended to reflect the systemic risk associated with intra-financial system assets and liabilities and with securities issued by banking organizations, which can serve as transmission channels for stress throughout the financial system.[42] For purposes of the interconnectedness indicators, the current FR Y-15 instructions define "financial institutions" as depository institutions, bank holding companies, securities brokers and dealers, insurance companies, mutual funds, hedge funds, pension funds, investment banks and central counterparties.

The GSIB Surcharge Proposal would expand the definition of "financial institution" for purposes of the FR Y-15 interconnectedness indicators to include private equity funds, asset management companies and ETFs.

[42] *See* 88 Fed. Reg. at 60391.

Inclusion of Client Cleared Transactions in the Complexity Indicators

The FR Y-15 complexity indicators are intended to reflect the systemic risk associated with a banking organization's positions or exposures which may be considered complex or opaque, such as OTC derivatives exposures. Currently, the complexity indicators do not require banking organizations to include transactions where the banking organization guarantees a client's performance to a central counterparty in the notional amount of OTC derivatives reported on Form FR Y-15. The GSIB Surcharge Proposal would instead require banking organizations to include in the complexity indicator for OTC derivatives the notional amount of client cleared derivative positions where the banking organization guarantees its client performance to a central counterparty.[43] The Federal Reserve suggests that the "inclusion of guarantees by a banking organization of a client's performance on derivative contracts would provide a more accurate assessment of the firm's complexity, because it would provide a more complete picture of the firm's derivative exposures."[44]

ii. **Negative consequences to funds and their investors**.

Inclusion of ETFs in the Y-15 Interconnectedness Indicators

This proposed change would disincentivize large banking organizations from holding exposures to the affected entities, including from holding equity securities issued by ETFs, which could hinder the price discovery process and concentrate and, thereby, exacerbate systemic risks related to interconnectedness.

The Federal Reserve justifies its proposed addition of ETFs to the scope of financial institutions for purposes of the FR Y-15 interconnectedness indicators by analogy to mutual funds, which are already included within the applicable definition of financial institution.[45] However, as the Federal Reserve notes in the GSIB Surcharge Proposal, "[c]urrently, the instructions for this line item state not to include bond exchange-traded funds."[46] That instruction is consistent with the Basel Committee on Banking Supervision's (the **Basel Committee's**) instructions for determining

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[43] 88 Fed. Reg. at 60392.

[44] *Id*.

[45] 88 Fed. Reg. at 60392 (stating that the inclusion of ETFs in the definition of financial institution "would improve the clarity of reporting instructions and the consistency of treatment of asset management entities and provide a more complete measure of a banking organization's interconnectedness.")

[46] 88 Fed. Reg. at 60392.

GSIB status.[47] To help ensure global consistency of the standards regarding GSIB status and surcharges, the Federal Reserve should not change its instructions regarding the treatment of ETFs until the treatment is also changed by the Basel Committee.

Moreover, the proposed change to the treatment of ETFs for purposes of the interconnectedness indicators could reduce the willingness of large banking organizations to play an important role as an intermediary for ETFs, as authorized participants and otherwise. In turn, this result could harm price discovery. In particular, any reduced willingness of large banking organizations to intermediate in ETF markets would affect not only liquidity and price discovery in ETF markets, but also markets for instruments such as equities or corporate bonds held by ETFs which banking organizations would intermediate less readily. A robust and well-functioning ETF market has positively influenced fixed income market structure in respect of liquidity, price transparency, competition, and risk transfer solutions such as portfolio trading.

To be sure, other market participants may expand their roles as intermediaries to replace large banking organizations. From a systemic risk perspective, however, the replacement of one financial intermediary such as a large banking organization with another would not reduce the overall level of interconnectedness within the system. To the contrary, to the extent large banking organizations cease acting as intermediaries in the price discovery process for ETF shares, this systemic risk transmission channel would be more concentrated in those other market participants.

Inclusion of Client Cleared Transactions in the Complexity Indicators

This proposed change would disincentivize large banking organizations from acting as clearing members on behalf of their clients. The encouragement of central clearing has been a significant goal of U.S. and international financial regulatory reforms since the GFC. This change could introduce barriers for end users of derivatives seeking to access clearing services. Reduced provision of clearing services by large banking organizations may concentrate risks among remaining clearing members, thereby undermining public policy objectives which seek to encourage central clearing to enhance transparency and simplicity in OTC derivatives markets.

iii. **Recommended path forward**.

In recognition of the unique attributes of ETFs and to promote a robust price discovery process supported by a diverse range of financial institutions, we recommend that the Federal

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[47] *See* BASEL COMM., INSTRUCTIONS FOR THE END-2022 G-SIB ASSESSMENT EXERCISE 13-14 (2023) (instructing banking organizations to not include bond or equity ETFs when describing intra-financial system asset holdings for purposes of assessing systemic importance).

Reserve exclude ETFs from the definition of financial institution for purposes of the FR Y-15 interconnectedness indicators. In addition, in recognition of the importance of banking organizations as clearing members for clients in OTC derivatives markets and in support of financial regulatory goals since the GFC, we recommend that the Federal Reserve exclude client cleared transactions from the complexity indicator.

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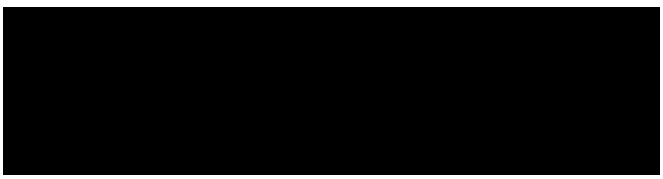
In conclusion, we urge the Agencies to carefully review our comments on the downstream impacts to retail, institutional, and fund investors as part of a broader evaluation of the U.S. bank capital framework. Our members are concerned that the likely resulting cost increases and liquidity decreases for investment products would inevitably negatively affect the ability of investors to achieve investment goals and hedge investment risks. While our members appreciate the Agencies' goals for a highly resilient banking sector, it is important that the Agencies seek further input from our members to achieve the best balance between resiliency for banking organizations and robust U.S. capital markets. We encourage the Agencies to proceed cautiously and will appreciate the opportunity to expand on the examples provided herein so that the Agencies can seek to avoid such negative downstream consequences for the investing public while crafting any revised U.S. capital rules for banking organizations. In the event, after consideration of our feedback, the Agencies elect to re-propose the rules, we stand ready to evaluate and provide comments on any re-proposal to better ensure the Agencies' goals are achieved while mitigating the risk of harm to investment and hedging opportunities for our clients, the investing public.

SIFMA AMG appreciates the Agencies' consideration of these comments and would be pleased to discuss our views in greater detail if it would assist with their deliberations on the Basel III Proposal. Please contact William Thum at bthum@sifma.org or at (202) 962-7381 if you wish to discuss the points raised in this letter further.

Sincerely,



William C. Thum
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