November 26, 2010

Ms. Elizabeth M. Murphy,
Secretary,
Securities and Exchange Commission,
100 F St., NE.,
Washington, DC 20549– 1090.

E-mail: *rule-comments@sec.gov*

Re: File Number S7–27–10; 17 CFR Part 242 Release No. 34–63107; RIN 3235–AK74; *Federal Register* / Vol. 75, No. 206 / Tuesday, October 26, 2010 / Proposed Rules / Pages 65882-65932

Dear Ms. Murphy:

We are sending this letter on behalf of the Independent Community Bankers of America (ICBA) and our 5,000 community bank members[1] in response to the Federal Register notice requesting public comments on the Commission's proposed new Regulation MC under the Exchange Act relating to conflicts of interest with respect to clearing security-based swaps. We appreciate the opportunity to comment and our views are expressed below.

Background – In accordance with Section 765 ("Section 765") of Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), the Securities and Exchange Commission ("SEC" or "Commission") is proposing Regulation MC under the Securities Exchange Act of 1934 ("Exchange Act") for clearing agencies that clear security-based swaps ("security-based swap clearing agencies") and for security-based swap execution facilities ("SB SEFs") and national securities exchanges that post or make available for trading security-based swaps ("SBS exchanges").

[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types in the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA members represent more than 20,000 locations nationwide and employ nearly 300,000 Americans. ICBA members hold $1 trillion in assets, $800 billion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community.

Regulation MC is designed to mitigate potential conflicts of interest that could exist at these entities. Specifically, the Commission seeks to mitigate the potential conflicts of interest through conditions and structures relating to ownership, voting, and governance of security-based swap clearing agencies, SB SEFs, and SBS exchanges.

According to the proposed rule, the Dodd-Frank Act is intended to close loopholes in the existing regulatory structure and to provide the Commission and the CFTC with effective regulatory tools to oversee the OTC swaps market, which has grown exponentially in recent years and is capable of affecting significant sectors of the U.S. economy.

The Dodd-Frank Act amends the Exchange Act to require, among other things, the following: (1) Transactions in security-based swaps must be cleared through a clearing agency if they are of a type that the Commission determines must be cleared, unless an exemption from mandatory clearing applies; (2) transactions in security-based swaps must be reported to a registered security-based swap data repository or the Commission; and (3) if a security-based swap is subject to a clearing requirement, it must be traded on a registered trading platform, *i.e.,* a SB SEF or SBS exchange, unless no facility makes such security-based swap available for trading. Furthermore, Section 765 of the Dodd-Frank Act requires the Commission to adopt rules to. mitigate specified conflicts of interest.

Section 765(a) requires the Commission to adopt rules, which may include numerical limits on the control of, or the voting rights with respect to, any security-based swap clearing agency, or on the control of any SB SEF or SBS exchange, by various specified entities. Section 765(b)—captioned "Purposes"—provides that the Commission shall adopt such rules if it determines they are necessary or appropriate to improve the governance of, or to mitigate systemic risk, promote competition or mitigate conflicts of interest in connection with a security-based swap dealer's or major security-based swap participant's conduct of business with, a security-based swap clearing agency, SB SEF, or SBS exchange. The proposed rule notes that the statutory objective of promoting competition, which may be furthered through enhanced access to cleared products and clearing venues, may to some extent be in tension with the objective of minimizing systemic risk through effective risk management of the clearing agency.

The Commission recognizes that if the measures proposed in this release are adopted and are too onerous for new entrants, they could hinder the further development of a market for security-based swaps by unduly discouraging competition and the formation of new security-based swap clearing agencies and of new SB SEFs or SBS exchanges. The Commission is also concerned that if it adopts rules that are too permissive, conflicts of interest may be inadequately mitigated and such conflicts may incentivize restricting access to centralized clearing and lack of transparency in the trading of security-based swaps.

General ICBA Views – ICBA believes that the Commission's concerns as stated are generally sound. We note that the SEC and CFTC will be coordinating new regulations on various Dodd-Frank Act provisions that will set precedents for each agencies regulations. This proposed rule, while intended to impact security- based swaps will lay the groundwork for regulations and/or market behavior for non-securities based swap transactions and will therefore have broad market implications related to clearing non-securities based swaps.

Furthermore, ICBA believes it is important to make appropriate distinctions between cleared swaps and customized swaps traded in the OTC market to ensure that the OTC market is not overly burdened by new regulations. The final rule should seek to ensure a competitive and vibrant OTC market that does not unduly or unfairly restrict access to clearing of what are currently viewed as customized swaps. This is particularly important if the customized swaps in question are not the types of swaps that would lead to systemic risks and essentially have similar or equal risks as cleared swaps.

Governance and Voting Rights – ICBA generally agrees with the proposal's efforts to require security-based swap clearing agencies, security-based SEFs and security based swap exchanges to adopt ownership and voting limitations as well as certain governance requirements. A 'Fact Sheet' summarizing the proposed rule from the SEC's website[2] provides two alternatives relating to governance. Both alternatives seem to have merit. Our preference would be alternative 2 due to its requirement that the board of directors and any of its committees be comprised of a majority of independent directors. This provision, inserted in lieu of the provision in alternative 1 requiring the board and its committees to be comprised of 35 percent of independent directors would make alternative 1 a sound choice as well.

Small Financial Institution Review Council Needed – ICBA also recommends that the final rule establish an inter-agency review council with representation from community banks and small market participants to provide on-going feedback of how this regulation is impacting the marketplace in order to minimize conflicts of interest and ensure competition in the derivatives markets among institutions of all sizes. Without this type of on-going review of the rule's effectiveness and potential changes needed, we are concerned that the already dominant role of the very largest banks will grow even larger. For example, five large commercial banks currently represent 97 percent of the total U.S. banking industry notional amounts of derivatives outstanding.[3]

It is particularly important that there be community bank representation on this inter-agency council and within the board structure consisting of independent directors envisioned in the two alternatives proposed by the SEC. Representatives of community banks and small market participants need to be ensured of a way for their voices to be heard as independent directors due to the issues related to the types of swaps community banks are involved in and the significant and growing number of community banks that could be involved in utilizing swaps in the future as well as the significant number of community banks that will want to hedge their interest rate risks as part of their risk management strategies. Similarly, small market participants will not have a voice if there is not a mandated way for them to provide meaningful feedback on how the marketplace is functioning and their efforts to accommodate participation by small financial institutions such as community banks. ICBA estimates that over 1,000 community banks will be impacted by the new derivatives paradigm implemented by the Dodd-Frank Act.

We believe this recommendation is consistent with statements made in the proposed rule, including the SEC's comment : "As commenters review the instant proposals, they are urged to

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[2] http://www.sec.gov/news/press/2010/2010-190.htm

[3] Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, First Quarter 2010

consider generally the role that regulation may play in fostering or limiting the development of the market for security-based swaps (or, vice versa, the role that market developments may play in changing the nature and implications of regulation) and specifically to focus on this issue with respect to the proposals to mitigate conflicts of interest ."[4]

Our recommendation is intended to ensure more voices in decision making regarding which types of swaps would be allowed to be cleared; who has access to clearing platforms; and reducing the current conflicts of interest derived from the amount of large volume business transactions that will otherwise determine the competiveness and transparency – or lack thereof – of the derivatives market.

Lack of Transparency in Rule Making – It appears that large financial institutions are actively promoting a lack of transparency. For example, a recent Wall Street Journal article[5] reported that both the CFTC and the SEC are releasing proposals that, while requiring all swaps and security-based swaps to be reported, would only require those trades of over $250 million to be reported as "$250 million+" even if the trades were actually $3 billion or more. However, smaller trades under $250 million would all be reported. This type of proposal is obviously derived from lobbying of large financial institutions in an effort to **conceal** their business activities and foster a lack of transparency in the marketplace.

Given the immense amount of rhetoric regarding 'transparency' it is disturbing that federal agencies would cater to large financial institutions in this manner. There would be no additional burden from reporting large trades than reporting small trades. This proposal conceals what is occurring in the marketplace and would facilitate large trades at lower proportional costs than smaller trades – thus harming the competitive position of small financial institutions compared to large financial institutions. The methods of calculating the amounts of trades are also complex and lead to a lack of transparency. The agencies' proposals on this matter is an example of how large institutions are influencing proposed agency rules in a manner that is counter to the objectives of the Dodd-Frank's act's focus on transparency. Transparency should cover both large and small trades and needs to be applied to all market participants and all trades.

Concerns Regarding Hypothication – This regulation will likely have far-reaching impact including potentially affecting hypothecation in the OTC market. It appears that margin received by a Futures Commission Merchant or swap dealer to secure uncleared swaps will likely be subject to rules applicable to cleared Swaps. That is, there is a material chance that rehypothication will be prohibited in the OTC market.

Community banks are caught in an unfortunate scenario simply because the characteristics of the swaps they use precludes them from clearing (at least initially) and forces them to the OTC market (uncleared) which may prohibit rehypothication. The prohibition against rehypothication of margin for uncleared swaps could be catastrophic. Such a prohibition will severely curtail or possibly eliminate the community banks' access to the swap market. To understand why this is the case, it is important to understand how the community bank swap market operates and how it is served.

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[4] *Federal Register* / Vol. 75, No. 206 /10-26-10 / Proposed Rules / Page 65883

[5] *Wall Street Journal*, Nov. 22, 2010, Article entitled: "Derivatives Rule Seen Lifting the Cost of Swaps"

Most community bank swap transactions will not meet the initial criteria for clearing simply because they are "customized". As explained below, the "customization" is done to allow the swap to conform to the risks being hedged. The risk being hedged is typically associated with community bank borrowings (CDs or FHLB borrowings) or commercial loans. For example, a community bank making a commercial loan that amortizes; pays monthly; and is tied to 1-month LIBOR must "customize" the swap to those characteristics to appropriately hedge their exposure.

While these types of swaps are a relatively small part of the overall swap market, they are extremely critical to the community bank market. Large swap dealers typically do not solicit business from small to medium sized community banks that fall below their thresholds for trade volume. The community bank market is typically served by middle market swap dealers who aggregate business up to the large dealers.

In a typical swap transaction, a middle market swap dealer executes a derivative transaction with a community bank (downstream counterparty) and then hedges their position with a large swap dealer (upstream counterparty). The middle market swap dealer requires the downstream counterparty to post margin (both independent and full mark-to-market) and then rehypothicates that margin to the upstream counterparty.

This process has worked for years to mitigate credit risk and allows for the efficient operation of the community bank swap market. Without rehypothication, middle market swap dealers will be required to obtain marginable assets to meet their upstream margin requirements. The cost of obtaining marginable assets could force middle market swap dealers to exit the market, which in turn would effectively eliminate the community banks' access to the swap market. It is noteworthy that many capital markets allow, and rely upon, rehypothication or similar arrangements. An obvious example is the repurchase agreement market, where securities are routinely rehypothicated among market participants.

The SEC's efforts to prevent rehypothication in clearing houses make sense because the clearing house does not hypothecate or reuse margin that has been posted by other participants. There is therefore no need for rehypothication at the clearing house level. However, the OTC market works quite differently as there is no clearing house or central protection method. Each end user does business with a dealer who then hedges their position with another dealer. The end user posts collateral with the first dealer, who uses that collateral to collateralize the hedge the first dealer puts in place with the upstream dealer. This collateral is rehypothicated in a way that everyone is protected. The collateral is still attributable to the end user and the end user's collateral is not comingled with dealers' proprietary funds as it is kept in depository custodial accounts. Therefore, it is extremely important not to prohibit rehypothication in the OTC market.

Recommendations for Broad Access to Clearing Platforms – As noted above, a significant concern is whether small financial institutions such as community banks will have access to clearing platforms or whether they will be shut out of clearing. The latter result would impose significant and unnecessary capital and regulatory burdens upon community banks.

It appears community banks could be unfairly denied access to clearing platforms for the immediate future without adequate steps taken through this and other regulations. One reason is that clearing houses will focus initially on plain-vanilla swaps that large financial institutions utilize in very significant volumes. This creates significant financial incentives for cleared swaps to only encompass plain vanilla swaps. Many customized swaps, created largely by Wall Street firms to be used by highly sophisticated end users, have complex features that present unique risks and, therefore, may not suitable for clearing and should result in higher capital requirements relative to cleared swaps.

By contrast, the customized swaps used by community banks are simply interest rate swaps that look much like standard interest rate swaps, but need customization of key terms in order to (1) have an effective hedge and (2) achieve hedge accounting treatment under US GAAP. The vast majority of community bank swaps are customized interest rate swaps that have non-standard notional amounts (odd-lot notional amounts and/or notional amounts that amortize on a schedule established at inception) as well as non-standard rate indices, payment frequencies, tenors, and interest accrual day count conventions.

These terms are customized to coincide with the hedged loan or borrowing to create an effective hedge that meets US GAAP requirements. The variance in these terms do not present incremental risk to a clearinghouse or cause a community bank to accept greater risk than one posed by a standard swap.

Therefore, consistent with the SEC's objectives in this proposal of promoting competition and transparency and minimizing conflicts of interest, ICBA believes the final rule should require the clearing of "customized" swaps that are similar to plain vanilla swaps. For purposes of clarity, we believe the characteristics of these customized swaps that should initially be required to be accepted by the clearinghouse for clearing upon presentment include the characteristics and wording defined below.

Suggested Wording for Final Rule

"With the effective date of this regulation, swaps required to be accepted by a clearing house upon presentment shall include customized interest rate swaps that are:

(1) customized from a cleared swap only as it relates to –
- (a) notional amount, provided notional amount is known at inception for the entire contract period;
- (b) rate index, provided it is equal to, or calculated by adding or subtracting a fixed amount to, LIBOR, Prime, US Treasury Bill, Fed Funds Rate, or SIFMA;
- (c) start date;
- (d) end date;
- (e) payment frequency;

(f) floating rate reset frequency; or
(g) day count conventions; and

(2) if such swaps are presented by counterparties acceptable to a clearinghouse for clearing, they will be accepted by the clearinghouse for clearing upon presentment."

Because the customized swaps structured as outlined above are easily defined, present minimal risks and are useful for risk management purposes for many community banks, and help further the objectives of the proposed rule, ICBA believes they should be mandatory for clearing purposes. Other types of customized swaps that do not meet these qualifications can be considered subsequently by the appropriate institutions and their boards.

Without such a requirement for mandatory clearing of these near-plain-vanilla swaps it is possible, if not likely, that much of the swaps business and customers will shift to the largest financial institutions to the detriment of community banks and the smaller swap dealers they utilize. This will have the opposite affect from what the proposed rule hopes to achieve.

Our recommendation is consistent with the proposed regulation, which states: "A registered clearing agency is also required to provide *fair access to clearing and to have the capacity to facilitate the prompt and accurate clearance and settlement of securities transactions and derivative agreements, contracts, and transactions* for which it is responsible (emphasis added)."[6]

Conclusion

ICBA appreciates the opportunity to provide comments on the SEC's proposed rule. ICBA agrees with the concerns reflected in the proposed rule in terms of limiting or eliminating conflicts of interest in clearing houses. However, community banks and small market participants need to have voices on the boards and access to clearing houses for their low-risk near-plain-vanilla swaps. Without such required protections for small market and community bank participants the goals and objectives of this proposed rule will not be met and will be thwarted by the economic self-interests of large financial institutions. Therefore, we request that the recommendations made in this comment letter be considered for inclusion in the final rule. Should you have any questions regarding the content of this letter, please feel free to contact Mark Scanlan at 202-659-8111.

Sincerely

/s/

Mark Scanlan
Vice President, Agriculture and Rural Policy, ICBA

[6] Ibid, pg 65885