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VIA ELECTRONIC MAIL

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

RE: Protection of Collateral of Counterparties to Uncleared Swaps (RIN 3038-AD28)

Dear Mr. Stawick:

On behalf of the Federal Home Loan Banks (the "FHLBanks"), we appreciate this opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") above-referenced proposed rules designed to implement the important new statutory right of counterparties to swap dealers ("SDs") and major swap participants ("MSPs") to elect to have initial margin segregated with an independent custodian. One of the central tenets of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") is that no financial institution is too big to fail. Having initial margin held by an independent custodian protects counterparties to uncleared swaps from incurring losses with respect to initial margin should their SD or MSP swap counterparty become insolvent.

The FHLBanks are generally supportive of the proposed rules as currently drafted, but have a number of comments that primarily reflect the FHLBanks' belief that the CFTC's final rule should ensure that the statutory right to segregation of initial margin is available, as a practical matter, to all end-users. In sum, the FHLBanks believe that the final rule should:

(1) provide a clear and easy mechanism for SDs and MSPs to notify counterparties of their right to elect segregation of initial margin and for counterparties to elect segregation of initial margin;

(2) require SDs and MSPs to offer to counterparties a tri-party custodial agreement containing commercially reasonable terms and require all parties to negotiate such arrangements in good faith;

(3) require SDs and MSPs to disclose, upon request, applicable costs to their counterparties;

(4) provide clear guidance as to what constitutes an "independent" custodian;

(5) establish that if the counterparties are unable to agree on a custodian, the counterparty electing to have its initial margin segregated should have the right to designate the custodian;

(6) allow counterparties to enter into arrangements for the investment of segregated initial margin, without imposing overly restrictive requirements for eligible investments; and

(7) prohibit the SD/MSP from refusing to segregate initial margin unless the end-user counterparty agrees to allocate to the SD/MSP the gains and losses from investment of segregated funds.

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 major SDs to mitigate financial risk, primarily interest rate risk. As of December 31, 2009, the aggregate notional principal amount of interest rate swaps held by the FHLBanks collectively was $975.1 billion. At present, none of the FHLBanks post initial margin ("Independent Amounts" or "IA" in the terminology employed in documentation published by the International Swaps and Derivatives Association ("ISDA")) to their dealer counterparties. This is largely due to the financial strength of the FHLBanks.[1] Although it is uncertain what percentage of the FHLBanks' swaps will be subject

[1] All twelve FHLBanks are individually rated as Aaa by Moody's. Ten of the twelve FHLBanks are individually rated AAA by Standard & Poor's. The remaining two FHLBanks are rated AA+ by S&P. Thus, the FHLBanks typically have higher credit ratings than their dealer counterparties. Because the SDs pose more insolvency risk to the FHLBanks than vice versa, it is anticipated that any initial margin requirements imposed with respect to uncleared swaps should be reciprocal. Stated differently, if the FHLBanks are required to post initial margin to their dealer counterparties, they would expect to also receive initial margin from such counterparties. The 1994 Credit Support Annex subject to New York Law (the "CSA") to the ISDA Master Agreement contemplates the possibility that both parties may be required to post IA and, as a result, both parties may hold posted collateral simultaneously. *See* CSA Para. 3 and the User's Guide to the 1994 ISDA Credit Support Annex, Appendix C. The instant rulemaking only addresses segregation of margin posted by an end-user counterparty to an SD or MSP. However, in finalizing the rule, care should be taken to impose requirements that would not be inconsistent with SDs or MSPs posting IA to their end-user counterparties.

to mandatory clearing under Dodd-Frank and how much initial margin will be required to support those swaps that are not cleared, the amount could be in the hundreds of millions or even billions of dollars for the FHLBanks combined.[2] As discussed below, this initial margin could be at serious economic risk if it is not segregated and held by an independent custodian. Accordingly, the FHLBanks believe that it is important that the provision in Dodd-Frank which requires SDs and MSPs to segregate initial margin with an independent third-party custodian on request of a swap counterparty be implemented in a manner that provides assurance that tri-party custodial arrangements, reflecting commercially reasonable terms, will be available to swap counterparties.

I. Background

In the existing uncleared over-the-counter ("OTC") market, the FHLBanks perform extensive credit analyses on their counterparties to protect themselves from counterparty credit risk. In addition, the FHLBanks enter into credit support agreements with their swap counterparties pursuant to which they post or receive collateral based on the mark-to-market value of their outstanding trades with each counterparty.[3] As a general matter, posting collateral to a counterparty based only on mark-to-market valuations (*i.e.*, variation margin) poses less of a credit risk to the FHLBanks than the posting of initial margin would. The reason for this is that the variation margin posted to one counterparty (the "secured party") by the other party (the "pledgor") should approximate the amount that would be owed to the secured party upon an early termination of swaps under the ISDA Master Agreement.[4] As noted above, the FHLBanks

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[2] One percent of the notional amount of FHLBanks' swaps outstanding as of December 31, 2009 would be $9.7 billion. In analyzing the potential impact of the margin requirements of Dodd-Frank, ISDA estimated that "the initial margin requirement would be 1% (a typical level) of the notional amount." *See* "US Companies May Face US $1 Trillion of Additional Capital and Liquidity Requirements As a Result of Financial Regulatory Reform, According to ISDA Research," ISDA Press Release dated June 29, 2010, *available at* http://www.isda.org/media/index.htm. Because the proposed rules regarding capital and margin have not been published as of the date of this letter, it is impossible for the FHLBanks to gauge with any certainty the amount of initial margin they will be required to post. Dodd-Frank seems to contemplate that SDs/MSPs will require many, if not all, end-users counterparties to post both initial and variation margin in connection with "all swaps that are not cleared by a registered derivative clearing organization" (Dodd-Frank § 731).

[3] The terms governing the exchange of collateral based on mark-to-market changes in the value of outstanding swaps are set out in the CSA. The collateral posted based on changes in mark-to-market valuations is generally referred to as variation margin. Under the CSA, "initial margin" is referred to as the "Independent Amount" and is generally specified in either Paragraph 13 of the CSA or in confirmations for particular trades. In these comments, when we refer to "initial margin" we intend to refer to the Independent Amounts specified in the CSA or trade confirmations.

[4] There is still risk, however, with respect to posted variation margin. The posting and return of variation margin lags market movements by several days. If the market moves in favor of one party, it may be materially over-collateralized until it obtains the return of the "excess" collateral. This excess is exposed to loss should the counterparty become insolvent before it is returned.

have not entered into credit support agreements that require them to post initial margin to their swap counterparties. The posting of initial margin, as contrasted with variation margin, always entails credit risk for the pledging party. The reason for this is that initial margin, by definition, represents an over-collateralization of the secured party's exposure to the pledgor. Thus, if the secured party should become insolvent, it likely will be holding collateral in excess of the amount owed to it by the pledgor. In this case, the pledgor will likely have only a general creditor's claim against the estate of the insolvent counterparty for the excess amount of collateral over the amount owed by the pledgor to the insolvent secured party.[5]

In recent years, following the insolvency of a number of significant participants in the swaps markets, increased attention has been paid to counterparty credit risk. One consequence of this has been that swap dealers have increasingly sought initial margin from end-user counterparties that they believe pose the greatest credit risk. To date, hedge funds have been the end-user counterparties most likely to be subject to initial margin requirements.[6] The purpose of initial margin is to offer additional protection to the secured party in the event of a counterparty default. For example, it provides a "cushion" for changes in value of swaps that may occur between transfers of variation margin and during the period following a default before transactions can be terminated and collateral liquidated. However, initial margin provides a significant additional benefit to the SD that is completely unrelated to its primary purpose. Margin posted under the CSA may, at the election of the parties, be rehypothecated by the secured party. Because initial margin has traditionally been lumped in a "single bucket/account" with variation margin that may be rehypothecated under the CSA, initial margin has become a source of reliable, low cost liquidity for SDs.[7] The large SDs responding to the most recent ISDA Margin Survey reported rehypothecating eighty-two percent of the collateral received.[8]

In October 2008, recognizing that "the financial industry is facing turbulent times," ISDA, the Asset Management Group of SIFMA, the MFA and several large SDs (the "Swaps Industry")

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[5] *See* Independent Amount White Paper published by ISDA, the Managed Funds Association ("MFA") and the Securities Industry and Financial Markets Association ("SIFMA") ("IA White Paper"), March 1, 2010 at pp. 6-7. The IA White Paper is available at: http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf. *See also* Christian A. Johnson, "Derivatives and Rehypothecation Failure: It's 3:00 p.m., Do You Know Where Your Collateral Is?," 39 Ariz. L. Rev. 949 (1997).

[6] According to the 2010 ISDA Margin Survey (the "ISDA Margin Survey") hedge funds collateralized 141% of their net exposures, as compared with 78% for banks and broker-dealers, 58% for institutional investors, and 47% for corporate counterparties. Hedge funds were the only type of entity with average collateralization levels exceeding 100% of net exposures, a figure that reflects the IA posted by these firms. *See* ISDA Margin Survey 2010 at p. 11 (*available at* http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf).

[7] According to the 2010 ISDA Margin Survey, 82% of the IA received by large SDs was commingled with variation margin and only 9% was segregated with a custodian or third party. *See id.* at p. 8.

[8] *Id.*

made a number of commitments to the Federal Reserve Bank of New York.[9] Among these commitments was a pledge to deliver a "Roadmap for Collateral Management" during 2009 that would address various regulatory and market concerns.[10]

In June 2009 the Swaps Industry delivered its Roadmap for Collateral Management, which promised publication of a detailed paper on both the buy-and sell-side views of the "Segregation of Initial Margin issue," to be followed by a collaborative effort of the three trade associations "to produce a set of options for industry consideration that will address the Segregation of Initial Margin issue by September 30, 2009."[11] The IA White Paper, not completed until March, 2010, succinctly stated the concerns of end-users:

> The Lehman experience has led to an increased awareness of the risk associated with posting IA. It has translated into a strong desire on the part of certain End-Users to ensure that IA posted to a Dealer is held in a manner that ensures it is remote from the bankruptcy of the Dealer counterparty and immediately recoverable (*i.e.*, 'portable') upon the occurrence of such an event.[12]

In an April 15, 2010 update, ISDA published the "2010 Roadmap for Collateral Management," in which ISDA committed to "establish a working group by May 31, 2010 consisting of ISDA, SIFMA, MFA and market participants (including custodians) to develop standard provisions that may be incorporated into documents for Third Party Custodian and Tri-Party Collateral Agent IA holding arrangements in order to facilitate negotiation and consistency of operation for SDs/MSPs and end-user counterparties who elect to use such arrangements."[13] As of the date of this letter this group has been established, is meeting by conference call regularly, but has yet to make any recommendations.[14]

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[9] Each of the twelve FHLBanks is a Subscriber Member of ISDA. ISDA's Subscriber Membership category is designed for corporations, financial institutions and government entities that use privately negotiated derivatives to better manage financial risks. (SDs are Primary Members of ISDA.)

[10] *See* Letter to Timothy F. Geithner, President of the Federal Reserve Bank of New York from ISDA, SIFMA, MFA and major swaps dealers dated October 31, 2008 at Annex A-Collateral Management.

[11] *See* ISDA, "The Roadmap for Collateral Management" at p. 5, 7 (attached to letter to Mr. Theo Lubke, OTC Derivatives Supervisors Group, Federal Reserve Bank of New York from representatives of ISDA dated June 2, 2009).

[12] IA White Paper at p. 7. http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf. Recommendation 12 of the IA White Paper states:
ISDA, SIFMA, MFA, and market participants should expeditiously work together to develop standard provisions that may be incorporated into documents for Third Party Custodian and Tri-Party Collateral Agent IA holding arrangements. Consideration should be given to applying these standard provisions to the holding of IA by Dealer Affiliates also, where appropriate.

[13] *See* ISDA, "2010 Roadmap for Collateral Management" at p. 5.

[14] The FHLBanks are participating in this working group through their outside counsel.

According to the most recent ISDA Margin Survey, which reports on market practice as of December 31 of 2009, only 9 percent of the IA received by large dealers was segregated with a custodian or with a third party.[15]

It is against this background that a number of end-user counterparties sought, and that Congress agreed to provide, a statutory right to insist that initial margin for uncleared swaps be segregated with an independent custodian.

Based on a review of the proposed regulation, the FHLBanks have a number of comments, which are set out below.

II. Proposed Definitions

The FHLBanks believe the definitions of "Initial Margin" and "Variation Margin" should be conformed to the standard terms utilized in the OTC derivatives markets to refer to the amounts of collateral posted by parties to uncleared swaps. The FHLBanks concur with the comments of ISDA that the final rules should refer to "Exposure Collateral" and "Independent Amount" as replacements for Variation Margin and Initial Margin, respectively. These terms are widely used and understood by OTC market participants and, accordingly, the FHLBanks believe that utilizing these terms in the rules will greatly facilitate the implementation of Section 724(c) of Dodd-Frank. Although implementation of this new statutory provision will require revisions to the CSA, the agreement most often employed to document margin requirements for uncleared OTC swaps, the objective should be to keep the required changes to a minimum so as not to unnecessarily disrupt the important uncleared OTC swaps market.

III. Notification Issues

A. Frequency of Notification/Confirmation/Election

The FHLBanks are concerned that the notification requirements imposed on SDs and MSPs not be unduly burdensome, as the costs of complying with these requirements will likely be passed on to end-user counterparties. As sophisticated market participants, the FHLBanks do not require notification of their rights on a yearly basis. So long as it is clear that a party has the right to change its election at any time by written notice, there is no need to require repetitive notice of the election after a party makes its original determination to elect (or not to elect) segregation of initial margin.

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[15] *See* ISDA Margin Survey 2010, *supra* note 7 at 8. According to the Survey, seven percent was subject to a "Tri-party" arrangement.

B. Disclosure of Segregation Costs

The FHLBanks believe it is very important for SDs/MSPs to respond to requests for information regarding the additional costs that may be imposed on end-user counterparties that elect to have initial margin segregated with an independent custodian. Recognizing that custodian fees are generally outside the control of the SD/MSP, the SD/MSP should be permitted to estimate, based on the experience of the SD/MSP with various custodians, those costs that are outside of their control. If, however, the SD/MSP itself intends to impose specific charges on end-user counterparties exercising their segregation rights or to quote different spreads depending on whether initial margin segregation is elected, they should be required to disclose these costs to the end-user counterparty on request. As indicated, SDs have generally been entitled to commingle initial and variation margin and have been permitted to rehypothecate such margin. Thus SDs have enjoyed billions of dollars of relatively low cost funding as the result of requiring initial margin from certain end-user counterparties.[16] If the SDs/MSPs intend to replicate that funding source (either directly through fees or indirectly through transaction pricing) where end-user counterparties elect to have initial margin segregated, they should be required to disclose this information to such counterparties upon request. In addition, the FHLBanks would expect any rebates, discounts or other compensation that an SD/MSP expects to realize by selecting or recommending a particular custodian to also be disclosed.[17]

Because it is contemplated that an election to segregate initial margin will be effective until revoked, the FHLBanks recognize that it may not be possible for SDs/MSPs to disclose precisely how pricing on future trades will be affected. However, end-user counterparties electing to segregate initial margin should be permitted to request, and the SDs/MSPs should be required to disclose, information on the price the end-user counterparties are paying for this election upon entering into new trades.

C. Form of Notification/Confirmation/Election

The FHLBanks believe that end-user counterparties should be authorized to elect to have their initial margin segregated (which election may be changed in the future) in their ISDA Master Agreement or an amendment thereto. In addition, an election outside an ISDA Master Agreement should be sufficient if it is executed or delivered by a person duly authorized to execute the ISDA Master Agreement.

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[16] *See* note 7, *supra*.
[17] Presumably this information would be required to be disclosed in any event pursuant to the business conduct requirements relating to material incentives or conflicts of interest (*See* Dodd-Frank, § 731).

IV. Requirements for Segregated Collateral

A. Qualification as "Independent" Custodian

The proposed regulation requires the custodian to be "independent of both the swap dealer or major swap participant and the counterparty," but is silent as to who is entitled to designate or select the custodian. Moreover, the proposed regulation fails to provide clear guidance as to what constitutes an "independent" custodian. The preamble states that the proposed regulation "does not require that the initial margin be held in an account that is independent of any affiliate of the SD or MSP or counterparty, in order to permit parties to engage in swap transactions with affiliates of their usual depositories." This language appears inconsistent with the language of the proposed rule itself which requires a custodian "that is independent of both the swap dealer or major swap participant and the counterparty ..."[18] The FHLBanks do not object to allowing an affiliate of the SD/MSP to act as custodian so long as this selection is by mutual agreement of the parties and the SD/MSP is required to offer segregation with at least one non-affiliated custodian.

B. Separate Account

The FHLBanks support the concept that the segregated account may, upon agreement of all parties, also hold "Variation Margin"/"Exposure Margin."

C. Selection of Independent Custodian

The FHLBanks would expect the selection of the independent custodian to be by mutual agreement of the counterparties. However, the FHLBanks believe that the end-user counterparty electing to have its initial margin segregated should have the right to designate the custodian if the parties are unable to agree on a custodian. Otherwise, this important statutory right could be effectively vitiated by an SD/MSP selecting a custodian that charges inordinately high fees, imposes commercially unreasonable custodial terms, or is not financially sound. The FHLBanks do not discount the importance to both counterparties parties of selecting qualified custodians. In this regard, the FHLBanks also believe the final regulations should offer protection to all counterparties by specifying the minimum requirements for custodians. These can include minimum financial requirements pertaining to size, capital adequacy, etc. If it is

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[18] Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 75 Fed. Reg. 75,432, 75,434 *as compared to* 75,438 (Dec. 3, 2010) (to be codified at 17 C.F.R. pts. 23 and 190). It is not clear what is intended by the preamble language. It could mean that a swap entered into between end-user A and SD X could designate custodian C, unrelated to either of them, as their independent custodian, even though end-user A or SD X also enter into swaps with SD Y, which is an affiliate of custodian C. This should be clarified in the final rule.

necessary for the CFTC to establish qualifications and license parties desiring to act as custodians for this purpose, the FHLBanks would find that acceptable. Hopefully, such additional steps by the CFTC will not be necessary.

V. Form of Custodian Agreement

A. Tri-Party Agreement

The proposed regulation seems to require that segregated margin be held pursuant to a tri-party agreement signed by both parties to the swap and by the custodian. The FHLBanks agree that this is the appropriate form of agreement for the statutory right to have initial margin held by an independent custodian.[19] Except for a particular requirement pertaining to the "[t]urnover of control of such margin" (discussed below), the proposed regulations are silent as to the terms of such agreement. The FHLBanks believe that the terms of the tri-party agreement will likely be critical to the decision of a counterparty to exercise or forego its right to have margin segregated. As indicated in the discussion of the background to enactment of Section 724(c) (above), there are presently no standardized documents for tri-party agreements that have industry-wide acceptance. In the absence of such standardized documents, the FHLBanks believe the proposed regulation should be modified to establish a standard of commercial reasonableness for such agreements.[20] This would preclude an SD or MSP from offering segregation on terms that are designed to discourage counterparties from exercising their statutory right. In addition, the regulations should require SDs and MSPs, upon request, to provide counterparties with a commercially reasonable tri-party agreement at the beginning of a swap transaction.

We believe it is important to establish a "commercial reasonableness" standard for tri-party agreements in order to adequately protect the interests of end users. It is clear that there are

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[19] In its pre-proposal comment letter to the CFTC, ISDA suggested that a bilateral custodial approach, which would involve an agreement between the SD and the custodian, should also be acceptable provided that the SD makes both the tri-party and bilateral approach available. *See* ISDA letter dated October 8, 2010, *available at* http://www.isda.org/speeches/pdf/ISDA-Comment-IA-Seg.pdf. The FHLBanks strongly prefer the tri-party approach, which will give the owner of the collateral direct privity of contract with the custodian, and believe that the SD/MSP should always be required to offer a tri-party agreement. If the final regulation also allows the SD/MSP to offer segregation pursuant to a bilateral agreement between the SD/MSP and custodian, the final regulation should, at a minimum, require the bilateral agreement to meet a standard of commercial reasonableness. Otherwise, the end-user's choice between a bilateral agreement and a tri-party agreement may not be meaningful. The FHLBanks believe that Sec. 724(c) of Dodd-Frank should enable them to have initial margin segregated pursuant to a tri-party agreement with commercially reasonable terms.

[20] A "commercial reasonableness" standard is not foreign to the OTC derivatives market. *See e.g.*, 2002 ISDA Master Agreement Section 14 definition of "Close-out Amount" requiring the party determining the termination payment to "use commercially reasonable procedures in order to produce a commercially reasonable result" and allowing such party to take into account gains and losses incurred in connection with terminating, liquidating or re-establishing a hedging transaction "when it is commercially reasonable to do so."

conflicting interests at work here. The SDs/MSPs have both economic and legal incentives to continue to insist on holding initial margin directly. The right of SDs to rehypothecate margin has clear economic value and the unfettered right of the SD/MSP to control the margin is desirable should the posting party default on its obligations.[21] At the same time, because the sole purpose of posting initial margin is to provide additional protection to the SD/MSP against a possible default by the end-user counterparty (and not to otherwise benefit or protect the SD/MSP), the end-user has compelling reasons not to want such margin to be exposed to loss if the SD becomes insolvent or otherwise defaults. In addition, the end-user counterparty has every reason to expect such margin to be immediately returned (as is contemplated by the CSA) when an ISDA Master Agreement is terminated on account of insolvency or other default of the SD.[22] Notwithstanding the concerns and efforts of end-user counterparties in respect of this issue, progress in resolving this matter has been slow. As stated above, as of December 31, 2009, only nine percent of the initial margin held by the major SDs was segregated with third parties.[23]

Congress has now stepped in and created a statutory right for every counterparty of a SD/MSP "to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty."[24] The FHLBanks do not believe that this statutory right of end-user counterparties under Dodd-Frank was meant to merely provide end-users the opportunity to negotiate with SDs for the segregation of initial margin. End-users have had the opportunity to negotiate this matter since long before Dodd-Frank was enacted. Section 724(c) was enacted in response to the difficulty end-user counterparties have encountered in achieving protection of the initial margin posted to SDs; the proposed rules should address and take steps to alleviate this difficulty.

As noted above, there is currently a working group organized under the auspices of ISDA that is attempting to reach agreement on terms that would be generally acceptable to both pledgors and secured parties who elect to have margin held by a third party custodian under a tri-party agreement. Potential custodians are also involved in this effort. The FHLBanks hope that this effort will succeed and, accordingly, by the time this proposed regulation becomes effective, there should be a standard for determining whether the terms of a tri-party agreement offered by an SD or MSP are "commercially reasonable."

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[21] Substantially all initial margin posted is held by SDs. It is exceedingly rare for SDs to post initial margin to end-users. *See* ISDA Margin Survey 2010, *supra* note 7. It is not yet clear whether this will continue to be the case under the Dodd-Frank margin rules for uncleared swaps. *See* note 1, *supra*, regarding the ability of the FHLBanks to require SDs to post initial margin. As noted above, proposed rules regarding margin requirements have yet to be issued.

[22] *See* CSA ¶ 8(b).

[23] *See* note 15, *supra*.

[24] Dodd-Frank § 724(c).

The FHLBanks believe that when the proposed regulations are finalized and become effective, SDs/MSPs should be required to make available to their end-user counterparties a commercially reasonable tri-party agreement that can, if the counterparty so elects, be executed to permit the segregation of initial margin posted to the SD/MSP upon execution of new uncleared swaps.[25] The tri-party agreement should meet a standard of commercial reasonableness, and it should be available upon request to the SD/MSP at any time the end-user counterparty contemplates entering into trades with the SD/MSP. End-user counterparties should have the opportunity to review and compare the initial margin segregation proposals of various SDs/MSPs before entering into trades, as this could impact their choice of SD/MSP.[26] This is not to say that the parties should not be free to negotiate different terms than those offered by the SD/MSP, but only that an end-user counterparty should have the opportunity to have its initial margin held by a third party independent custodian under commercially reasonable terms that are known prior to the time the counterparties enter into an uncleared swap. The FHLBanks believe that this is in fact what Congress sought to achieve when it enacted Section 724(c) of Dodd-Frank.

B. "Turnover of Control"

The circumstances and conditions for the transfer of margin from the custodian to either the end-user counterparty or the SD/MSP go to the heart of the agreement between the parties. It is critical that the terms specified in the tri-party agreement be "commercially reasonable" in this regard or, to state it differently, the terms must be generally acceptable to both the counterparty posting the margin and the counterparty with a security interest in the margin. Provisions that skew the rights in favor of one counterparty or the other could effectively vitiate this important statutory right. From the perspective of the end-user counterparty, it is most important that (i) the margin be protected against inappropriate transfer to the SD or MSP when the solvency of such party is in doubt and (ii) the margin be promptly returned to the end-user counterparty upon the early termination of the ISDA Master Agreement resulting from the insolvency or other default of the SD/MSP.

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[25] Counterparties should also be permitted to agree on additional terms that would permit both initial and variation margin to be segregated with the independent custodian. As noted earlier, counterparties should also be permitted allow for posting of initial margin by both counterparties simultaneously. *See* Note 1, *supra*.

[26] This is consistent with the way the OTC markets have operated. Parties generally, but not always, negotiate their ISDA Master Agreement, including the CSA which sets forth the margin requirements, with their swap counterparty before entering into a trade with an SD. The credit support terms, including both the amount of margin and how margin will be held, are often the central focus of negotiations between counterparties. This is also consistent with the manner in which trades have been documented when they are entered into before a full ISDA Master Agreement has been negotiated and executed. In these cases, parties typically employ a "long-form confirmation" which basically incorporates the printed ISDA Master Agreement and certain credit support terms. The parties commit to negotiate a full ISDA Master Agreement within a reasonable period, but the long-form confirmation acts as a back-up if that process does not succeed, for whatever reason. Parties generally have the opportunity to review the long-form confirmation in advance of any trading.

The FHLBanks believe that there should be a "reasonable legal basis" for any statement of a counterparty asserting a contractual right to exclusive control of collateral held by a custodian. This would, at a minimum, require counterparties to consult with counsel before demanding a turnover of control. However, the FHLBanks do not believe it is appropriate to require the statement to be made under oath or penalty of perjury.

VI. Investment of Segregated Collateral

A. Eligible Investments

Although the amount of initial margin that the FHLBanks may be required to post to SDs/MSPs in uncleared trades is not presently known, it could amount to hundreds of millions of dollars.[27] Accordingly, the FHLBanks have a very strong interest in how these funds will be invested.

The preamble to the proposed regulations states that regulations "provide that the SD or MSP and the counterparty may enter into any commercial arrangement, in writing, regarding the investment of segregated initial margin and the related allocation of gains and losses resulting from such investment."[28] The FHLBanks fully agree with this. However, the proposed regulations actually provide for something that is entirely different from and inconsistent with what is stated in the preamble. The proposed regulations require that initial margin segregated pursuant to the election provided by Sec. 724(c) of Dodd-Frank "may only be invested consistent with §1.25 of this Chapter."[29] This requirement is unnecessarily restrictive and inconsistent with both present market practice and the language of Dodd-Frank. The §1.25 regulations govern certain margin held by futures commission merchants ("FCMs") in connection with margin provided to secure regulated futures transactions. There is nothing in Dodd-Frank that says that margin held by a third-party custodian to secure swaps that are not cleared must be subject to the same or even similar requirements. Indeed, an examination of the statutory provisions relating to the investment of margin for cleared swaps, as compared to those provisions applicable to uncleared swaps, clearly supports the conclusion that different investment requirements were contemplated.

With respect to margin for cleared swaps, Sec. 724(a) of Dodd-Frank specifies that investments are permitted in "obligations of the United States, in general obligations of any State or of any political subdivision of a State, and in obligations fully guaranteed as to principal and interest by the United States, or in any other investment that the Commission may by rule or regulation

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[27] *See* Note 2, supra
[28] 75 Fed. Reg. 75,734, *supra* note 18, at 75,434.
[29] 75 Fed. Reg. 75,734, *supra* note 18, at 75,438.

prescribe, and such investments shall be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe."

With respect to margin for uncleared swaps that is segregated with an independent custodian, Dodd-Frank merely states that the requirements for segregated margin "shall ... (ii) not preclude any commercial arrangement regarding—(I) the investment of segregated funds or other property that may only be invested in such investments as the Commission my permit by rule or regulation; and (II) the related allocation of gains and losses resulting from any investment of the segregated funds or other property."[30]

Congress appropriately did not seek to limit how margin for uncleared swaps would be invested because it was assumed that both the end-user counterparty and the SD/MSP would necessarily be involved in the decision as to how such funds would be invested. The rationale articulated for the much more restrictive investment provisions of §1.25 is that only the FCM, and not the cleared swap counterparty (*i.e.*, the FCM's customer), is making the investment decisions with respect to the funds posted with the FCM as margin for cleared swaps. The limitations on investing margin posted for uncleared swaps that is held by third-party custodians are clearly not consistent with what Dodd-Frank contemplates or, for that matter, with existing market practice. In both cases, it is assumed that the counterparties will agree upon how margined funds will be invested and how gains/losses will be allocated. At most, it seems appropriate for the proposed regulations to be revised to require that the investments agreed upon by the counterparties shall be capable of being readily valued on a daily basis with reference to third party pricing sources, that the invested assets remain sufficiently liquid such that they can be liquidated within a reasonable time, and that the counterparties agree upon appropriate "haircuts" for investments that are subject to significant price volatility. The counterparties should be free to agree upon investment in assets having less liquidity provided that the amounts of initial margin and haircuts are sufficient to satisfy the credit concerns of the secured party.

B. Allocation of Gain and Loss on Investment of Segregated Funds

Under the CSA, the counterparty posting collateral is generally entitled to the benefit of earnings on posted securities and to some stated interest amount (generally tied to the Federal Funds rate) on cash collateral. The payment of interest on cash collateral is consistent with the right of the secured party to use the cash in its business pursuant to rehypothecation rights. Assuming that an end-user counterparty elects to have initial margin posted to an SD/MSP segregated with an independent custodian, such funds will not be available to the SD/MSP and it cannot, therefore, be expected to pay interest on such funds. However, the end-user counterparty posting the collateral should be entitled to whatever interest is earned on the investment of the initial margin.

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[30] Dodd-Frank § 724(c).

Thus, while the FHLBanks agree that the allocation of gains and losses resulting from such investment should be subject to the agreement of the counterparties, they do not believe it would be commercially reasonable for the SD/MSP to insist on allocation of gains from such investments in exchange for agreeing to segregate.

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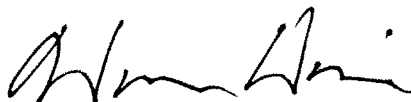
We appreciate the opportunity to comment. Please contact Warren Davis at 202.383.0133 or Warren.Davis@sutherland.com with any questions you may have.

Respectfully submitted,



Warren Davis
Of Counsel

cc: FHLBank Presidents
FHLBank General Counsel