SUTHERLAND

SUTHERLAND ASBILL & BRENNAN LLP
1275 Pennsylvania Avenue, NW
Washington, DC 20004-2415
202.383.0100 Fax 202.637.3593
www.sutherland.com

WARREN N. DAVIS
DIRECT LINE: 202.383.0133
E-mail: warren.davis@sutherland.com

January 18, 2011

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

RE: Advanced Notice of Proposed Rulemaking ("ANPR")—Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (RIN 3038-AD99)

Dear Mr. Stawick:

On behalf of the Federal Home Loan Banks (the "FHLBanks"), we appreciate this opportunity to comment on the above-referenced ANPR. We have previously addressed the subject of the ANPR in a letter to Commissioner O'Malia (copy attached) and this letter will supplement our comments contained in that letter. For the reasons noted below, the FHLBanks continue to believe that swaps customers are not well-positioned to conduct the type of credit analysis on other customers of their clearing members, as is entailed in the baseline model described in the ANPR. Accordingly, the FHLBanks support the idea of departing from the existing futures model and mandating individual customer segregation of initial margin for cleared swaps. The FHLBanks do, however, believe that the Commodity Futures Trading Commission (the "CFTC") should carefully study the financial impact of each of the proposed market structures in the ANPR and insure that the market structure adopted by the CFTC fairly protects the interests of end-users such as the FHLBanks.

Atlanta Austin Houston New York Washington DC

The FHLBanks

Each of the 12 FHLBanks is a government-sponsored enterprise of the United States, organized under the authority of the Federal Home Loan Bank Act of 1932, as amended, and structured as a cooperative. The FHLBanks serve the general public interest by providing liquidity to their financial institution members, thereby increasing the availability of credit for residential mortgages, community investments, and other services for housing and community development. Specifically, the FHLBanks provide readily available, low-cost sources of funds to their members.

Each of the FHLBanks enters into swap transactions with traditional swap dealers to mitigate financial risk, primarily interest rate risk. At December 31, 2009, the notional principal amount of interest rate swaps held by the FHLBanks collectively was $975.1 billion. At present, none of the FHLBanks clear any of their swap transactions. Although it is uncertain what percentage of the FHLBanks' swaps will be subject to mandatory clearing under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and how much initial margin will be required to support the cleared swaps, the amount could be substantial. Each of the FHLBanks will individually post initial margin in order to protect its clearing members (referred to herein as "clearing members" or "FCMs"), and thereby the clearinghouse, against the highly unlikely risk of the FHLBank's default, thereby reducing systemic risk. The use of initial margin for that purpose is not at issue here. Rather, this comment letter addresses whether such initial margin should be at risk of loss upon defaults **by other customers** of the FHLBanks' FCMs ("fellow-customer risk").

Under the current over-the-counter ("OTC") model, the FHLBanks perform extensive credit analyses on their counterparties to help protect themselves from counterparty credit risk. In contrast, under the existing futures model, the FHLBanks would not have access to credit information concerning (or even the identity of) their FCMs' other customers and would be required to commingle their initial margin in omnibus accounts without the ability to do any credit analysis on the FCM's other customers. Even if the FHLBanks perform an extensive review of the FCM, they are still exposed to the possibility of significant losses if the FCM fails to perform a similarly extensive review or manage credit risk on even one of its other customers.[1] The FHLBanks do not support any model that could expose their collateral to more risk than they currently have under the OTC model.

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[1] As discussed below, this risk would not arise with respect to the FHLBanks uncleared swaps if they exercise their right under Section 724 of Dodd-Frank to have initial margin posted to their swap counterparties held with independent custodians in separate accounts. The FHLBanks cannot support any model that exposes their collateral to more risk than it is currently exposed to under the OTC model.

The Benefit of Segregated Accounts

The benefits of Model 1 as set forth in the ANPR are obvious and many. Full physical segregation eliminates the credit exposure that a customer of a clearing member has to other customers of the clearing member and, unlike Model 2, provides for clear recordkeeping of the assets pledged by each of a clearing member's customers. As such, Model 1 allows customers to limit their credit exposure by performing the same type of extensive credit analysis on clearing members that they currently perform on their OTC counterparties. In addition, Model 1 is consistent with the statutory right of OTC market participants to have collateral posted as initial margin in uncleared derivative transactions held by an independent custodian in order to protect such collateral upon the insolvency of their counterparties.[2] It seems unlikely that Congress would have intended to mandate clearing for many OTC swaps to reduce systemic risk arising from bilateral counterparty credit risk only to force swaps into a clearing system that exposes market participants to fellow-customer risk.[3] Finally, we understand that Model 1 would effectively remove a customer's collateral from the default waterfall in all cases except upon a default by such customer. We believe that such protection is appropriate for a nondefaulting customer.

Model 2 as set forth in the ANPR is an improvement over the existing futures model in that it requires at least legal segregation of a customer's collateral but we do not think it goes far enough in reducing risk to the customer. Under this model, we believe that customers would still be at risk if there is a shortfall in the omnibus account or if a clearinghouse or clearing members fail to keep accurate books and records, in each case due to the vagaries of applicable bankruptcy regimes.

Model 3 as set forth in the ANPR would continue to expose customer initial margin for cleared swaps to fellow-customer risk, but that risk would be reduced by moving customers farther down the default waterfall. While this may not be the preferred position of the FHLBanks, it should certainly be the minimum requirement imposed on all clearinghouses and clearing members. As discussed below, as among the clearinghouses, the clearing members and the customers of the clearing members, the customers are the least able to provide oversight for

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[2] See Dodd-Frank, § 724.

[3] The statutory language of Dodd-Frank suggests that Congress did not intend to create requirements that would increase fellow-customer risk. In the section dealing with segregation of collateral for cleared swaps, Dodd-Frank specifically refers to the segregation of property belonging to the "swaps customer," in the singular, of an FCM. By contrast, in addressing this matter for futures, the Commodity Exchange Act (the "CEA") refers to "swaps customers," in the plural. CEA § 4d(a)(2). We see this as direction to the Commodity Futures Trading Commission to ensure that customer initial margin is not put at risk on account of actions of other customers. The can be accomplished by prohibiting any commingling of customer margin as proposed in Model 1 or presumably by allowing commingling but providing for legal segregation as proposed in Model 2.

the clearing members. Under the existing futures regime (Model 4), if a customer perceives its clearing member or any of the clearing member's significant customers to be in financial distress, as a practical matter, the only way for the customer to protect its initial margin is to attempt to port its trades to another clearing member. The FHLBanks have significant concerns about whether such pre-default porting will in fact be available to a customer in times of great market volatility and financial stress, particularly if the other clearing members with which the customer has existing relationships are unable (or unwilling) to accept additional transactions.

As a final matter, it should be recognized that many participants in the OTC swaps markets, including the FHLBanks, have little or no exposure to, or experience with, the existing U.S. futures markets. Thus, while the FHLBanks would endorse revisiting the existing model for futures customers, we see no reason why that model should be determinative for cleared swaps transactions. The CFTC has already recognized that there is a reason to distinguish between the treatment of margin for cleared swaps versus futures.[4] Moreover, the rationale for the current futures model articulated in 1985 Interpretative Statement No. 85-3, attached to the ANPR, seems outdated and questionable with respect to its suggestions that clearinghouses cannot monitor the customers of their clearing members. Our understanding today is that clearinghouses are able to, and do in fact, look through their clearing members to evaluate the positions of the clearing members' customers.[5] Such a "look through" is necessary for, among other things, the enforcement of clearinghouse position limits. Accordingly, it seems clear that clearing members and clearinghouses are in a much better position than customers, such as the FHLBanks, to perform the necessary and ongoing credit analysis of, and margin management for, other swaps customers.

Costs Relative to the Baseline Model

The ANPR requests that cleared swaps customers discuss what costs they would expect to incur for each of the models relative to the baseline model (Model 4). Unfortunately, the FHLBanks are not in a position to answer this question or, as requested in the ANPR, to provide a "detailed basis" for any estimate. Until all the rules are in place that will govern the treatment of clearinghouses for swaps and clearing members that elect to clear swaps, and all applicable fees are known, we do not see how any prospective customer would be able to provide this information.

The questions posed in the ANPR with respect to the costs customers may be willing to incur for each of the proposed models relative to the baseline model suggests that the baseline model does not involve any cost. The FHLBanks, however, believe that the baseline model does have a "cost." Under the baseline model, the FHLBanks' initial margin for cleared trades

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[4] See 17 C.F.R. 190 for a discussion of the CFTC's regulation creating a separate Section 4d account class for cleared OTC derivatives and allowing for the separation of collateral for cleared OTC derivatives and collateral for futures.

[5] See CME Rulebook, Rule 560 Position Accountability.

would be at economic risk to losses resulting from fellow-customer risk. The FHLBanks would essentially have a contingent risk that is not quantifiable until circumstances arise in which the risk becomes actual and the dollar amount of their losses are established. Additionally, at an open meeting in December 2010, the CFTC proposed a dramatic reduction in the minimum capital requirements for clearing members of swaps clearinghouses.[6] Capital requirements for clearing members will obviously be a material factor to be taken into account in assessing the risk a customer would incur under the baseline model.

Presumably, the direct costs incurred by FCMs and passed through to their customers in connection with Models 1 and 2 should theoretically be the same or similar to the actual cost to the FHLBanks of insuring against the risk to which they would be exposed under the baseline model. The same should be the case with respect to Model 3, but the direct costs would be less because the probability that the FHLBanks would incur a loss at the bottom of the waterfall should be considerably less than the probability of incurring a loss under the baseline model.

In our letter to Commissioner O'Malia, we commented on our discussion with one clearinghouse that has been clearing inter-dealer interest rate swaps for a number of years. Our understanding is that this clearinghouse offers its clearing customers three alternatives for initial margin, including complete segregation (Model 1), commingling in an omnibus account (Model 4), and a third model that permits an investment manager to commingle accounts under its control while excluding accounts of unrelated customers. The choice, which entails cost differentials for the various alternatives, rests with the customer. We understand that this clearinghouse would like to offer these alternatives to US customers, but is presently precluded by CFTC rules from doing so. At this point, we see no reason why the CFTC rules should not accommodate a clearinghouse that believes it can offer alternative protections for customer margin on a cost effective basis.

Moral Hazard Issues

The questions posed in the ANPR regarding customers "risk managing their clearing members" are highly relevant. As stated in the letter to Commissioner O'Malia, the FHLBanks believe that the CFTC should consider carefully the limited ability of end-users to assess the financial condition and risk management practices of clearing members. We believe that clearing members and the clearinghouses themselves are in a significantly better position to make such assessments and oversee the creditworthiness of all clearing members.

The FHLBanks are in the process of reviewing Futures Account Agreements provided by a number of clearing members. Unlike the ISDA Master Agreement, which was developed with the understanding that either party could be the "debtor party" or the "creditor party" in a swap transaction, the Futures Account Agreements we have reviewed appear to be written from the

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[6] See CFTC Proposed Rule on Risk Management Requirements for Derivatives Clearing Organizations (issued on December 16, 2010 but not yet published in the Federal Register).

perspective that the clearing member will always be the "creditor party" and the customer will always be the "debtor party." The apparent rationale for this is that, on the one hand, the customer is looking to the creditworthiness of the clearinghouse and all its clearing members for assurance of payment rather than to the creditworthiness solely of its clearing member and, on the other hand, the customer's clearing member is effectively guaranteeing the customer's trade to the clearinghouse. Thus, the over-arching objective reflected in Futures Account Agreements is the protection of the clearing member against losses arising from possible customer defaults. None of the Futures Account Agreements we have reviewed contain provisions that address fellow-customer risk with respect to a customer's initial margin.[7] For example, none of the Futures Account Agreements we have reviewed require the clearing member to provide any information regarding its financial condition to the customer. None make any representation regarding the clearing member's risk management practices beyond compliance with applicable law. In short, there is nothing in the Futures Account Agreements that we have reviewed to suggest that clearing members view their customers as providing any oversight whatsoever to the activities of the clearing member or any means to do so.

Currently, an "Addendum" to the Futures Account Agreement is being developed under the auspices of the Futures Industry Association. The Addendum is intended to overlay and modify the Futures Account Agreement to accommodate cleared swaps. As currently drafted, the Addendum does not contain provisions that would facilitate management of fellow-customer risk. Even assuming that provisions of the Futures Account Agreement and Addendum will be negotiated, it is difficult to foresee any circumstances in which a clearing member would be able and willing to share much information regarding its business with other customers or agree to limit its business with other customers.

Although customers have little or no input into the risk management practices of clearing members, the clearinghouse and other clearing members have extensive input into such practices. The FHLBanks believe that these parties are far better suited than customers to manage fellow-

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[7] This may be explained by the fact that to date there have been few clearing member bankruptcies that have resulted in losses to solvent clearing member customers and none of these have involved losses on the scale of those experienced during the recent financial crisis. It may also be explained by the fact that futures customers have not fully appreciated the risks they incur with respect to their clearing members. In any event, the amount of margin that will likely be at risk in connection with cleared swaps may greatly exceed the margin that has been posted with respect to exchange-traded futures. This difference is due in part to the fact that the duration of cleared swaps (up to 30 years for rate swaps) may far exceed the duration of exchange-traded futures and, as a result, the amount of margin required for such cleared swaps may vastly exceed the margin required for interest rate futures. Another factor is the potential size of the cleared swaps market as compared to the existing exchange-traded futures market. It appears that the FHLBanks could have hundreds of millions of dollars of initial margin at risk if a significant percentage of their OTC swaps must be submitted for clearing.

customer risk. Also, from a cost and efficient use of resources perspective, it does not seem to make sense to ask hundreds or thousands of derivatives customers to each undertake management of fellow-customer risk.

As mentioned above, as a practical matter, the primary way for customers to manage their fellow-customer risk is to have advance arrangements in place that would allow them to quickly move their cleared trades from a defaulting clearing member to another clearing member (assuming that this is even possible). We are not sure that this makes sense from a systemic risk perspective because it may prompt the equivalent of a "run on the bank" when information becomes available that suggests a clearing member may be facing financial stress. Moreover, it is uncertain whether porting of cleared swaps between clearing members will actually work in times of great market volatility and financial stress. These issues should be carefully considered by the CFTC before any decisions are made to retain the existing futures model for cleared swaps collateral.

Conclusion

For the foregoing reasons, the FHLBanks strongly support full collateral segregation as set forth in Model 1. As noted above, while we are not in a position to fully analyze the costs of this model, to the extent these costs are not prohibitive, we believe that Model 1 is most consistent with the intent of Dodd-Frank's clearing requirements. Full collateral segregation places the economic risk of cleared swap transactions on the proper parties and also places the burdens of due diligence and credit analysis on the proper parties.

The FHLBanks appreciate the opportunity to provide advance comments on this important issue and look forward to reviewing and providing comments once the CFTC issues a Notice of Proposed Rulemaking in the future. Please contact Warren Davis at 202.383.0133 or Warren.Davis@sutherland.com with any questions you may have.

Respectfully submitted,

Warren Davis /AMB

Warren Davis

cc: FHLBank Presidents
FHLBank General Counsel

FHLBank
ATLANTA
A FEDERAL HOME LOAN BANK

Jill Spencer
Interim President and
Chief Executive Officer

November 15, 2010

Commissioner Scott D. O'Malia
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Section 724 (Segregation and Bankruptcy) of the Wall Street Reform and Consumer Protection Act (the "Act")

Dear Commissioner O'Malia:

On behalf of the Federal Home Loan Banks ("FHLBanks"), we are pleased to have this opportunity to respond to your letter of November 3, 2010 relating to the segregation of client funds for cleared swaps.

The 12 FHLBanks are government-sponsored enterprises of the United States, organized under the authority of the Federal Home Loan Bank Act of 1932, as amended ("FHLBank Act") and structured as cooperatives. The FHLBanks serve the general public interest by providing liquidity to members, thereby increasing the availability of credit for residential mortgages, community investments, and other services for housing and community development. The FHLBanks provide a readily available, low-cost source of funds to their members. The FHLBanks are regulated and supervised by the Federal Housing Finance Agency ("FHFA").

Title VII of the Act is intended to dramatically change the regulatory regime for over-the-counter ("OTC") derivatives, a market that has been widely described as consisting of bilateral, privately negotiated derivative contracts whose aggregate "notional amounts" outstanding in 2008 and 2009 were approximately $600 trillion. The largest category of OTC derivatives is interest rate contracts, and this category of OTC derivatives is estimated to account for slightly more than $400 trillion of the total outstanding derivative contracts (or approximately two-thirds of the OTC derivatives market).

OTC interest rate derivatives are an integral part of the FHLBanks' financial management strategies, and these instruments significantly affect their financial statements. The FHLBanks routinely use the following instruments to manage their exposure to interest rate risks inherent in their normal course of business: interest rate swaps, interest rate cap and floor agreements, and

1475 Peachtree St. NE | Atlanta, GA 30309 | Tel: 404.888.8520 | jspencer@fhlbatl.com | Fax: 404.897.1846

swaptions. As of December 31, 2009, the aggregate notional amount of such contracts outstanding for the FHLBanks was approximately $975 billion.[1]

Although it is impossible to know today what percentage of the FHLBanks' swaps will be subject to the mandatory clearing requirements of the Act, we expect that over time many of the swaps employed by the FHLBanks to manage their interest rate risk will be cleared. We, along with other end-users, are spending a great deal of time trying to assess how implementation of the Act will affect both our hedging costs and the risks associated with our derivatives activities. In this regard, we note that the FHLBanks are not currently required by their counterparties to post initial margin ("Independent Amounts" in the terminology of the ISDA-based OTC markets) in connection with their OTC bilateral transactions. We understand that under the Act, margin requirements will change with respect to both our cleared and uncleared transactions. Given the volume of our derivatives activities, we expect the amount of initial margin that we will be required to post will be significant. Accordingly, we are keenly interested in the amount of initial margin we may be required to post and in how that margin will be protected in the event that the party holding it should become insolvent.

While your letter focuses on the treatment of client funds for cleared swaps, we note that another provision of the Act[2] provides end-users with additional rights designed to protect the initial margin they post in connection with uncleared transactions. As we understand that provision, the FHLBanks will have the right to insist that initial margin posted with dealers be held in an account with an independent custodian. It is our hope and expectation that such account will be subject to a tri-party agreement with the dealer and the custodian such that it will not be exposed to loss should the dealer for whatever reason become insolvent.[3] Obviously, there will be some cost associated with such arrangements and we will have to weigh such costs in deciding whether to enter into such arrangements rather than other alternative arrangements that may entail additional risks. The point here is that the FHLBanks expect to have the option of seeking maximum protection for the initial margin posted with dealers for uncleared transactions.

As a general proposition, the FHLBanks see no reason why the initial margin posted with respect to cleared swaps should be at greater risk than the initial margin posted for uncleared swaps. We were surprised to learn that under the existing futures model funds posted to a futures commission merchant ("FCM") by the FHLBanks could indeed be at risk if other customers of the FCM default and, as a result, the FCM is unable to meet its obligations to the clearing house. Accordingly, we generally would be inclined to support the idea of departing from the futures model and mandating individual customer segregation accounts for cleared swaps. That said, we

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[1] See note 11 to the audited combined financial statements of the FHLBanks as reported in the Federal Home Loan Banks 2009 Combined Financial Report (FHLBanks 2009 Financial Report) at p. 259.

[2] Act, §724(c).CEA §4s(l).

[3] See letter dated October 8, 2010 to CFTC from ISDA regarding "Pre-proposal Comments Related to Segregation of Collateral for Uncleared Swaps."

are aware that there is substantial opposition to this approach, primarily for cost and operational reasons, by members of the FCM community and by certain of the clearing houses.

Unfortunately, at this time we do not have enough information to evaluate these concerns and thus cannot say definitively whether the idea of individual account segregation should be mandated. However, we hope that such a model could at least be accommodated so that the market can decide whether the costs and operational issues are as great as suggested. In this regard, our discussions with a clearing house that has been clearing inter-dealer interest rate swaps for a number of years using an individual account segregation model indicate that such a model can be economically viable for client clearing if permitted by CFTC rules. At this point, we see no reason why the CFTC rules should not accommodate a clearing house that believes such a model is workable on a cost effective basis.

Finally, we believe that the Commission should consider carefully the ability of end-users to assess the financial condition and risk management practices of FCMs as compared with the opportunities for such assessment and oversight by fellow FCMs and the clearing houses themselves. Based on the experience with the failures of Bear Stearns and Lehman Brothers, we question whether end-users are the best situated entities to determine whether an FCM is engaging in other customer business that could put client funds at risk.

Again, thank you for the opportunity to respond to your letter and we look forward to a continuing dialog regarding implementation of the Act.

Sincerely,

Jill Spencer
Interim President and
Chief Executive Officer