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August 8, 2011

VIA ELECTRONIC SUBMISSION

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

Re: Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions (RIN 3038-AC99)

Dear Mr. Stawick:

On behalf of the Federal Home Loan Banks (the "FHLBanks"), we appreciate this opportunity to comment on the above-referenced proposed rules (the "Proposed Rules") issued by the Commodity Futures Trading Commission (the "CFTC") under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Proposed Rules address the treatment of customer assets held by a futures commission merchant ("FCM") or derivatives clearing organization ("DCO") as collateral for cleared swaps. For the reasons discussed herein, the FHLBanks continue to believe that customer collateral for cleared swaps should be completely physically segregated on a customer-by-customer basis at both the FCM and DCO levels and therefore urge the CFTC to reconsider the "Physical Segregation Model." The FHLBanks are, of course, concerned about the additional costs that could be associated with the Physical Segregation Model, but, as noted below, are hopeful that this approach can be implemented at a lower cost than was suggested in the Proposed Rules.

In the alternative, if the Physical Segregation Model is not adopted, the FHLBanks would support the CFTC's choice of the "Complete Legal Segregation Model" (formally known as, "Legal Segregation with Commingling") in the Proposed Rules because this approach would be a significant improvement over the "Futures Model" (*i.e.*, physical and legal commingling, which is the regime currently in place for customer collateral associated with futures contracts). The FHLBanks also believe that the Complete Legal Segregation Model is superior to the "Legal Segregation with

Recourse Model" because it provides material additional protection to non-defaulting cleared swaps customers without additional operational costs.

The FHLBanks previously commented on the treatment of customer collateral held by an FCM or DCO and stated their preference for complete physical segregation of such assets in their comment letter to the CFTC dated January 18, 2011, a copy of which is available at:
http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27194&SearchText=federal%20home%20loan%20banks (the "Original FHLBank Comment Letter"). Pursuant to the supplemental comments herein, the FHLBanks reaffirm their preference expressed in the Original FHLBank Comment Letter for complete physical segregation of customer collateral.

I. <u>The FHLBanks</u>

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 financial 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 financial institutions through loans referred to as "advances."

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. While it is impossible to predict the percentage of the FHLBanks' swaps that will ultimately be subject to mandatory clearing under the Dodd-Frank Act, the FHLBanks expect that over time many of the swaps they enter into for risk mitigation purposes will be 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. <u>Customer Collateral Posted to a DCO under Each Model</u>

A. The Complete Legal Segregation Model

The Proposed Rules adopt the "Complete Legal Segregation Model," which requires both FCMs and DCOs to maintain an accounting of any customer collateral that they hold for cleared swaps on a customer-by-customer basis. However, under this model, an FCM may physically commingle collateral posted by all of its customers into one account and a DCO may physically commingle all collateral posted by customers of an FCM in one "omnibus account" for the FCM. If an FCM defaults to a DCO because of a default by one of the FCM's customers, the Proposed Rules prohibit the DCO from using collateral posted by non-defaulting customers of the FCM to satisfy the obligations of the FCM's defaulting customer.[1]

As noted above, the FHLBanks believe that the Complete Legal Segregation Model is a significant improvement over the Futures Model and support the CFTC's decision to provide enhanced protection to collateral posted by cleared swaps customers. In addition, the FHLBanks support the CFTC's selection of the Complete Legal Segregation Model over the Legal Segregation with Recourse Model, which, as discussed below, does not provide the same amount of protection to customer collateral and could inhibit prompt porting. However, the FHLBanks do believe that the CFTC should seriously consider the following shortfalls of the Legal Segregation Model, which could be eliminated by adopting the Physical Segregation Model.

Fellow-Customer Risk. While the Complete Legal Segregation Model eliminates a great deal of the fellow-customer risk discussed below with respect to the Futures Model, it does not eliminate all of such risk. In the event of a customer default that causes an FCM default, the Proposed Rules direct the applicable DCO to determine how much collateral in the omnibus account was posted by the defaulting customer by reference to the FCM's daily reports regarding collateral posted by each of its customers.[2] In general, an FCM must deliver such daily reports to the applicable DCO on the business day following the date of the calculations in such report.[3] This could result in some exposure for non-defaulting customers because of the lag between the FCM's report and the day on which the default occurs.[4] However this exposure should be quite small in relation to the amount of collateral posted by non-defaulting customers.

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[1] There could in fact be some nominal exposure to collateral posted by non-defaulting customers because the allocation between collateral posted by the non-defaulting and defaulting customers would apparently be based on FCM reports provided the day prior to the FCM default and thus would not reflect movements in the value of cleared swaps on the day of default. The CFTC acknowledges this risk in footnotes 72 and 185 to the preamble to the Proposed Rules at 76 Fed. Reg. 33826 and 33848, respectively.

[2] *See* Proposed CFTC Reg. §22.14. The FHLBanks understand that LCH.Clearnet Group ("LCH") has the technology necessary to track collateral posted by individual customers on a real-time basis. While the FHLBanks are not in a position to calculate the costs associated with such technology, the FHLBanks believe that requiring DCOs to track collateral posted by customers on a real-time basis, independent from FCM calculations and reports, would increase the customer protection afforded by the Complete Legal Segregation Model. If such technology were required for all DCOs, then upon a customer default that causes an FCM default, the DCO itself would know (1) how much collateral had been posted by the defaulting customer at the time of the default and (2) how much collateral had been posted by non-defaulting customers at such time (which collateral could then be promptly ported along with the positions of such non-defaulting customers).

[3] *See* Proposed CFTC Reg. §22.11.

[4] See Note 1, supra.

Operational Risk. In addition, the daily accounting, calculations and reporting associated with the Complete Legal Segregation Model could entail unnecessary operational complications and risk (*i.e.*, "operational risk"). Such risk could arise from any discrepancies in the FCM's daily reports to the DCO or in any other mechanisms used by the FCM or DCO to account for collateral posted by customers of each FCM. Additionally, if there is a shortfall in the omnibus account under the Complete Legal Segregation Model (or any of the other models), it could be time-consuming to determine which customer is ultimately responsible for such shortfall. During any period in which such a shortfall existed, the collateral of all of the FCM's customers could potentially be at risk. In contrast, under the Physical Segregation Model, if there is a shortfall in, or some other mistake with respect to, a collateral account at a DCO (or at an FCM), the customer to which such shortfall or mistake should be attributed could be identified immediately so that prompt corrective action could be taken. Meanwhile, the collateral accounts of non-defaulting customers should not be adversely impacted in any way.

If the CFTC retains the Complete Legal Segregation Model in its final rules (as opposed to adopting the Physical Segregation Model), the FHLBanks believe that FCMs should be required to provide more specific information to DCOs than "information necessary to identify, for each Cleared Swaps Customer, the portfolio of rights and obligations arising from the Cleared Swaps that such [FCM] intermediates for such customer"[5] and that DCOs should be required to calculate and record more than "the amount of collateral required at such [DCO] for each Cleared Swaps Customer."[6] At a minimum, in their daily reports to DCOs, FCMs should be required to identify the collateral posted by an individual customer as cash or securities, and with respect to identifiable securities, FCMs should be required to specify which customer posted such securities. DCOs should be required to maintain such information. Finally, such information should also be provided to cleared swaps customers on a daily basis so that any discrepancies may be identified and promptly corrected. The foregoing additional requirements should substantially reduce operational risk associated with the Complete Legal Segregation Model.[7]

In summary, while operational risk associated with Complete Legal Segregation may be difficult to quantify, the FHLBanks believe such risk could be very disruptive in a stress scenario. Accordingly, the final regulations should seek to further address this risk.

Investment Risk. Certain of the FHLBanks currently negotiate limitations on whether and/or how their swap counterparties may invest collateral posted by the

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[5] *See* CFTC Proposed Reg. §22.11(c)(2).

[6] *See* CFTC Proposed Reg. §22.12(c)(1).

[7] In addition, as discussed in footnote 1 above, requiring DCOs to monitor customer collateral transfers on a real-time basis would reduce operational risk, as well as fellow-customer risk, associated with the Complete Legal Segregation Model.

FHLBanks. Under the Complete Legal Segregation Model (and under the Complete Legal Segregation with Recourse Model and the Futures Model), FCMs and DCOs would have to comply with CFTC requirements regarding investment of customer collateral but customers would apparently not have any input regarding such investments. In addition, as acknowledged by the CFTC in the preamble to the Proposed Rules, because customer collateral would be held in an omnibus account under the Complete Legal Segregation Model (and under the Complete Legal Segregation with Recourse Model and the Futures Model), neither an FCM nor a DCO would be able to attribute investments of such collateral (including losses thereon) to any particular customer.[8] If an investment caused the value of collateral in an omnibus account to decline, even if such collateral was "legally segregated," all customers would apparently share in the decline *pro rata*. Such would be the case even if the invested collateral belonged to certain customers and not others.[9] Alternatively, under the Physical Segregation Model, a customer could have the opportunity to control how an FCM or DCO invested such customer's collateral based on the customer's own credit analyses and risk tolerance. Moreover, such customer's collateral would not be at risk if the value of invested collateral posted by other customers declined.

Porting. In addition to subjecting the collateral of non-defaulting customers to a limited amount of fellow-customer risk, the Complete Legal Segregation Model could inhibit porting. Under the Complete Legal Segregation Model, the collateral of non-defaulting customers could potentially be tied up in the omnibus account pending resolution of issues regarding the allocation of comingled collateral among defaulting and non-defaulting customers and the satisfaction of obligations to the DCO. During this time, non-defaulting customers would presumably be required to post additional collateral to their transferee FCMs, thus unnecessarily tying up the liquid assets of such customers or, in the worst case scenario, prohibiting such customers from porting if they do not have sufficient additional assets readily available to post to a transferee FCM.[10] It is widely accepted that the ability to promptly port open positions and related collateral is one of the primary benefits of clearing. In addition, other CFTC proposed rules require DCOs to have the ability to promptly transfer (*i.e.*, "port") a customer's swaps <u>and related collateral</u> upon the request of such customer, thus recognizing the importance of such porting.[11] It would be anomalous for the CFTC to adopt rules that seek to accommodate porting of swap positions and related collateral, while at the same time adopting any model which could inhibit porting.

If the CFTC's final rules include the enhanced reporting and recordkeeping requirements discussed above in connection with "Operational Risk," or the real-time

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[8] 76 Fed. Reg. 33827.

[9] The CFTC acknowledges this risk in footnote 22 to the preamble to the Proposed Rules at 76 Fed. Reg. 33821.

[10] The CFTC acknowledges this possibility in the preamble to the Proposed Rules at 76 Fed. Reg. 33827.

[11] See Proposed CFTC Reg. §39.15(d).

monitoring requirements discussed in footnote 2 above, the potential porting-related problems associated with the Complete Legal Segregation Model could be reduced. As discussed in more detail below, adoption of the Physical Segregation Model should largely eliminate such problems.

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The Physical Segregation Model would eliminate the fellow-customer risk and investment risk associated with the Complete Legal Segregation Model, greatly reduce operational risks associated with collateral held by an FCM or DCO and should facilitate prompt porting of swap positions and related collateral. Accordingly, the FHLBanks disagree with the CFTC's statement in the preamble to the Proposed Rules that the Complete Legal Segregation Model and the Physical Segregation Model provide similar benefits[12] and urge the CFTC to give serious additional consideration to adopting the Physical Segregation Model instead of the Complete Legal Segregation Model (or the Futures Model or the Legal Segregation with Recourse Model). Alternatively, the FHLBanks recommend that the CFTC revise the Proposed Rules to incorporate some of the additional requirements discussed above.

B. The Futures Model

Under the Futures Model, DCOs do not maintain an accounting of individual customer collateral that they hold. Instead, all DCO records are maintained at the FCM level. Accordingly, if an FCM defaults to a DCO because of a default by one of the FCM's customers, the DCO does not have any means to differentiate between collateral posted by the defaulting customer of the FCM and the FCM's other, non-defaulting, customers. As a result, collateral posted by the FCM's non-defaulting customers may be used by the DCO to satisfy the obligations of the FCM's defaulting customers.

In the preamble to the Proposed Rules, the CFTC notes that it is still considering applying the Futures Model to cleared swaps. As noted in the Original FHLBank Comment Letter, market participants have a statutory right to require segregation with an independent custodian of any initial margin they post for uncleared swaps, which leads to the result that the Futures Model could expose initial margin posted for cleared swaps to more risk than initial margin posted for uncleared swaps. In addition, with respect to variation margin, market participants are able to conduct extensive and ongoing credit analysis on their counterparties that may be holding such variation margin.[13] However, while market participants would be able to conduct limited credit analyses of their FCMs, it would be impossible for a market participant to conduct the same level of credit analysis on the other customers of their FCMs. In addition, as noted in the Original FHLBank comment letter, DCOs and FCMs, and not customers, are in a superior position

[12] 76 Fed. Reg. 33828.

[13] Each of the FHLBanks currently undertakes such credit analyses for each of its swap counterparties.

to conduct credit analyses of FCMs and their cleared swaps customers.[14] Accordingly, DCOs and FCMs, and not non-defaulting customers, should bear the risk of an FCM default resulting from a default by a customer of such FCM.

As noted above, market participants may negotiate investment restrictions on collateral posted for their uncleared swaps. However, if collateral for such customers' cleared swaps is held in an omnibus account, the customers would not have any control over how such collateral is invested. Accordingly, because of the fellow-customer risk and the investment risk associated with the Futures Model, collateral posted by market participants for their cleared swaps could be exposed to greater investment risk than the collateral they post for their uncleared swaps. Such an outcome is inconsistent with the Dodd-Frank Act's objectives of enhancing the safety and soundness of the overall financial system.

In addition to the foregoing, by allowing DCOs to use collateral posted by non-defaulting customers to satisfy obligations of a defaulting customer, the Futures Model inhibits non-defaulting customers' ability to port their swaps to non-defaulting FCMs to an even greater extent than the Complete Legal Segregation Model. Under the Futures Model, such collateral could be tied up in the omnibus account indefinitely, and it would be more likely that the DCO would actually use such collateral.[15] For the reasons stated above and for the other reasons stated in the Original FHLBank Comment Letter (many of which were acknowledged by the CFTC in the preamble to the Proposed Rules), the FHLBanks urge the CFTC not to apply the Futures Model to cleared swaps.

C. The Legal Segregation with Recourse Model

In the preamble to the Proposed Rules the CFTC also notes that it is still considering a "Legal Segregation with Recourse Model," which would function like the Complete Legal Segregation Model except that upon a default by an FCM resulting from a default by one of the FCM's customers, the applicable DCO would be able to use collateral posted by non-defaulting customers of the FCM after the DCO applied its own capital and the guaranty funds of its non-defaulting FCMs. Such a model would pose the same issues discussed above with respect to the Complete Legal Segregation Model but with even greater fellow-customer risk. In addition, like the Complete Legal Segregation

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[14] Notwithstanding the FHLBanks' position that DCOs are in the best position to perform credit analysis on FCMs and cleared swaps customers, in response to a question asked by the CFTC in the preamble to the Proposed Rules at 76 Fed. Reg. 33827, the FHLBanks encourage the CFTC to make additional financial information about FCMs publicly available. Additionally, the FHLBanks request that the CFTC make such information available on as close to a "real-time" basis as possible.

[15] FCMs and DCOs frequently point out that all customer positions and related collateral were successfully ported when Lehman Brothers Inc. ("Lehman FCM") defaulted. However, it should be noted that Lehman FCM's default was not the result of a customer default. Accordingly, DCOs did not have recourse against any of the collateral in Lehman FCM's omnibus customer accounts and therefore the collateral in such accounts was not tied up. However, this most likely would not have been the case if DCOs had any recourse against such collateral.

Model and the Futures Model, the Legal Segregation with Recourse Model could inhibit porting by tying up collateral posted by non-defaulting customers until the obligations of such customers' defaulting FCM and such FCM's defaulting customer were satisfied in full. Accordingly, the FHLBanks urge the CFTC not to apply the Legal Segregation with Recourse Model to cleared swaps.

D. The Physical Segregation Model

Under the Physical Segregation Model, FCMs must maintain separate accounts for collateral posted by each of their respective customers, and DCOs must also maintain separate accounts for each of an FCM's customers. In the preamble to the Proposed Rules the CFTC states that, prior to a customer default that causes an FCM default, the Physical Segregation Model and the Complete Legal Segregation Model only differ operationally.[16] Accordingly, the only additional costs of the Physical Segregation Model as opposed to the Complete Legal Segregation Model would be operational costs. The CFTC also states in the preamble to the Proposed Rules that the operational costs of departing from the Futures Model would not be as significant as the costs associated with DCOs no longer having access to collateral posted by non-defaulting customers (so-called "risk costs").[17] Accordingly, while the FHLBanks do not have the information necessary to calculate the costs associated with the Physical Segregation Model as opposed to the Complete Legal Segregation Model, the FHLBanks find it difficult to understand why the purely operational costs associated with the Physical Segregation Model would be as much as thirty-three times the costs associated with the Complete Legal Segregation Model.[18] By contrast, as discussed above, the FHLBanks do understand the reasons why accounting and other reports required in connection with the Complete Legal Segregation Model would entail operational costs in excess of the operational costs associated with the Futures Model.

Most importantly, the FHLBanks believe that any additional costs associated with the Physical Segregation Model as opposed to the Complete Legal Segregation Model

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[16] 76 Fed. Reg. 33820.

[17] 76 Fed. Reg. 33821.

[18] 76 Fed. Reg. 33823. The FHLBanks understand that the significant additional cost estimates of the Physical Segregation Model may be driven largely by the complete physical segregation of collateral posted by each of the individual customers of certain investment managers because, in some instances, such investment managers have hundreds or even thousands of customers. In these situations, it may be appropriate and significantly less costly to treat the investment manager as the "customer" so that collateral posted by all of the investment manager's customers would be in one physically commingled account that is legally segregated on a customer-by-customer basis. Customers of the investment manager would be subject to a certain amount of fellow-customer risk, operational risk and investment risk, but such risk would be less than if their collateral were physically commingled with all customers of their investment manager's FCM. Any physically commingled "customer" account for the customers of a single investment manager would be physically separate from accounts for other larger customers of the investment manager's FCM, such as the FHLBanks. Thus, all customers of the FCM should benefit from this cost-saving approach.

must be weighed against the benefits of the Physical Segregation Model. As noted above, Physical Segregation would eliminate the fellow-customer risk and investment risk associated with all of the other models discussed above and would greatly reduce the operational risk that is associated with such models.

The Physical Segregation Model is the only model that is entirely consistent with other rules proposed by the CFTC to facilitate prompt porting of cleared swap positions and related collateral. Additionally, the Physical Segregation Model is the only model that would afford collateral posted for cleared swap counterparties with the level of protection available to collateral posted for uncleared swaps under the Dodd-Frank Act. Given the inherent differences between futures contracts and swaps (*e.g.*, average tenor and complexity),[19] the FHLBanks believe that the correct starting point for determining how to treat collateral for cleared swaps is the uncleared swaps market, and not the existing futures market.

E. The Optional Approach

In the preamble to the Proposed Rules the CFTC notes that it also considered the "Optional Approach," pursuant to which customers could select whether their collateral would be legally segregated but physically commingled (*i.e.*, held pursuant to the Complete Legal Segregation Model) or physically segregated (*i.e.*, held pursuant to the Physical Segregation Model). Under the Optional Approach, customers selecting physical segregation would presumably pay a premium for such additional protection. However, the CFTC also notes that under Section 766(h) of the United States Bankruptcy Code and part 190 of the CFTC's regulations, collateral posted by customers selecting physical segregation may still be at risk upon the default of a customer of the same FCM if the defaulting customer had selected legal segregation. Accordingly, the FHLBanks agree with the CFTC that the Optional Approach is not a viable solution to the increased costs allegedly associated with the Physical Segregation Model as opposed to the Complete Legal Segregation Model. However, if the bankruptcy issues associated with the Optional Approach could be resolved by CFTC action, the FHLBanks would strongly support a model that allowed customers to choose between physical segregation and legal segregation with physical commingling. Such an outcome would be consistent with market participants' right to choose whether the initial margin they post for their uncleared swaps should be segregated with an independent third-party custodian or held by their swap counterparties.

II. Permitted Depositories

Under the Proposed Rules, FCMs and DCOs must hold customer collateral at a bank located in the United States, a trust company located in the United States or a DCO. The FHLBanks agree that customer collateral should only be held in banks or trust companies located in the United States. However, the FHLBanks also believe that any

[19] See the Original FHLBank Comment Letter for a more detailed discussion of these differences.

collateral held by a DCO should be required to be held in the United States. Accordingly, if a DCO is not located in the United States, the FHLBanks believe that such DCO should be required to hold collateral posted by United States customers at a bank or trust company located in the United States. Otherwise, such customers would not be guaranteed the protections of United States insolvency laws with respect to their collateral.

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The FHLBanks 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
Sutherland Asbill & Brennan LLP

cc: FHLBank Presidents
FHLBank General Counsel