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By Comments Online process at: <http://comments.cftc.gov>

January 3, 2011

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

Re: Notice of Proposed Rulemaking: Process for Review of Swaps for Mandatory Clearing;
RIN 3038-AD00

Dear Secretary Stawick:

Freddie Mac is pleased to submit these comments in response to the Notice of Proposed Rulemaking regarding the process for review of swaps for mandatory clearing published by the Commodity Futures Trading Commission (the "Commission") on November 2, 2010 (the "Proposal")¹ pursuant to Sections 723 and 745 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Proposal would add a new Section 39.5 to the Commission's regulations to implement processes for determining the eligibility of a derivatives clearing organization ("DCO") to clear swaps and for the submission of specific clearing proposals to the Commission for review and mandatory clearing determinations.

Freddie Mac was chartered by Congress in 1970 with a public mission to stabilize the nation's residential mortgage markets and expand opportunities for homeownership and affordable rental housing. Our statutory mission is to provide liquidity, stability and affordability to the U.S. housing market. Freddie Mac currently operates under the direction of the Federal Housing Finance Agency as our Conservator.

Freddie Mac appreciates the Commission's efforts to establish an open and transparent process for the review of DCO clearing submissions and supports the goals of the Dodd-Frank Act to establish a framework to reduce systemic risk with respect to the review of swaps for mandatory clearing. However, Freddie Mac is concerned that the transition to mandatory clearing could have unintended negative consequences for swap users if certain terms of the mandatory clearing requirement are not clarified. Additionally, the mandatory clearing requirement could allow DCOs to raise the costs and increase the risks to swap users if adequate procedures are not established to permit all stakeholders to provide timely input into the clearing approval process.

¹ 75 Fed. Reg. 67277.

For these reasons, Freddie Mac urges the Commission to consider the following recommendations:

- Clarified treatment for good faith clearing failures. The Commission should clarify by rule or interpretation that the Dodd-Frank Act requires parties to a swap subject to the clearing requirement to *submit* a swap for clearing but does not require parties to terminate or “unwind” swaps that fail to clear. To reduce uncertainty for market participants in cases where swaps fail to clear despite the good faith efforts of the parties, the Commission should clarify that it is permissible to maintain such swaps as valid over-the-counter (“OTC”) derivatives contracts.
- Equal input for stakeholders. To establish an equal and adequate opportunity for all stakeholders to participate in the mandatory clearing approval process, the Commission should require DCOs to provide pre-submission notice of any clearing proposal and a meaningful opportunity to comment to *all* interested stakeholders, rather than merely to the DCO’s own members. Additionally, the Commission should extend the period for notice and comment on a mandatory clearing submission beyond 30 days, as currently proposed.

I. Clarified Status for Good Faith Clearing Failures

Freddie Mac requests that the Commission clarify in its rules or in an interpretive statement that when an OTC swap transaction within the scope of a mandatory clearing determination fails to clear or is required to be removed from a clearing system after initial acceptance for clearing (*i.e.*, “de-cleared”), it is not necessary for a party to the transaction to terminate the swap where the party has made a good faith effort to clear the swap and had a reasonable expectation of clearing. Section 723(a) of the Dodd-Frank Act makes it unlawful for a person to engage in a swap that is the subject of a mandatory clearing determination unless such person *submits* the swap for clearing. The language of the Dodd-Frank Act notably refers to an obligation to “submit” the swap for clearing rather than a requirement that swaps ultimately must be cleared. By contrast to the framework for transacting futures contracts, a clearing failure should not void a swap from its inception under the Dodd-Frank Act, and the statute does not require that an uncleared or “de-cleared” swap become illegal *per se* or require the parties to such a swap to terminate or “unwind” such a transaction. Indeed, Section 739 of the Dodd-Frank Act amends Section 22(A) of the Commodity Exchange Act (“CEA”) to provide that no swap transaction between eligible contract participants:

shall be void, or voidable or unenforceable, and no party to such agreement, contract or transactions shall be entitled to rescind, or recover any payment made with respect to, the agreement, contract or transaction under this section or any other provision of Federal or State law based solely on the failure of the agreement, contract, or transaction...to be cleared in accordance with section 2(h)(1).

Enforcement authority provided to the Commission under the Dodd-Frank Act is consistent with this view. Section 723 of the Dodd-Frank Act authorizes the Commission to prescribe rules as necessary “to prevent evasions of the mandatory clearing requirements.” Section 741 of the Dodd-Frank Act provides the Commission with ample ability to impose civil liability on a swap dealer or major swap participant that “knowingly or recklessly evades or participates in or facilitates an evasion of the requirements of section 2(h).” By drawing the

line at knowing or reckless evasion, we believe that Congress has indicated that parties to a swap should be deemed in compliance with the mandatory clearing requirement when they have submitted a swap for clearing in good faith and have a reasonable expectation of clearing.

Uncertainty about the legality of OTC swaps that are subject to a mandatory clearing determination may lead swap dealers to develop market practices requiring swaps that are rejected for clearing, fail to clear, or are removed from a clearing system, in each case through no fault of a customer, to be terminated to avoid potential legal or regulatory sanction. In fact, such market practices currently may be developing. Freddie Mac is aware of a number of draft agreements for the execution and clearing of swaps – and at least one industry advisory letter – that provide for the termination of swaps that fail to clear *at the discretion of the executing broker* without the assent of, and on terms that are unfavorable to, swap end users.

Unless the Commission clarifies the status of uncleared swaps, swap users employing derivatives for legitimate economic hedging purposes could face substantial risks as such users would not be certain of the validity of their hedges and their resulting economic position with respect to a swap until it has been finally accepted for clearing. For entities such as Freddie Mac that use swaps to hedge large-scale commercial risks on an ongoing basis, even a one- or two-day period of uncertainty could be detrimental, as the unexpected termination of a hedge could expose the firm to market risk that may generate substantial losses. Moreover, this risk would largely be outside of the control of a swap user since a swap could fail to clear for a number of reasons, many of which are unrelated to the good faith efforts of the end user. Among other causes, swaps may fail to clear or be required to be “de-cleared” by a DCO due to position or concentration limits imposed by the DCO on a swap party’s futures commission merchant (“FCM”), a position limit imposed by a clearing member on its customer after the fact of an existing trade, operational errors, or extraordinary events outside of the control of the parties to a swap and their intermediaries.

Conversely, clarifying that parties are permitted to maintain an OTC swap that has failed to clear despite good faith efforts is likely to have no appreciable negative impact on systemic risk. Provided that swap counterparties submit swaps for clearing as required in good faith, cases of clearing failures are extremely unlikely to rise to the level where the volume of uncleared trades could create material risk for the financial system or U.S. economy as a whole. Indeed, the failure to clarify the permissibility of maintaining swaps in this context could, if anything, increase systemic risk by increasing the likelihood of unanticipated losses for large swap users.²

II. Equal Comment Opportunities for Stakeholders

The Dodd-Frank Act requires the Commission to consider the effects on competition and the adequacy of cleared swaps as substitutes for OTC swaps, among other factors, in making

² We note that parties to swaps eligible for clearing may have substantial economic incentives to effectuate clearing since the Dodd-Frank Act requires the Commission and other regulators to establish margin and capital requirements for uncleared swaps that are appropriate “[t]o offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared”. See CEA Section 4s(e)(3).

any mandatory clearing determination.³ Mandatory clearing necessarily will limit choice for swaps users, particularly where only one or a small number of DCOs have the exclusive right(s) to clear a particular swap contract. As a result, mandatory clearing gives significant power to DCOs in the market for swap intermediation (and indirectly to their clearing firm owners and members) meriting vigorous Commission oversight. In addition to costs to end users that may be imposed through the imposition of fees and charges, DCOs may impose burdens and liabilities on swap users through rules, practices and procedures relating to the provision and use of margin, eligibility for clearing membership, and the allocation of risks of loss to different stakeholders in various situations. Of particular importance to large swap users such as Freddie Mac, mandatory clearing potentially gives DCOs tremendous power in the allocation of risks to different stakeholders in the event of a default or bankruptcy of an FCM through the structuring of a DCO's financial safeguards "risk waterfall."⁴

Given the significant impact on competition that could result from mandatory clearing and the potential burdens on swap users, Freddie Mac believes that it is essential that all stakeholders in the market for a particular swap be given equal and adequate opportunity to consider and comment on any DCO clearing proposal. Freddie Mac recognizes that the Dodd-Frank Act requires the Commission to make mandatory clearing determinations within 90 days after submission of an application by a DCO, and that the Commission must have adequate time to consider comments. However, in Freddie Mac's view, the Commission's current proposal to provide 30 days for public comment is not adequate. Mandatory clearing raises complex questions about potential market effects, allocation of costs, and risks among market participants and the likely effects on systemic risk. Moreover, because DCOs typically submit clearing proposals to their membership (primarily sell-side institutions, which may benefit from the structure, costs and risk allocations of a clearing proposal) prior to submission to the Commission, a short time period for public comment could create an unequal playing field by providing certain stakeholders (*i.e.*, member firms involved in DCO governance) valuable time to assess and influence the shape of a proposal that may not be available to customers and other market participants.

To ensure an equal and adequate opportunity for all stakeholders to assess and comment on any proposals for clearing, Freddie Mac recommends that the Commission provide that a DCO submission will not be deemed complete unless the DCO has published full details of any clearing proposal to all interested stakeholders and solicited comments prior to submission to the Commission. We believe that the Commission should require publication of an advanced public notice of a clearing proposal in a manner reasonably designed to be available to all participants in a swap market, including all applicable contract terms, margin requirements, clearinghouse financial safeguards and customer protection rules. DCOs should be required to provide sufficient time for meaningful review and comment by all interested stakeholders and to provide a summary of any opposition to the submission expressed by members, swap users and other stakeholders, as part of the submission to the Commission.

³ See CEA Section 2(h)(2)(D).

⁴ For example, DCO financial safeguard packages may dictate that margin provided by non-defaulting customers of an FCM in one asset class may be used to satisfy unpaid obligations of the defaulting FCM to the DCO with respect to a different asset class as well as placing customer margin at risk before the DCO's own capital and contributions of other FCMs.

Freddie Mac believes that the proposed 30-day period for public comment on a mandatory clearing submission to the Commission should be extended for as long as reasonably practicable after publication on the Commission's website and the Federal Register. Where the Commission believes the remaining time is inadequate to consider fully the submission and public comments, the Commission should request the DCO to agree to an extension of the statutory 90-day time limit as permitted under CEA Section 2(h)(2)(C) of the CEA, determine not to impose mandatory clearing pending further study, or issue a mandatory clearing determination and simultaneously stay the mandatory clearing requirement to allow time for further consideration.

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Freddie Mac appreciates the opportunity to provide our views in response to the Proposal. Please contact me if you have any questions or would like further information.

Sincerely,

A handwritten signature in black ink, appearing to read "Lisa M. Ledbetter". The signature is written in a cursive, flowing style.

Lisa M. Ledbetter