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June 3, 2011

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

Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant" (RIN 3235-AK 65)
Proposed Rule on Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties (RIN 3038-AD25)
Proposed Rules on the Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers (RIN 3038-AC96)
Proposed Rules on the Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants (RIN 3038-AC96)
Core Principles and other Requirements for Swap Execution Facilities (RIN 3038-AD18)
Proposed Rules Establishing Risk Management Requirements for Derivatives Clearing Organizations (RIN 3038-AC98)

Dear Mr. Stawick:

On behalf of the Federal Home Loan Banks (the "FHLBanks"), we appreciate this opportunity to comment on the above-named proposed rules whose public comment periods were reopened by the Commodity Futures Trading Commission (the "CFTC"). The FHLBanks' views with respect to each of these proposed rules are set out in detail below.

I. The FHLBanks

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,

and structured as cooperatives. Each is independently chartered and managed, but the FHLBanks issue consolidated debt obligations for which each is jointly and severally liable. The FHLBanks serve the general public interest by providing liquidity to approximately 8,000 member institutions, 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 member institutions.

The FHLBanks enter into swap transactions as end-users with swap dealers to facilitate their business objectives and to mitigate financial risk, primarily interest rate risk. As of March 31, 2011, the aggregate notional amount of over-the-counter interest rate swaps held by the FHLBanks collectively was $759.6 billion. At present, all of these swap transactions are entered into bilaterally and none of them are cleared. Certain of the FHLBanks also provide their member institutions, particularly smaller, community-based institutions, with access to the swap market by intermediating swap transactions between the member institutions and the large swap dealers, thus allowing such members to hedge interest rate risk associated with their respective businesses.

II. The Swap Dealer Definition

As the FHLBanks have previously noted in their comment letter submitted to the CFTC on February 22, 2011 regarding the CFTC's proposed rules on the Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Swap Participant," the FHLBanks have concerns about the over-inclusivity of the proposed definition of "swap dealer."[1] Specifically, the FHLBanks are concerned about the potentially large number of entities, such as the FHLBanks, that are not thought of as "dealers" in the swaps market but that could nevertheless be deemed swap dealers under the CFTC's proposed rules.

As previously noted, in addition to the swaps that the FHLBanks enter into as end-users for hedging purposes, consistent with their statutory mission,[2] certain of the FHLBanks enter into swap transactions as an intermediary between their member

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[1] *See* Letter dated February 22, 2011 regarding "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participant' (RIN 3038-AD06 and RIN 3235-AK65) (SEC File Number S7-39-10)" from Warren N. Davis, on behalf of the Federal Home Loan Banks, to David A. Stawick, Secretary of the CFTC, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27925. The FHLBanks maintain all of their positions stated in their original comment letter and offer the comments contained herein as a supplement to such positions.

[2] In describing the FHLBanks' mission to provide financial products and services to their member institutions, the Federal Home Loan Bank Act of 1932 lists "intermediary derivatives contracts" as a core mission activity of the FHLBanks. *See* 12 U.S.C. §1265.3(d).

institutions and the major swap dealers.[3] The FHLBanks' member institutions are generally smaller, community-based institutions and include commercial banks, thrifts, insurance companies and credit unions that are themselves subject to federal and/or state regulation. These institutions often enter into swaps of relatively small notional amounts and lack the ability to deal directly with the large Wall Street dealers. By intermediating these swaps, certain FHLBanks provide their member institutions with a more cost-effective way to hedge their own interest-rate and other risks.

The swaps intermediated by the FHLBanks for their member institutions are incidental to the FHLBanks' overall business activities and constitute a very small portion of such FHLBanks' overall swap activity.[4] These swaps are treated by the FHLBanks as another form of credit extension to their member institutions and, as such, the swaps are fully collateralized by the assets securing the FHLBanks' advances to such member institutions.[5] Finally, like all of the FHLBanks' transactions with their member institutions, the swaps between the FHLBanks and their member institutions are subject to extensive regulation, including Section 7(j) of the Federal Home Loan Bank Act of 1932, which requires the FHLBanks to act fairly, impartially and without discrimination in dealing with their member institutions.

Despite the relatively small number and aggregate notional amount of swap transactions that certain FHLBanks enter into with their member institutions, the FHLBanks strongly desire to continue offering these transactions. However, if such transactions cause the FHLBanks to be subject to extensive regulation as swap dealers, it is likely that the FHLBanks will have to suspend these services. Accordingly, the FHLBanks believe that the CFTC should either liberalize the "de minimis" exception from the definition of "swap dealer" or develop a more limited regulatory regime that allows entities like the FHLBanks to offer swap transactions that are incidental to their primary business.

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[3] Six of the FHLBanks currently enter into swap transactions with their member institutions in varying amounts and with varying frequency. Four of the other FHLBanks have entered into swap transactions with their member institutions in the past but have suspended these activities pending final regulations under the Dodd-Frank Act. Two of the FHLBanks do not offer swaps to their member institutions.

[4] The aggregate notional amount of swaps that the FHLBanks had entered into with their member institutions as of March 31, 2011 was less than $4 billion, compared to the FHLBanks' total aggregate notional amount of swaps outstanding of approximately $759.6 billion as of the same date.

[5] If the FHLBanks are treated as swap dealers with respect to intermediated swaps, then the many assets that they take as collateral today to secure the swap obligations of their member institutions (i.e. mortgage loans made by such institutions) would not qualify as eligible collateral for swaps between financial entities under the margin regulations proposed by the CFTC and the prudential regulators. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (April 28, 2011) and Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 (May 11, 2011). This could result in a serious impediment to risk management by the member institutions served by the FHLBanks.

A. The "De Minimis" Exception

In order to qualify for the "de minimis" exception under the CFTC's proposed rules, a market participant must have entered into no more than $100 million aggregate notional swaps for which it was the swap dealer counterparty over the previous 12 months. Additionally, the market participant must not have entered into more than 20 swaps with more than 15 counterparties as a swap dealer over the previous 12 months. In their original comment letter, the FHLBanks suggested that the *de minimis* exception be amended to apply to a swap dealer with no more than $1 billion aggregate notional swaps for which it is the swap dealer counterparty, no more than 50 swaps and no more than 25 counterparties, all over the previous 12 months. The FHLBanks also suggested completely excluding swaps that are incidental or tangential to underlying primary business relationships (*i.e.*, FHLBank advances) when determining whether an institution is a swap dealer. The FHLBanks continue to believe that such criteria are more appropriate for determining whether an entity should be exempted from regulation as a swap dealer and also offer the additional suggestion discussed below.

In a speech on May 11, 2011, CFTC Commissioner O'Malia asked market participants whether the *de minimis* test should be amended to look at a market participant's swap dealing activities as a percentage of the market participant's overall swap activities. O'Malia suggested that, similar to the predominance test for determining an entity's status as a "nonbank financial company,"[6] the *de minimis* exception might apply to all swap dealers whose swap dealing activities constitute less than 15% of their overall swap transactions. The FHLBanks support this test as consistent with Congress' intentions for the *de minimis* exception and further believe that, consistent with the current proposal, the 15% test should be measured on a rolling 12-month look-back basis. By definition, entities satisfying this test enter into the vast majority of their swap transactions as end-users. To regulate such entities as swap dealers would contradict the much more limited regulatory regime that the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the CFTC's proposed rules prescribe for end-users.

B. "Limited" Swap Dealers

If the "de minimis" test is not liberalized, those FHLBanks that continue to offer swaps to their member institutions should at least benefit from a less stringent regulatory regime. In their previous comment letter, the FHLBanks argued that institutions whose swap dealing activities are incidental to other business activities should be able to register with the CFTC in a limited capacity and that the CFTC's proposed rules for swap dealers should only apply to such institutions' swap dealing activities. Additionally, the

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[6] *See* §102(a)(6) of the Dodd-Frank Act, which applies an 85% standard for gross revenue from financial activity to determine if a company is predominantly engaged in financial activities, and ultimately, a nonbank financial company.

FHLBanks argued that "limited" swap dealers who are regulated by a prudential regulator should only have to comply with the CFTC's "external" (*e.g.*, reporting and disclosure) requirements for swap dealers. Under such a regime, the customers of limited swap dealers would receive the same protections that they would receive if they entered into swaps with a traditional swap dealer, but the limited swap dealer would not have to comply with duplicative internal requirements. The FHLBanks maintain the foregoing positions as an acceptable alternative to a liberalized swap dealer definition.

Additionally, as noted in their previous comment letter, the FHLBanks believe that just as swap dealers and major swap participants will determine themselves whether they have to register as such, "limited" swap dealers should themselves determine whether they may register with the CFTC in a limited capacity. Under the proposed rules, limited swap dealers would be required to apply to the CFTC for a "limited" designation and would have to comply with all of the requirements imposed upon swap dealers while the CFTC's determination is pending. The FHLBanks believe that such a procedure is unnecessarily costly and that the CFTC's final rules should instead adopt the procedure alluded to in the preamble to the proposed rules whereby the limited swap dealer designation would "apply on a provisional basis starting at the time that the entity makes an application for limited purpose designation."[7]

The FHLBanks would welcome the opportunity to answer any questions that the CFTC may have regarding the swaps that certain FHLBanks offer to their member institutions, the importance of such transactions to the member institutions and the regulations to which such transactions are already subject.

III. Proposed Rule on Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties

As noted above, except to the extent that some FHLBanks intermediate swaps for their member institutions as part of their federally mandated mission,[8] each FHLBank is an end-user of over-the-counter derivatives in that they do not act as swap dealers with respect to their swap transactions. However, the proposed rule requirements on swap dealers and major swap participants could nevertheless adversely impact end-users such as the FHLBanks in a number of ways.

A. Know Your Counterparty, Proposed Rule § 23.402(c)

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[7] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant." "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174 at 80183.

[8] In describing the FHLBanks' mission to provide financial products and services to their member institutions, the Federal Home Loan Bank Act of 1932 lists "intermediary derivatives contracts" as a core mission activity. *See* 12 U.S.C. §1265.3(d).

The FHLBanks are generally supportive of the proposed rule requirement that swap dealers and major swap participants use "reasonable due diligence to know and retain a record of the essential facts concerning each counterparty." However, the requirements to obtain information required to (i) "effectively service the counterparty," (ii) "implement any special instructions from the counterparty" and (iii) "evaluate the previous swaps experience, financial wherewithal and flexibility, trading objectives and purposes of the counterparty" go far beyond current market practice. Further, the proposed rule does not provide any concrete, standardized information which swap dealers and major swap participants must obtain. In a prior comment letter to the proposed rule, the FHLBanks requested that the CFTC actively promote and sponsor the development of standardized disclosure and diligence materials to be distributed by swap dealers and major swap participants to their end-user counterparties in connection with standard swaps.[9]

The FHLBanks are particularly concerned that even with the implementation of standardized documentation, the vague nature of the "know your counterparty" proposed rule as currently drafted would create situations in which compliance may only be determined through hindsight judgment based on facts and interpretations not reasonably foreseeable prior to entry into a derivatives transaction. The potential for hindsight judgment would apply not only with respect to CFTC regulatory enforcement, but also with respect to potential private rights of action under Section 22(a) of the Commodity Exchange Act. The resulting uncertainty in the derivatives markets would likely significantly increase transaction costs (which would invariably be passed along to end-users) and may also create a decrease in the willingness of swap dealers and major swap participants to enter into certain derivatives transactions. If the derivatives markets are unduly constrained on account of increased legal risk, the intended benefits of the external business conduct rules will not be realized. Instead, end-users may see liquidity diminished and their ability to engage in essential hedging transactions reduced. This outcome is directly opposed to Dodd-Frank Act's public policy goals of reducing systemic risk in the derivatives markets and promoting sound risk management. The final regulations should strike a more appropriate balance between ensuring appropriate market conduct by swap dealers and preserving a robust market for all market participants.

B. Recommendations, Proposed Rule § 23.434

In the course of serving the needs of their member institutions, the FHLBanks may distribute to their members certain general materials about their services which

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[9] *See* Letter dated February 22, 2011 regarding "Proposed Rule on Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties (RIN 3038-AD25)" from Warren N. Davis, on behalf of the Federal Home Loan Banks, to David A. Stawick, Secretary of the CFTC, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27923 ("FHLBank External Business Conduct Comment Letter"). The FHLBanks maintain all of the positions stated in their original comment letter and offer the comments contained herein as a supplement to such positions.

describe the types of swaps that the FHLBanks make available to their members. The FHLBanks believe that, if they are ultimately determined to be swap dealers or limited swap dealers, these general materials should qualify as information that is "general transaction, financial or market information" and therefore be excluded from the institutional suitability requirements as contemplated by proposed § 23.434(c)(2)(i). In a prior comment letter, the FHLBanks requested that the CFTC clarify this proposed rule such that the distribution of general materials indicating the types of swaps made available to customers, as opposed to the recommendation of specific swaps to a customer based on an individual customer's particular circumstances and needs, does not trigger the institutional suitability requirements of proposed §23.434.[10] However, the FHLBanks cannot be certain that such general materials would be excluded under §23.434(c)(2)(i) until the CFTC finalizes the proposed rule.

> Under the proposed rule, a swap dealer or major swap participant must have a
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> reasonable basis to believe that any swap or trading strategy recommended to a counterparty is suitable for the counterparty based on information obtained through reasonable due diligence concerning the counterparty's financial situation and needs, objectives, tax status, ability to evaluate the recommendation, liquidity needs, risk tolerance, ability to absorb potential losses related to the recommended swap or trading strategy, and any other information known by the swap dealer or major swap participant.

Like the above "know your counterparty" due diligence requirements of proposed § 23.402(c), this proposed rule requires swap dealers and major swap participants to conduct due diligence that reaches far beyond current market practice. Further, the FHLBanks believe that the breadth and depth of the due diligence required pursuant to the proposed rule is overly prescriptive. This may be particularly problematic in circumstances where there is a relatively short time between the recommendation of a potential swap or trading strategy and the end-user's desire to execute a trade.

In the case of the FHLBanks, trading is currently conducted subject to contractual terms providing that, absent a written agreement to the contrary, the Banks are not relying on the investment advice of their swap dealer counterparties. This does not mean that swap dealers are precluded from informally responding to questions or making trading suggestions. It does mean that it is the responsibility of the FHLBanks to evaluate the information provided by the swaps dealers and to ultimately make their own financial decisions. The FHLBanks, as sophisticated end-users, are obviously comfortable with this allocation of responsibility for evaluating risks and making the final investment decisions. Thus, for the FHLBanks, the effect of the proposed rule, if it is finalized in its present form, will likely be that swap dealers will be less forthcoming with respect to providing requested information or suggestions that could be construed as "recommendations." This result would not be helpful to the FHLBanks.

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[10] *See* FHLBank External Business Conduct Comment Letter.

Additionally, the similarly vague language with respect to this due diligence requirement also lends itself to hindsight judgment in regulatory compliance and potential private rights of action based on facts and interpretations not reasonably foreseeable at the time a swap in entered or a trading strategy is implemented. The significant amount of due diligence required pursuant to the proposed rule may similarly limit the availability of certain derivatives transactions and thus adversely affect the ability of end-users to hedge or mitigate their commercial risk. Therefore, the FHLBanks believe that, as currently proposed, the rules regarding swap dealer recommendations will not further the Dodd-Frank goals of reducing systemic risk and promoting sound risk management.

C. Disclosure of Material Information, Proposed Rule § 23.431

The proposed rule requires that swap dealers and major swap participants distribute "material information concerning [a] swap in a manner reasonably designed to allow the counterparty to assess" the material risks, material characteristics and material incentives of a swap dealer or major swap participant with respect to any swap. The FHLBanks believe that the disclosure requirement related to material risks is particularly troublesome, as the determination of what risks may be material at the time a swap is entered easily lends itself to the same type of hindsight judgment based on factors and events that may occur long after a transaction is entered. Information on potential risks may be inappropriately determined to be subject to a disclosure requirement pursuant to hindsight judgment after the occurrence of an adverse event, even if such event was not reasonably foreseeable at the time a transaction is entered.

The result of this vaguely drafted disclosure may be that swap dealers and major swap participants determine to disclose any and all possible risks that may affect the value of a trade, no matter how tenuous or unlikely such event may be. Not only would this outcome significantly increase transaction costs and the time and processes required to execute a trade, but such monolithic disclosure would take away from the practical, reasonable disclosure distributed to end-users. This would effectively serve to decrease the amount of quality information available to end-users in implementing their hedging strategies. Further, this disclosure requirement, as currently written, may also decrease the willingness of swap dealers and major swap participants to enter into certain derivatives transactions, particularly long-term transactions, which would negatively affect end-users' ability to effectively hedge and would frustrate the public policy goals of the Dodd-Frank Act.

While the FHLBanks generally support the proposed rule, they are concerned that the proposed rule as currently drafted is overly broad and vague with respect to the disclosure and due diligence requirements discussed above. Specifically, the FHLBanks are concerned that the result of the proposed rule may be to create a culture of unreasonable hindsight judgment with respect to the derivatives markets. This outcome would clearly decrease certainty in, and the continuity of, the derivatives markets and may lead to certain derivatives products that are essential to effective and prudent risk

management becoming unavailable or prohibitively expensive to end-users. As such, the FHLBanks urge the CFTC to clarify the proposed rule to enhance certainty in the derivatives markets and avoid such hindsight judgment.

The FHLBanks also have concerns regarding the "one size fits all" nature of the proposed disclosure requirements. Sophisticated end-users, such as the FHLBanks, do not require these extensive disclosures every time they enter into a swap transaction. Standardized disclosures for the types of trades entered into by the FHLBanks should be sufficient unless specific requests for additional disclosure are made to swap dealer counterparties by the FHLBanks. The regulations should permit the parties to avoid redundant and unnecessary disclosures so long as the end-user retains the right to request additional disclosures.

IV. Proposed Rules – Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers ("Rule 1.71") and Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants ("Rule 23.605" and together with Rule 1.71, the "Conflicts of Interest Proposed Rules")

A. Rule 1.71

The Dodd-Frank Act requires that swap dealers and major swap participants establish "structural and institutional safeguards" to ensure that clearing personnel are separated by appropriate informational partitions from communications that might potentially bias their judgment or supervision and contravene the core principles of open access and the business conduct standards recently promulgated by the CFTC under the Dodd-Frank Act. However, Rule 1.71(d)(2)(i), as currently drafted, goes far beyond the mandate of the Dodd-Frank Act in that it completely prohibits any business and trading personnel from participating in any way with the provision of clearing services and other activities of futures commission merchants (including engaging in routine, ordinary course communications with clearing personnel) ("FCMs"). This blanket prohibition on any communication between business trading units and clearing units does not simply restrict communication that would bias judgment, it creates an absolute informational partition between business, trading and clearing affiliates that would restrict the ability of swap dealers, major swap participants and FCMs to run their day-to-day trading and clearing operations and the servicing of end-user accounts. The FHLBanks expect to enter into both cleared and uncleared derivatives transactions with various swap dealers. As discussed below, there are a number of entirely legitimate reasons why swap dealers will want to consider both types of trades entered into with the FHLBanks.

B. Rule 23.605

Although Rule 23.605 does not contain the same blanket prohibition on communication contained in Rule 1.71(d)(2)(i) with respect to swap dealers and major swap participants and their clearing member affiliates, it also goes beyond the standards set forth in the Dodd-Frank Act. As discussed above, the Dodd-Frank Act specifically

limits information partitions to communications that would bias the judgment of clearing personnel in a manner that contravenes open access and the business conduct standards. However, Rule 23.605 requires the implementation of informational partitions that restrict any communication that may "influence" clearing personnel. Clearly, many daily, routine communications among business, trading and clearing affiliates may influence clearing personnel, but not necessarily in a manner that would bias judgment or contravene open access or the business conduct standards. As such, Rule 23.605 also overly restricts the ability of swap dealers and major swap participants to run their trading and clearing operations and effectively service the needs of their end-user counterparties.

C. *The Conflicts of Interest Proposed Rules on Clearing Activities Restrict Effective Risk Management and Servicing of End-Users*

The FHLBanks believe that the Conflicts of Interest Proposed Rules, as currently drafted, would greatly restrict the ability of swap dealers, major swap participants and FCMs to properly service their end-user counterparties. For example, end-users would be required to have separate discussions with multiple personnel across their financial institutions' affiliates to receive all of the information required, such as pricing and collateral requirements, to make an informed decision regarding whether and how to execute and clear a trade. This adversely affects the ability of end-users to timely enter into trades and engage in effective hedging or mitigating of their commercial risk.

The FHLBanks are fully supportive of the Conflicts of Interest Proposed Rules to the extent that such proposed rules seek to establish an information partition between a clearing member/FCM and its affiliated swap dealer or major swap participant with respect to a customer's trading activities and positions. In particular, information regarding a customer's positions or the trading parties with whom a customer executes trades should not be communicated between a swap dealer's or major swap participant's business trading unit and its affiliated clearing member/FCM. The FHLBanks believe that the same informational barrier should apply to communications of such information by a clearing member/FCM to its affiliated swap dealer or major swap participant. That said, the Conflicts of Interest Proposed Rules should not discourage communications that would be potentially beneficial to both parties, particularly communications which would also serve to decrease systemic risk and promote prudent risk management. These communications would potentially include communications to accommodate portfolio margining between cleared and uncleared swaps or new netting arrangements that could reduce counterparty exposure between a customer and its swap counterparty, clearing member or FCM.

The Conflicts of Interest Proposed Rules could inhibit swap dealers, major swap participants and FCMs from taking prudent, well-informed and timely actions in situations with respect to the closing out of transactions, in a default scenario or otherwise. Under the Conflicts of Interest Proposed Rules, clearing affiliates may be prohibited from discussing pricing information and other risk-reduction measures with their business and trading affiliates in connection with a default or other closing out of a transaction. The FHLBanks believe that this is an inappropriate constraint to impose on

entities encountering a default or other close-out scenario. The FHLBanks further believe that this constraint is adverse to the Dodd-Frank Act's public policy goals of reducing systemic risk and promoting prudent risk management.

Finally, as currently drafted, the Conflicts of Interest Proposed Rules may be read to include credit, operations, control and support personnel. Many financial institutions are organized into various affiliates that have integrated legal, compliance, credit and operations divisions that are critical to the proper servicing of end-users' accounts, as well as for maintaining regulatory compliance. Accordingly, the FHLBanks urge the CFTC to clarify the Conflicts of Interest Proposed Rule to expressly not apply to back-office, credit and other client support operations.

The FHLBanks believe that the Conflicts of Interest Proposed Rules, as currently drafted, create informational partitions between swap dealers and major swap participants and their clearing affiliates that excessively interfere with the internal operations of these financial institutions in a manner that is adverse to the interests of end-users and their ability to timely and effectively engage in critical hedging activities. The FHLBanks further believe that these prohibitions are adverse to the public policy goals of the Dodd-Frank Act to promote prudent risk management and business conduct standards that increase the availability of quality information to inform end-users with respect to hedging decisions. Conversely, the Conflicts of Interest Proposed Rules effectively limit end-users' abilities to timely obtain essential information and execute and clear trades with their swap dealers, major swap participants and FCMs, which is directly adverse to the Dodd-Frank Act's stated purpose of enhancing the "core principles of open access and the business conduct standards." Accordingly, the FHLBanks urge the CFTC to clarify the Conflicts of Interest Proposed Rules as discussed above to allow for the streamlined, integrated servicing of end-user client accounts. Specifically, the FHLBanks believe that informational partitions should be expressly limited to trading matters, including positions and orders.

V. Core Principles for Swap Execution Facilities

The FHLBanks anticipate that, upon the implementation of the Dodd-Frank Act, and associated regulations, some portion of their cleared swaps will be executed on swap execution facilities (SEFs). Accordingly, the FHLBanks have a number of concerns regarding the prescriptive nature of the CFTC's proposed rules for SEFs, the effect that such rules could have on the costs and liquidity of the FHLBanks' swap transactions and the effect that such rules could have on the FHLBanks' use of swaps as hedging tools. With respect to the last point, the FHLBanks believe that the proposed rules for SEFs fail to account for the unique nature of swaps and the difference between even those swaps that are standardized enough for clearing and exchange-traded futures contracts. Finally, the FHLBanks have concerns about the uncertainty that still exists with respect to how swaps will function operationally, how swaps executed on SEFs will be documented and how swaps executed on SEFs will be submitted for clearing.

As noted above, the FHLBanks enter into swap transactions exclusively for hedging purposes. While a portion of the FHLBanks' swaps may be sufficiently standardized and liquid to be eligible for clearing, such swaps are nonetheless uniquely tailored to meet the FHLBanks' specific hedging needs. The FHLBanks utilize swaps to meet these hedging needs because exchange-traded futures are not sufficient for these purposes. As discussed below, by forcing swaps to trade more like futures contracts, the CFTC's proposed SEF rules could unnecessarily increase the risk associated with the FHLBanks' underlying business transactions. For a discussion of the differences between exchange-traded futures contracts and swap transactions, the FHLBanks commend the letter submitted to the CFTC by Barclays Capital on March 8, 2011 regarding the Notice of Proposed Rulemaking on the Core Principles and Other Requirements for Swap Execution Facilities (the "Barclays Letter").[11]

The FHLBanks have specific concerns about the following aspects of the proposed rules for SEFS:

A. The number of market participants who must receive request-for-quotes ("RFQs")

While the statutory provisions of the Dodd-Frank Act require SEFs to facilitate "multiple-to-multiple" interaction, the Dodd-Frank Act does not specify a minimum number of market participants to which RFQs must be submitted. In contrast, the CFTC's proposed rule requires that each RFQ be submitted to at least five market participants. The FHLBanks believe that the CFTC's rules in this regard are overly prescriptive and unnecessary to satisfy the statutory guidelines in the Dodd-Frank Act. Additionally, the FHLBanks believe that the burdens associated with transmitting five RFQs will, in some instances, actually decrease the liquidity of swap transactions.

The FHLBanks believe that market participants themselves are in the best position to determine how many quotes to request in order to best obtain favorable pricing and best execution. In some instances, five quotes will be overly burdensome, inefficient and may expose too many market participants to information about a particular swap, which in turn could increase both the transaction costs associated with such swap and the pricing of such swaps. With respect to pricing of certain swaps, including the relatively unique swaps entered into by the FHLBanks to meet their hedging needs, the FHLBanks believe that potential counterparties will likely quote larger spreads based on their concern that market knowledge of the swap will make it more difficult and costly to enter into hedging transactions. In other instances, for highly standardized and very liquid swaps, it may be necessary to obtain five quotes to ensure the best pricing for a

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[11] *See* Letter dated March 8, 2011 regarding "RIN Number 3038-AD18 – Notice of Proposed Rulemaking on the Core Principles and Other Requirements for Swap Execution Facilities" from Patrick Durkin, Managing Director, US Head of Government Business Relations for Barclays Capital to David Stawick, Secretary of the CFTC, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31319.

swap transaction. In either case, the FHLBanks believe that the statutory intent is satisfied by providing market participants with the ability to transmit RFQs to multiple other market participants, but not by actually requiring transmission of RFQs to a minimum number of market participants.

Based on the foregoing, the FHLBanks believe that the CFTC's final rules for SEFs should require that SEFs facilitate the transmission of RFQs to multiple market participants, but permit market participants themselves to determine the number of other market participants to which their swaps are transmitted.

B. Fifteen second delay for offsetting transactions

Under the CFTC's proposed rule, a broker executing offsetting swap transactions must wait for at least 15 seconds between the two transactions. The FHLBanks believe that this requirement will likely increase the bid/ask spread for such transactions and therefore negatively impact pricing. By waiting for 15 seconds before entering into an offsetting transaction, brokers will be exposed to risks associated with market fluctuations and will have to pass the costs of these risks along to its customer, thus increasing the price of the original swap transaction. As noted above, under the proposed rule regarding RFQs, in addition to normal market fluctuations that could occur during the 15-second pause, the broker will also face risks associated with the market knowing information about the original swap transaction that the broker seeks to offset.

C. Which swaps must be executed on SEFs

The CFTC's proposed rules leave the determination of which swaps must be executed on SEFs (or designated contract markets ("DCMs")) largely up to the SEFs themselves. Under the Dodd-Frank Act, swaps (other than block-trades)[12] that are subject to mandatory clearing must be executed on SEFs or DCMs if they are "made available for trading" by a SEF or DCM. The CFTC asked for comment on the meaning of the phrase "made available for trading" but it did not seek to define this phrase in its proposed rules for SEFs. Specifically, the CFTC's proposed rules require SEFs to assess,

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[12] For a discussion of the definition of "block trade" and the negative consequences that will arise if this definition is too narrow, see the comment letter submitted to the CFTC by the FHLBanks on February 7, 2011 regarding the CFTC's Proposed Rules on Swap Data Recordkeeping and Reporting Requirements; Real-Time Reporting of Swap Transaction Data; and Reporting, Recordkeeping and Daily Trading Records for Swap Dealers and Major Swap Participants. *See* Letter dated February 7, 2011 regarding "Proposed Rules – Swap Data Recordkeeping and Reporting Requirements (RIN 3038-AD19); Real-Time Reporting of Swap Transaction Data (RIN 3038-AD08): Reporting, Recordkeeping and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants (RIN 3038-AC96)" from Warren N. Davis, on behalf of the Federal Home Loan Banks, to David A. Stawick, Secretary of the CFTC, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27611. The FHLBanks agree that block trades should not be subject to mandatory execution requirements but are concerned that the CFTC's proposed definition "block trade" in its proposed rule regarding Real-Time Reporting of Swap Transaction Data will exclude many transactions that do in fact function as block trades and should therefore be regulated as such.

at least annually (and more often upon the request of the CFTC), whether it has made a swap available for trading.

The FHLBanks believe that the CFTC (as opposed to SEFs) should determine which swaps are "available to trade." Otherwise, market participants will not have the necessary certainty regarding how their swaps must be executed. Additionally, the CFTC should carefully consider which swaps should be subject to mandatory execution requirements based on the liquidity and other characteristics of a swap transaction. Some swaps may very well be suitable for clearing but not for execution on a SEF or DCM. In determining which swaps are "available to trade," the CFTC's proposed rules indicate that a SEF may consider (1) the *frequency* of transactions in the swap or similar swaps, (2) the *open interest* in the swap or similar swaps, and (3) any other factor requested by the CFTC. The FHLBanks believe that the first two points are the correct factors to be considered in determining whether a swap must be executed on a SEF, but the FHLBanks believe that it is the CFTC, and not the SEFs themselves that will have the information necessary, and will be in the best position, to consider these factors.

D. Documentation for swaps executed on SEFs

At this time, it is still somewhat unclear what documentation will be required for swaps executed on SEFs. For each swap executed on a SEF, the CFTC's proposed rules require the SEF to produce a confirmation satisfying the CFTC's requirements for such swap. The majority of trades executed on SEFs (and all trades that are required to be executed on SEFs) will then be submitted for clearing. Assuming that such swaps are in fact accepted for clearing, then the documentation between each counterparty and its respective clearing members, along with the documentation between those clearing members and the applicable derivatives clearing organization ("DCO"), will presumably govern, and the two original counterparties to the swap will no longer have a relationship with each other.

However, what happens if a confirmed trade is not accepted for clearing? If the swap was required to be cleared, must it be terminated at this point because it cannot remain as an uncleared swap between the two counterparties? Will the CFTC's final rules allow the contractual terms of the Cleared Derivatives Execution Agreement currently under development by the industry under the auspices of the Futures Industry Association be allowed to govern? The FHLBanks believe it is critical that these issues be clearly addressed in the final SEF regulations.

E. The role of clearing members in SEF execution

Unlike in the case of futures contracts that are currently executed on, and cleared through, the existing exchanges, clearing members will not necessarily be involved in the execution of swaps on SEFs. Instead, the counterparties themselves will enter into the swaps on the SEFs but then those swaps will have to be submitted for clearing either directly by the SEFs or by the counterparties' respective clearing members. The ability of a counterparty's clearing member to reject a swap that has been executed on a SEF

greatly increases the uncertainty associated with such swap because, as noted above, if such swap is subject to mandatory clearing and for whatever reason is not actually cleared, such swap will most likely have to be terminated. This uncertainty is unacceptable for market participants entering into swaps for hedging purposes.

Pursuant to rules proposed by the CFTC, SEFs and DCOs must coordinate and facilitate the prompt clearing of swaps executed on SEFs. Specifically, SEFs and DCOs must put in place the infrastructure necessary to transmit swaps directly from a SEF to a DCO. The longer the period of time between when a swap is executed and when it is ultimately accepted for clearing, the greater the risk associated with such swap. If the SEF has to "ping" the counterparties' respective clearing members before it can submit the swap for clearing, the time between execution and clearing will increase and therefore the risk associated with the swap will increase as well.

Based on the foregoing issues, the FHLBanks believe that certainty of clearing and efficient processing of cleared swaps should be integral components of the final rules for SEFs. The regulators should continue to seek input from the industry regarding best practices and technological capabilities with respect to these issues. The most important point is that there should be minimal, if any, risk that a trade executed on a SEF that is within the limits established with the FHLBanks's clearing member will not be accepted for clearing.

VI. Risk Management Requirements for Derivatives Clearing Organizations

As noted in a prior letter,[13] the FHLBanks generally support the CFTC's proposed rules establishing risk management requirements for DCOs. Some aspects of the proposed rules may adversely impact market participants that will use cleared swaps to hedge or mitigate their commercial risks, however. Aside from the issues raised in the prior letter, the FHLBanks are concerned that proposed rule 39.13(g)(8)(ii) will make cleared swap transactions unduly burdensome and costly for end-users.

Proposed rule 39.13(g)(8)(ii) stipulates that DCOs must require their clearing members to collect margin in excess of the DCO's initial margin requirements for "non-hedge" customer positions. The CFTC's rationale for proposed rule 39.13(g)(8)(ii) is that the excess margin collected will serve as a "cushion" for clearing members that will enable them to "deposit additional margin with a DCO on behalf of their customers, as necessitated by adverse market movements, without the need for the clearing member to make frequent margin calls to their customers."[14]

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[13] *See* Letter dated March 21, 2011 from Warren N. Davis, on behalf of the Federal Home Loan Banks, to David A. Stawick, Secretary of the CFTC, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=32030.

[14] *See* Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698 at 3706 (January 20, 2011).

The FHLBanks recommend against adoption of proposed rule 39.13(g)(8)(ii). The determination of whether and how much excess margin is necessary (irrespective of whether a position is classifiable as a "hedge" or "non-hedge" position), should be left to clearing members. Clearing members need flexibility to establish their own excess margin requirements that account for variations in their customers' creditworthiness. Existing DCOs' rulebooks recognize this fact.[15] It would be inappropriate for a DCO to dictate arbitrary excess margin requirements that are applicable to all customers. Such a result will inevitably lead to the imposition of excess margin requirements on highly creditworthy end-users like the FHLBanks that will reduce their liquidity and increase their risk-mitigation costs.

The FHLBanks also believe that drawing a distinction between "hedge" and "non-hedge" positions is unnecessary because DCOs, in setting initial margin requirements, will be required to take into account the risks posed by each product or portfolio, including any unique characteristics of, or risks associated with, such products or portfolios. Thus, a DCO's initial margin requirements should adequately protect the DCO from potential exposure(s), and excess margin should not be necessary. Further, the ability of customers to satisfy their obligations with respect to cleared swaps will depend on the overall financial condition of the customer, not whether a particular transaction is entered into for hedging purposes. A customer with "AAA" credit should not be penalized because it enters into a swap that does not qualify as a "hedge" position, however that may be defined.

Finally, the FHLBanks are concerned with the ambiguities contained in proposed rule 39.13(g)(8)(ii). The FHLBanks urge the CFTC, if proposed rule 39.13(g)(8)(ii) is ultimately adopted as a final rule, to provide additional guidance and/or establish criteria for DCOs with respect to setting the amount of excess margin that will be required. More importantly, the FHLBanks are concerned that the proposed rule does not define the term "non-hedge" and does not specify who will make the "non-hedge" determination. If the CFTC ultimately adopts proposed rule 39.13(g)(8)(ii), it should provide guidance to market participants with respect to (1) what constitutes a "non-hedge" position, and (2) how the determination will be made. The comments on the proposed rule that we have reviewed suggest that there is confusion as to whether the hedge/non-hedge determination is made at the DCO, clearing member, or customer level.[16] If the proposed additional margin requirement is intended to reduce the risk of

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[15] *See, e.g.*, CME Rule 8G930.E: "IRS Clearing members may call for additional performance bond at their discretion." *Available at* http://www.cmegroup.com/rulebook/CME/I/8G/. *See also* Rules of the International Derivatives Clearinghouse, LLC, Rule 614(g): "A Clearing Member may call, at any time, for [margin] above and beyond the minimums required by the Clearinghouse." *Available at* http://www.idch.com/pdfs/idch/20100901rulebook.pdf.

[16] For example, LCH.Clearnet, in commenting on the proposed rule, assumed that the "non-hedge" determination would be made at the DCO/clearing member level, whereas the Futures Industry Association assumed that the determination would be made at the customer level. *See* Letter dated March 23, 2011 from Roger Liddell, Chief Executive, LCH.Clearnet, to David A. Stawick, Secretary of the CFTC, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=32162; Letter dated

default by the customer, the FHLBanks believe that the determination must be made at the customer level. In this regard, the FHLBanks believe that a clearing member's customers should be responsible for determining and certifying, to their clearing members or DCOs, whether their swap positions are "hedge" or "non-hedge" positions. This approach would be consistent with the CFTC's proposed rules pertaining to the end-user clearing exception, which rely on end-users to certify that they qualify for the exception. Any other approach that involves the clearing member or DCO making the "non-hedge" determination will impose significant costs and disclosure obligations on end-users in connection with providing either or both of these parties with the information necessary to make the determination.

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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 /AM13

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FHLBank General Counsel

April 7, 2011 from John M. Damgard, President, the Futures Industry Association, to David A. Stawick, Secretary of the CFTC, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=42290.