FHLBank ATLANTA
A FEDERAL HOME LOAN BANK

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VIA ELECTRONIC DELIVERY

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

Re: Follow-up to CFTC Roundtable held on February 29 and March 1, 2012

The Federal Home Loan Banks ("FHLBanks") appreciate the opportunity to follow-up on the comments made during the recent Commodity Futures Trading Commission ("CFTC" or the "Commission") roundtable to discuss additional protections for customer collateral. Below we address steps the Commission should consider to: (A) increase transparency regarding the financial condition and regulatory compliance of futures commission merchants ("FCMs"), (B) address "last-day risk" involving an FCM's failure to make variation margin payments to non-defaulting customers,[1] and (C) examine the feasibility of other segregation arrangements that would avoid the ratable distribution requirements of Section 766(h) of the Bankruptcy Code in the event of an FCM's insolvency.

A. Increase FCM Transparency

As was evident from the discussion at the CFTC roundtable, the adoption of the "Legal Segregation with Operational Commingling" ("LSOC") model for the segregation of cleared swaps customer collateral will significantly reduce, but not eliminate, risks to customer funds that could occur as the result of the insolvency of an FCM. Specifically, the LSOC model does not eliminate operational or malfeasance risk, investment risk or, in certain circumstances, fellow-customer risk, should an FCM become insolvent. Accordingly, there will continue to be a

[1] There appears to be "last day" fellow-customer risk where, due to a customer default and inadequate FCM resources, an FCM fails to make a variation margin payment owed to one of its non-defaulting customers due to the failure of another FCM customer to make its variation margin payment owed to the FCM. This risk follows from the fact that DCOs look to FCMs for variation margin on a net rather than gross basis. If an insolvent FCM was net flat with the clearing house at the time of its insolvency, a clearing house would not be obligated to make payments owing to the in-the-money customers of the failed FCM. In such a case there would be a shortfall in customer funds which, under Section 766(h) of the Bankruptcy Code, would be shared by all the FCM's customers. See discussion at Section B, infra.

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need for customers to monitor the performance and financial condition of their FCMs. The only way for customers to be certain that they will not suffer economic loss from clearing through a particular FCM is to avoid being a customer of that FCM when the FCM becomes insolvent.

With this in mind, the FHLBanks have sought, in their negotiation of clearing documentation with various FCMs, to require FCMs to make periodic financial disclosures and prompt disclosure of other matters reported to the CFTC (such as violation of rules applicable to cleared swaps) that could indicate that the FCM is facing material economic stress or regulatory issues. The purpose of these provisions is to allow the FHLBanks the opportunity to assess whether it would be prudent to port their trades to another FCM. Some FCMs have agreed to a number of these contractual provisions, but others have declined to agree, citing various concerns, including:

- that the periodic public disclosure of FCM financial information by the CFTC should be sufficient;
- confidentiality restrictions in CFTC rules;
- that selective disclosure of this nature to some, but not all, customers could give rise to legal risk; and
- that it is not operationally feasible to prepare ad hoc reports for particular customers.

The FHLBanks believe that additional transparency regarding the FCM's financial condition and regulatory compliance is in the public interest. The clearing model is based on the understanding that the customer looks to the clearing house, not its FCM, as its counterparty to satisfy its trades and that a customer should generally be free to move trades from its current FCM to another FCM if it is concerned about the performance or financial viability of its current FCM. Indeed, FCMs frequently cite this right as the major protection afforded to clearing customers. Of course, upon failure of an FCM, the customers look to the CFTC and the clearing house to direct the transfer of the accounts of non-defaulting customers to new, solvent FCMs.

It is not unusual for financial regulators to obtain information from financial institutions that is not made public. There is good reason for this. In the case of banks, for example, which borrow funds on a short term basis from depositors and lend those funds, on a longer term basis, to individuals and businesses, premature disclosure of financial or other information that calls into question the viability of the bank can lead to a run on the bank. No bank can immediately honor the demand of all its depositors for the withdrawal of their funds. However, this is not the case with respect to FCMs. Other than fees and commissions, FCMs are precluded from using customer collateral for their own purposes and from using the collateral of one customer to meet the obligations of another customer.[2] Although FCMs may invest customer funds and retain, as their own, any benefits accruing therefrom, such investments may only be made in accordance with the CFTC's stringent investment regulations and, further, an FCM must maintain the value

[2] *See* CFTC Rule 1.20, 17 C.F.R. § 1.20.

of customer funds in its customer segregated accounts at all times.[3] Thus, at any point in time, it should be feasible to port all of an FCM's customer positions and associated collateral to a new FCM at any time. Therefore, customers who port their trades from one FCM to another FCM, based on concerns regarding the financial viability of their FCM, do not pose a "run on the bank" problem or any other systemic risk.

Increased transparency is probably the easiest and most cost-effective way to increase the protection of customer funds. The FHLBanks believe that the information contained in the financial data reports that FCMs are required to deliver to the CFTC and their designated self-regulatory organizations ("DSROs"), in accordance with CFTC Rule 1.10, should be collected and disseminated to the public on expedited timeframes. Such expedited timeframes would appear to address each of the concerns raised by FCMs in our individual negotiations. Specifically, expedited timeframes would address the argument that FCMs should not be required to make disclosures beyond those currently required. Also, because we are talking about aggregate FCM data, not the delivery of information regarding individual FCM customers, there should not be material confidentiality concerns. Finally, such a regulatory policy would address concerns about the operational difficulties of producing ad hoc reports as well as concerns about selective disclosure to some customers and not others.

With respect to the portions of the CFTC Rule 1.10 FCM financial data reports that pertain to FCMs' "Adjusted Net Capital," "Net Capital Requirement," and "Excess Net Capital," such information should, upon submission to the Commission, be made immediately available through posting on the Commission's website. At the least, an FCM's "Adjusted Net Capital," "Net Capital Requirement," and "Excess Net Capital" should be reported to the Commission within 5 business days following the close of a month.[4] To facilitate this, the FHLBanks believe that this information should be submitted to the Commission in a form that would permit immediate posting on the Commission's website.

In addition, at the roundtable the Futures Industry Association ("FIA") discussed a number of initial recommendations for customer fund protection. These included a recommendation that FCMs provide to the Commission and their DSRO a daily computation of segregation requirements in accordance with Commission Rule 1.32 and twice monthly a report on investment of customer funds in accordance with Commission Rule 1.25. The FHLBanks believe that such reports should be made publicly available concurrently with their submission to the Commission via publication on the Commission's website. We believe daily reports of

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[3] *See* CFTC Rule 1.25, 17 C.F.R. § 1.25.

[4] Currently, FCMs are required to report such information to the CFTC within 17 business days following the close of a month and the CFTC, in turn, posts such information on its website 12 business days following receipt thereof. Thus, the public dissemination of FCM financial data on the CFTC's website typically takes place 29 business days following the close of a month. For example, the FCM financial data report for February 2012 will likely be published on Tuesday, April 10, 2012, which is 12 business days after March 23, 2012, the deadline for FCMs to file their February 2012 financial data reports with the CFTC and DSROs. The FHLBanks believe that such an extended delay is unacceptable.

compliance with segregation requirements would be considerably more meaningful to customers than the current aggregate FCM financial data reports that are disseminated on a monthly basis. For example, FCMs may add funds (commonly referred to as the FCM's "residual interest") to customer segregated accounts at the end of the month in order to convey financial strength, and then promptly withdraw those funds during the first days of the following month. Daily reporting of these amounts would illuminate any such practice.[5]

The FHLBanks maintain clearing relationships with FCMs premised on a representation by FCMs that they are in compliance with all laws and regulations applicable to cleared swaps. In accordance with Commission Rule 1.12(h), FCMs are required to immediately notify the Commission and its designated self-regulatory organization of any failure to comply with regulatory segregation requirements. (See FIA report entitled "Protection of Customer Funds Frequently Asked Questions, Q #8) The FHLBanks recommend that any such notice of failure to comply with segregation requirements promptly be made publicly available on the Commission's website. Again, the fact that such notice may cause certain customers to port their trades to a new FCM is entirely consistent with the model for central clearing and should not pose any systemic risk.[6] The fact that central clearing of certain swaps will no longer be optional for many customers, but will be mandated by federal statute, makes it even more important for the Commission to take all reasonable steps, within its authority, to provide maximum protection for cleared swap customers.

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[5] The FHLBanks recognize that, as of December 2011, the Commission's aggregate FCM financial data reports reflect FCMs' "Excess/Deficient Funds in Seg" in a new column (g). The FHLBanks suggest that excess funds in segregation (column (g)) be further described as an FCM's "residual interest" in order to distinguish between such amounts and funds that customers may leave in their FCM accounts over and above the margin required by their FCMs. The FHLBanks further recognize that data included in a new column (f), titled "Customers' Seg Required 4d(a)(2)," includes (a) customer margin required by the applicable clearing house, (b) any additional margin required by the FCM, and (c) any excess funds over and above (a) and (b) that customers leave in their FCM accounts. We believe it would be useful to break out in a separate column the amount of customer margin required by the FCM over and above the margin required by the clearing house. This would provide customers with useful information regarding how the FCM is managing customer risk. For example, if most FCMs are requiring, on average, 15% additional margin and one's FCM is not requiring any additional margin, one would be inclined to discuss with his/her FCM whether the FCM is adequately managing customer risk. It may also be useful to break out, in a separate column, the excess funds, over and above (a) and (b) above, that customers are leaving in their FCM accounts. Again, this would be an indicator of the confidence that customers have in the financial position of an FCM. Also, any rapid decrease in the amount of such excess funds could indicate customer concern regarding the financial viability of the FCM.

[6] To the extent that customers respond to an FCM's notice of failure to comply with customer segregation requirements by porting their trades to another FCM, the burden on the Commission of dealing with a later default by the FCM that filed the notice should be reduced, not heightened. Admittedly, the transfer of positions is likely to have an adverse impact on the profitability of the FCM losing the business. However, as noted in the commentary accompanying the adoption of LSOC: "The Commission agrees with the comment that 'swap margin is not meant to enhance the swap dealers' bottom line, but to protect the system against counterparty failure,' ..." Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6,336, 6,344 (Feb. 7, 2012) (to be codified at 17 C.F.R. pts. 22 and 190).

Finally, the FHLBanks support the Commission's recent adoption of final rules to establish clearing member risk management requirements.[7] Specifically, the FHLBanks agree that FCMs that are clearing members should conduct stress tests with respect to both their proprietary and customer accounts, and that such stress tests should take place regularly. In addition, the FHLBanks urge the Commission to require that the results of clearing member stress tests be publicly disseminated. Public disclosure of such results would promote increased transparency and, thereby, increase the safety of customer collateral.

In summary, the FHLBanks strongly believe that the recommended transparency measures discussed above represent cost-effective regulatory measures that would greatly assist cleared swaps customers in avoiding the risks associated with a default by their clearing FCMs. Such measures would encourage customers to establish clearing arrangements with multiple FCMs and should encourage FCMs to maintain strong balance sheets and significant residual financial interests in customer segregated accounts. With the adoption of LSOC, the Commission has gone a long way to reduce risks to customer funds. However, recent events remind us that all risks have not been addressed. Thus, customers will derive great benefit from greater transparency concerning the financial condition and regulatory compliance of their FCMs.

B. Dealing with "Last-Day Risk"

The FHLBanks understand that there is at least one scenario where customers may remain subject to "fellow-customer risk." This could arise where, due to a customer default and inadequate FCM resources, an FCM fails to make a variation margin payment owed to one of its non-defaulting customers due to the failure of another FCM customer to make its variation margin payment owed to the FCM.

This risk seems to follow from the fact that DCOs look to FCMs for variation margin on a net rather than gross basis. If the FCM is net flat to the clearing house with respect to variation margin, any payments to the FCM's in-the-money customers would be made with funds provided to the FCM from its out-of-the-money customers (or its own resources). In this situation, we understand that DCOs would not be responsible for the variation payment owed to the non-defaulting customer prior to the FCM default. This does not seem like a sensible result to us and seems inconsistent with the basic notion that the customer looks to the DCO, not the FCM, to honor its trade. If the in-the-money non-defaulting customer cleared its trade through another FCM, the DCO would be responsible for making the variation payment to that customer's FCM (who would, in turn, pass the payment along to the non-defaulting customer). Why should the result be different if the non-defaulting customer happens to be a customer of a defaulting FCM? It seems to us that the DCO should continue to be responsible for variation payments owed to non-defaulting customers. We understood that the collection of variation

[7] *See* CFTC Rules 1.73(a)(4) and 23.609(a)(4), which were adopted on March 20, 2012 and will become effective on October 1, 2012. Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management (pending publication in the Federal Register).

margin from FCMs on a net basis is done for reasons of economy – to minimize offsetting payment obligations. This seems entirely reasonable, but should not result in the "collateral damage" outlined above. We believe that the Commission should consider a rule that would require the DCO to fulfill the margin obligations to non-defaulting customers of a bankrupt FCM.[8] This would be consistent with LSOC and the requirement that DCOs collect initial margin on a gross rather than net basis.

C. **Consideration of Additional Arrangements to Enhance Protection of Customer Funds**

The FHLBanks encourage the Commission to continue to explore arrangements that would provide additional protection to customer funds, particularly arrangements that would avoid the ratable distribution requirements of Section 766(h) of the Bankruptcy Code in the event of an FCM's insolvency. We estimate that the FHLBanks will be posting billions of dollars in initial margin for cleared swaps.[9]

As a result of the Lehman Brothers bankruptcy, a number of FHLBanks (each a non-defaulting party) incurred losses with respect to excess variation margin posted to Lehman Brothers for their OTC swaps. Since the banks will now be posting large amounts of initial margin in addition to variation margin, we believe it is critical that the FHLBanks, and other market participants who meet their swap obligations, be assured that their posted margin will not be at risk.

Given the very large sums at risk, the FHLBanks would certainly consider arrangements that provide greater protection for their margin funds even if those arrangements involve some additional cost. In this regard, the FHLBanks believe the proposal presented at the roundtable by CIEBA and the CME clearly merits additional consideration by the Commission. The FHLBanks understand that LCH may also submit a proposal intended to achieve similar protections and would endorse careful consideration by the Commission of any such proposal as well.

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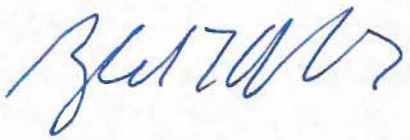
[8] Perhaps the DCO should have a call on the FCM's initial margin in the FCM's house account to cover any liability incurred by the DCO in this situation.

[9] The commentary to the LSOC Rules noted that, based on estimates by the CME and ISDA, "the expected scale of the cleared swaps market will require hundreds of billions of dollars of collateral to adequately secure swaps positions under any segregation model." 77 Fed. Reg. at 6369.

We appreciate the opportunity to comment. Please contact me at (404) 888-5353 (roshields@fhlbatl.com) or contact Warren Davis, our outside counsel, at (202) 383-0133 (warren.davis@sutherland.com) with any questions you may have.

Respectfully submitted,



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cc: FHLBank Presidents
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