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

February 28, 2011

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

Re: Notice of Proposed Rulemaking: Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants; RIN 3038-AC96

Dear Secretary Stawick:

Freddie Mac is pleased to submit these comments in response to the Notice of Proposed Rulemaking establishing requirements for swap confirmation, portfolio reconciliation and portfolio compression for swap dealers and major swap participants (MSPs) published by the Commodity Futures Trading Commission (the Commission) on December 28, 2010 (the Proposal)<sup>1</sup> pursuant to Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Section 731 of the Dodd-Frank Act requires swap dealers and major swap participants to conform to standards prescribed by the Commission for "timely and accurate confirmation, processing, netting, documentation, and valuation of all swaps" and requires the Commission to "adopt rules governing documentation standards for swap dealers and major swap participants."

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 uses swaps to hedge large-scale commercial risks on an ongoing basis. Freddie Mac currently operates under the direction of the Federal Housing Finance Agency as our Conservator.

### Summary and Recommendations

Freddie Mac supports the Commission's goals to reduce systemic risk, increase transparency and promote market integrity. Freddie Mac is concerned, however, that the Proposal, in many instances, would impose arbitrary and unrealistic time deadlines for transaction processing and requirements for transactional consolidation that may be difficult and costly to implement. Such deadlines would: (1) increase operational risks for end-users and hedging parties, like Freddie Mac; (2) sacrifice transactional accuracy and effective resolution of trade disputes in favor of speed of transactional processing; and (3) effectively force end-users and hedging parties to conform to the policies and procedures of market professionals. Additionally, if the

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<sup>1</sup> 75 Fed. Reg. 81519.

Commission's rules on reporting trades to swap data repositories (SDRs) give preference to a market professional's version of a trade, then end-users and hedging parties could be further disadvantaged in cases where the market professional owns the SDR.

Accordingly, Freddie Mac suggests that the Commission amend the Proposal consistent with the following recommendations, described further in our letter:

- Timely Confirmation: A swap dealer's or MSP's obligation to execute a swap confirmation in a timely manner should be deemed to be satisfied whenever a swap executed (i) electronically through a straight-through processing facility produces a match or otherwise legally binding execution under the terms of the relevant system rules; or (ii) manually by exchange of written documentation or electronic records directly between transacting parties is signed by each party as promptly as commercially reasonable.
- Accurate Confirmation: A swap dealer's or MSP's obligation to execute a swap confirmation in an accurate manner should be deemed to be satisfied whenever an executed swap confirmation (or other legally binding record) is signed (or otherwise agreed to) by each party and accurately records all of the material terms of the trade.
- Confirmations in the Event of Disputes: Any deadline for execution of a confirmation under the Proposal should be suspended in the event of any dispute over terms or objection by a transacting party to the terms in a document sent by the other party until such dispute or objection is resolved.
- Resolution of Disputes: A swap dealer's or MSP's obligation to resolve disputes, discrepancies in material terms or valuations identified in a portfolio reconciliation with respect to transactions not executed electronically through a straight-through processing facility or cleared through a derivatives clearing organization (DCO) should be deemed to be satisfied if the dispute or discrepancy is resolved as promptly as commercially reasonable.
- Limitation on Policies Adopted by MSPs or Swap Dealers: No policy or procedure required to be adopted by a swap dealer or MSP under the Proposal with respect to transactions with counterparties that are not swap dealers or MSPs should impose any requirement, expectation or obligation on the part of the counterparty to terminate or modify the terms of any swap, or otherwise agree to the resolution of any dispute with respect to such swap or portfolio of swaps, on less favorable terms than otherwise would be agreeable to the counterparty in the absence of such a policy or procedure applicable to the swap dealer or MSP.
- Netting, Documentation and Valuation: The netting, documentation and valuation provisions of Section 731(i) of the Dodd-Frank Act should be deemed satisfied whenever a swap executed electronically through a straight-through processing facility, or manually by exchange of written documentation or electronic records directly between transacting parties, is either (i) cleared by a DCO or, (ii) if not cleared, is subject to a written master netting agreement and collateral pledge agreement under which the parties mark net portfolio values to market and exchange collateral on the basis of such valuations as promptly as commercially reasonable.
- Portfolio Compression: Mandatory portfolio compression should be limited to circumstances in which two swaps match and offset cash flows exactly and an exception should exist for cases in which a hedging party requires an existing position to be maintained to preserve an effective hedge.

## Discussion

Freddie Mac has a long history and substantial experience in transacting both listed interest rate futures and options subject to existing Commission regulation, as well as over-the-counter (OTC) interest rate swaps that will become subject to Commission regulation under the Dodd-Frank Act. Freddie Mac uses interest rate derivatives exclusively as an end-user to hedge its interest rate risk and executes transactions exclusively with market intermediaries, including futures commission merchants and swap dealers.

Currently, Freddie Mac confirms most of its interest rate swaps through automated electronic straight-through processing facilities in which both parties enter trade information. Once matched, the system rules produce a binding confirmation of trade and provide other trade processing benefits, such as transaction reports. Certain transactions (generally, swaps linked to a structured debt security issued by Freddie Mac) are not accepted by these electronic processors and are confirmed manually, through an exchange of written or electronic documents, directly with Freddie Mac's counterparty. In all cases, regardless of whether such transactions are confirmed through an automated system or manually, each transaction is agreed to telephonically, trade terms are verified within one business day, and the trade forms a part of a portfolio of trades executed under a written master netting agreement and related security pledge agreement with each counterparty that is "marked-to-market" with collateral exchanged directly with the counterparty based on net exposures on a daily basis from the date of trade.

Freddie Mac expects that most of the interest rate swaps that we currently confirm electronically ultimately may be of the type accepted for execution through a swap execution facility (SEF) and eligible for clearing through a DCO. However, many of the swaps that we confirm manually ultimately may not be amenable to automated execution or central clearing. While Freddie Mac generally agrees with the Commission that swap dealers and MSPs should be able to comply with the confirmation and portfolio reconciliation requirements of the Proposal by executing a swap on a SEF or clearing a swap through a DCO,<sup>2</sup> Freddie Mac believes that the Proposal imposes unrealistic deadlines with respect to other transactions and other substantial burdens for the execution of confirmations and portfolio reconciliation and compression with counterparties that are not swap dealers or MSPs.

### a. Swap Confirmation

In Freddie Mac's experience, swap dealers often send to Freddie Mac initial drafts of written confirmations that incorrectly reflect the principal economic, legal or other terms of a transaction.<sup>3</sup> Such transactional documentation requires careful review by Freddie Mac, formulation of appropriate comments and a request for correction or clarification, communication of comments, and one or more rounds of corrected documentation to be exchanged before ultimate execution of a confirmation. Freddie Mac endeavors to resolve any open disputes or

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<sup>2</sup> See Proposal at 75 Fed. Reg. 81520.

<sup>3</sup> Currently, in many cases, Freddie Mac does not receive a confirmation from its dealer counterparty for several days after the execution of a trade. Notwithstanding the "lag time" in receipt and execution of formal legal confirmation, both parties will book the transaction and include the transaction in the net valuation of the open trade portfolio between the parties from the date of the trade.

disagreements over confirmation terms as expeditiously as possible, but this process often extends over several business days. In our view, the “same day” time period proposed by the Commission under proposed §§ 23.501(a)(1) and (2) for execution of a confirmation for a swap transaction that cannot be processed electronically simply would not permit sufficient time for correction of draft confirmations or resolution of many disputes over trade terms.<sup>4</sup>

Freddie Mac also is concerned with the requirements under proposed § 23.501(a)(3) for swap dealers and MSPs to establish and enforce policies and procedures designed to ensure execution of a confirmation on the same day as trade execution in transactions with a “financial entity”<sup>5</sup> and not later than the next business day in transactions with a counterparty that is not a swap dealer, MSP or financial entity. This provision includes the requirement to send to or receive from the counterparty “a draft ‘acknowledgment’ specifying all the terms of the swap transaction other than the applicable pricing and other relevant terms that are to be expressly agreed at execution.”<sup>6</sup> In Freddie Mac’s view, these two requirements, individually and cumulatively, could result in market professionals exerting undue pressure on a counterparty to quickly assent to the terms of a trade as dictated by a market professional, whether or not such terms were incorrect or objectionable. We believe that a market professional required to adopt such a policy might insist, as a condition of executing a trade, that its non-MSP counterparty agree to accept the terms framed by the market professional in any communication or risk the trade becoming void or otherwise failing.

We also believe that the obligation for a market professional to send a “draft acknowledgment”<sup>7</sup> to a counterparty *prior to* trade execution, rather than being helpful, will be unduly burdensome. This requirement, at a minimum, adds an extra step to the process of trade verification, since these documents will require review, and may impede the prompt execution of hedging transactions by adding additional administrative burdens as preconditions to the execution of trades. In addition, this document may give a market professional undue leverage in framing the terms of an inaccurate or disputed trade confirmation to the detriment of an end-user or hedging counterparty. The pressures on end-user counterparties from swap dealer and MSP policies imposing both time deadlines for executing trade confirmations and pre-execution documentation requirements could be exacerbated by the trade reporting requirements under the Dodd-Frank Act. Since swap dealers and MSPs, rather than their counterparties, are

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<sup>4</sup> Freddie Mac also believes that the 15-30 minute time frame under proposed § 23.501 for execution of a confirmation following a trade similarly may be unrealistic. While many electronic trade confirmations are, in fact, executed as promptly as 15-30 minutes, in Freddie Mac’s experience, it may take longer than this brief period for Freddie Mac to complete and submit the necessary information to produce a binding match even when trade details are not incorrect or in dispute. We believe other end users of derivatives may have similar difficulties meeting such tight time frames under many circumstances.

<sup>5</sup> Under proposed § 23.500(e), a “financial entity” has the meaning defined under § 2h(7)(C) of the Commodity Exchange Act, and Commission regulations thereunder, to include any bank or other financial institution, such as Freddie Mac, but excludes any swap dealer or MSP.

<sup>6</sup> Under proposed § 23.500(a), an “acknowledgment” means a written or electronic record of all of the terms of a swap signed and sent by one party to the other. We believe this definition, as currently written, would include the first version of a confirmation sent by a swap dealer to Freddie Mac.

<sup>7</sup> The concept of a “draft acknowledgement”, while somewhat ambiguous, appears to us to require the dispatch of a term sheet or draft confirmation with pricing and unspecified other details redacted.

required to report trade details to an SDR, a market professional's leverage to frame the terms of a disputed trade would be increased should the Commission permit SDRs to adopt rules that give preference or deference to a market professional's version of the trade even in the absence of full counterparty agreement.<sup>8</sup>

To address the foregoing concerns, Freddie Mac recommends that the Commission modify the Proposal to provide that, for purposes of Section 731(i) of the Dodd-Frank Act, (i) a swap confirmation would be executed in a timely fashion if executed either automatically or manually as promptly as commercially reasonable; (ii) a swap confirmation is accurate whenever a signed confirmation or other legally binding trade record captures all material terms of a trade; (iii) in the event of any dispute or objection over trade terms any deadline for execution of a confirmation would be suspended until such dispute or objection is resolved; (iv) any obligation to promptly resolve a dispute or discrepancy would be deemed to be satisfied if the dispute or discrepancy is resolved as promptly as commercially reasonable; and (v) no swap dealer or MSP policy (expressly or by implication or effect) will impose on any counterparty any obligation or expectation to terminate or modify the terms of any swap, or otherwise agree to the resolution of any dispute with respect to a swap or portfolio of swaps, on less favorable terms than otherwise would be agreeable to the counterparty.

b. Portfolio Reconciliation

As indicated above, Freddie Mac confirms the details of each new trade within one day of trade execution. Following trade execution, Freddie Mac and its counterparties exchange trade details and portfolio valuations (as of the close of business on the immediately preceding business day), and move collateral, on a daily basis. The process for portfolio valuation and movement of collateral is documented under negotiated versions of industry-standard forms of master agreements and related security agreements.<sup>9</sup> Under the Proposal, swap dealers and MSPs are required to agree in writing to the terms of portfolio reconciliation; "resolve immediately any discrepancy in a material term of a swap identified as part of a portfolio reconciliation"; and "resolve any discrepancy in a valuation identified as part of a portfolio reconciliation within one business day"<sup>10</sup> for any swap in which the counterparty is a swap dealer or MSP; and to adopt written policies and procedures "designed to resolve any discrepancies in the material terms or valuation of each swap identified as part of a portfolio reconciliation

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<sup>8</sup> Inherent conflicts of interest may be presented in cases in which an SDR, DCO or other trade processor may be owned, in whole or part, or otherwise under the influence of market professionals through governance arrangements or inducements stemming from the future flow of business opportunities.

<sup>9</sup> Freddie Mac and its counterparties use the International Swaps and Derivatives Association (ISDA) Master Agreement and related Credit Support Annex (CSA). The ISDA agreement and CSA specify the terms of the valuation of net exposures and the required terms of collateral pledge and return and dispute resolution.

<sup>10</sup> Proposed §§ 23.502(a)(1), (4) and (5). "Portfolio reconciliation" is defined as any process by which both parties to a swap portfolio (i) exchange the terms of all swaps; (ii) exchange each counterparty's valuation of each swap as of the close of business of the preceding business day; and (iii) resolve any discrepancy in material terms and valuations. Proposed § 23.500(i). "Material terms" are defined by reference to the Commission's rule proposals for Swap Data Recordkeeping and Reporting Requirements (75 Fed. Reg. 76574).

process in a timely fashion”<sup>11</sup> for any swap in which the counterparty is not a swap dealer or MSP. In both cases, the Proposal provides that a difference in valuation of less than 10% need not be deemed a discrepancy. The Proposal does not require reconciliation for cleared swaps.<sup>12</sup>

Freddie Mac believes its current portfolio reconciliation processes meet the intended purposes of the Dodd-Frank Act for prompt and accurate trade processing, valuation and portfolio reconciliation.<sup>13</sup> However, in some cases, it may be impossible to resolve a discrepancy in material terms immediately, or a discrepancy in valuation within one business day. In Freddie Mac’s view, the timely and accurate processing and valuation requirements of the Dodd-Frank Act should be deemed satisfied whenever an OTC derivatives transaction is subject to a written master netting agreement and collateral pledge agreement under which the parties mark net portfolio values to market and exchange collateral on the basis of such valuations *as promptly as commercially reasonable*.

c. Portfolio Compression

Freddie Mac supports the risk reducing benefits and operational efficiencies of portfolio compression. Freddie Mac is concerned, however, that mandatory portfolio compression requirements dictated by third parties could have unintended adverse consequences for end-users and hedging counterparties. Forced termination of offsetting trades in a portfolio compression exercise could result in termination of a necessary hedge position or unbalance a remaining portfolio. Accordingly, Freddie Mac believes that mandatory portfolio compression should be limited to cases in which two swaps match and offset cash flows from one another exactly. In addition, an exception to any mandatory requirement for portfolio compression should exist for cases in which an end-user relying on a particular transaction for hedging purposes requires the position to be maintained to preserve an effective hedge or otherwise reasonably believes the termination of an existing trade would result in an adverse effect on remaining trades.

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For the reasons stated above, Freddie Mac suggests that the Commission modifies the Proposal in the manner recommended in this letter. Freddie Mac appreciates the opportunity to

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<sup>11</sup> Proposed § 23.502(b)(1) and (4).

<sup>12</sup> Proposed § 23.502(c).

<sup>13</sup> In this regard, Freddie Mac urges the Commission not to favor portfolio reconciliation by third parties over bilateral portfolio reconciliation. In addition to the possibility that third party portfolio reconciliation services may not handle all transactions that form a part of a swap portfolio, the use of such third party services may entail direct and indirect costs and risks not present in a bilateral context. Such costs and risks include fees charged for use of the system; administrative and operational expenses to build, operate and maintain system access; and legal risks, including acceptance of non-negotiable and onerous terms of business such as open-ended indemnification provisions, disclaimers of liability in whole or part, and assertions of ownership by the system vendor or others over transactional data and other proprietary intellectual property of the transacting parties. In this regard, Freddie Mac also urges the Commission to closely scrutinize the necessity and propriety of the terms of business demanded by prospective service providers seeking registration as SDRs, SEFs and DCOs, and that it disapprove those terms that it finds to be overreaching.

David A. Stawick  
February 28, 2011  
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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 fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Lisa M. Ledbetter