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January 9, 2012

VIA E-MAIL

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

Re: Notice of Proposed Rulemaking on Protection of Cleared Swap Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provision (RIN 3038-AC99)

Dear Mr. Stawick:

On behalf of the Federal Home Loan Banks (the "FHLBanks"), we are submitting this letter to supplement comments we previously submitted[1] to the Commodity Futures Trading Commission (the "CFTC") regarding its proposed rules on "Protection of Cleared Swap Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions" (the "Proposed Rules"). This letter is prompted by the CFTC's announcement that it will hold a public meeting on January 11, 2012 to consider the adoption of final rules on this topic (the "Final Rules").

The FHLBanks are concerned that adoption of the Final Rules is premature in light of the events surrounding the bankruptcy of MF Global Inc. ("MF Global"), and particularly the uncertainties surrounding the apparent diversion of customer collateral and delays in porting associated with that bankruptcy. These events are of great concern to the FHLBanks and, we assume, to other market participants, as they cast the discussion that has occurred over the past

[1] *See* Letter dated February 1, 2011 to the CFTC from the FHLBanks regarding Protection of Collateral of Counterparties to Uncleared Swaps (RIN 3038-AD28); Letter dated August 8, 2011 to the CFTC from the FHLBanks regarding Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions (RIN 3038-AC99).

year regarding customer collateral in an entirely new light. The FHLBanks had been assured by clearing members and regulators that customer collateral under the futures model is legally protected by a strict regulatory and supervisory regime and that risk of loss was basically limited to "fellow-customer" risk, a risk that was fully vetted in the various proposals advanced by the CFTC for the protection of customer collateral in cleared swap transactions. Recent events underscore the need for the CFTC to reevaluate the various proposals previously advanced for protection of customer collateral and possibly to consider new proposals that may be better suited to prevent a repetition of the events unfolding at MF Global. For example, prior to the bankruptcy of MF Global market participants generally did not assess the likelihood of customer funds being diverted impermissibly under the various models suggested by the CFTC.

Additional Issues to Consider Before Adopting the Final Rules.

The FHLBanks have two particular concerns that they believe should be addressed fully by the CFTC, with the benefit of public comment, before adoption of the Final Rules. The first relates to the critical importance of accurate recordkeeping regarding customer collateral and the second relates to the availability of enhanced protection for customer collateral held by clearing members in excess of the collateral required to be passed along to the clearinghouse.

Clearing Member Records. The "Complete Legal Segregation Model"[2] adopted by the Proposed Rules assumes that the records of a defaulting clearing member would be complete and accurate and would provide a sound legal basis for assuring the protection of collateral posted by non-defaulting customers. The inadequacy of MF Global's recordkeeping is now apparent and the Chicago Mercantile Exchange Inc.'s (the "CME") oversight of such recordkeeping has been called into question. Public statements by regulators and the trustee for MF Global, as well as the fact that more than two months have passed since the bankruptcy of MF Global without clear resolution of how customer funds were diverted or where they might have been sent, call into question whether it is reasonable to adopt a model that relies upon the accuracy of clearing member records.[3] The CME stated in its comments in response to the Proposed Rule that it "believes, based on decades of clearing experience, that it is relatively unlikely that information received from an FCM each day will be 100% accurate." Presciently, the CME went on to remark that "...in a situation where an FCM has defaulted on its obligations to one or more clearinghouses, it is entirely possible that the FCM or its parent company has been under severe financial stress for some period of time, as was the case with the failure of Lehman Brothers. In such circumstances, systems are more likely to fail...financial markets may be highly volatile

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[2] In the advance notice of proposed rulemaking on this topic, this model was referred to as the "Legal Segregation with Commingling" model or "LSOC."

[3] *See, e.g.*, Scott Anderson and Aaron Lucchetti, Inside the Hunt for MF Global Cash, THE WALL STREET JOURNAL, Nov. 11, 2011, *available at* http://online.wsj.com/article/SB10001424052970203537304577030440112366870.html. *See also* Testimony of James W. Giddens, Trustee for the Securities Investor Protection Act Liquidation of MF Global Inc., U.S. Senate Committee on Agriculture, Nutrition and Forestry (Dec. 13, 2011), *available at* http://www.ag.senate.gov/download/?id=893e6836-3774-4a13-88bb-fe17fcfa0d22.

potentially increasing the amount of activity that the stressed FCM must process and decreasing the likelihood that equally stressed back office staff will identify and resolve reporting errors." **The FHLBanks believe that each of the collateral models suggested by the CFTC in its request for comment on the Proposed Rules should be reexamined to assess the risk that inadequate recordkeeping could frustrate the objectives of the collateral model.**

Excess Collateral Required by Clearing Member. MF Global did not default to the CME, its principal clearinghouse, and the FHLBanks understand that there was never a deficiency in the amount of customer collateral controlled by the CME. Instead, problems seem to have arisen with respect to customer collateral held by MF Global in excess of the amount required by the CME. Although such "excess" collateral was entitled to the same legal protections as the collateral posted to the CME, it was apparently not subject to the same controls and supervision. In connection with their negotiation of clearing arrangements for swaps with clearing members, the FHLBanks are seeking additional protections for collateral posted to clearing members that exceed the relevant clearinghouse requirements. One approach being considered is to require that such excess collateral be held by an independent third party custodian in a manner similar to the initial margin that may be posted with respect to uncleared swaps.[4] However, based upon a 2005 CFTC interpretation of rules pertaining to collateral for futures, the FHLBanks have been advised that this approach may not be permitted under CFTC rules.[5] **The FHLBanks believe that in connection with the adoption of any rules for the protection of collateral for cleared swaps, the CFTC should consider fully the potential applicability of this interpretation to collateral for cleared swaps. Additionally, the FHLBanks believe that the CFTC should reexamine the relevance of several of the points raised by the 2005 CFTC interpretation in light of the provisions of the Dodd-Frank Act giving market participants a right to require segregation of initial margin posted for uncleared swaps.**

The foregoing are illustrative of two important issues raised by the apparent loss of customer collateral in connection with the bankruptcy of MF Global, which occurred after the comment period for the Proposed Rules closed. It could indeed prove fortunate that these issues were brought to public attention before adoption of the Final Rules. However, the FHLBanks are concerned that the opportunity to learn from the disturbing events associated with the bankruptcy of MF Global could be lost as the result of premature adoption of the Final Rules.

Complete Physical Segregation.

The FHLBanks have previously expressed their preference for the Physical Segregation Model. The events surrounding MF Global would seem to lend further support for adoption of that model. However, CFTC and market participants must take the time to reexamine that model in light of the events at MF Global and determine whether its adoption would prevent the

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[4] *See* Section 4s(l) of the Commodity Exchange Act (as amended by the Dodd-Frank Act).

[5] *See* Amendment to Financial and Segregation Interpretation No. 10, issued by the CFTC Division of Clearing and Intermediary Oversight on May 5, 2005, available at http://www.cftc.gov/files/tm/tmint-10-1.pdf.

recurrence of the loss of customer funds and related porting delays experienced by customers of MF Global. **At a minimum, prior to the adoption of the Final Rules, the FHLBanks believe that the CFTC should hold one or more roundtables to assess the lessons learned from MF Global and to consider whether the model for protection of collateral for cleared swaps should be revised to afford additional protection for customers' collateral.**

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The FHLBanks appreciate the opportunity to offer these supplemental comments. 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: The Honorable Gary Gensler, Chairman
The Honorable Jill E. Sommers, Commissioner
The Honorable Bart Chilton, Commissioner
The Honorable Scott D. O'Malia, Commissioner
The Honorable Mark P. Wetjen, Commissioner
FHLBank Presidents
FHLBank General Counsel