We make home possible℠

Lisa M. Ledbetter
Vice President and Deputy General Counsel
Legislative & Regulatory Affairs

Tel: (703) 903-3189
Fax: (703) 903-4503
lisa_ledbetter@freddiemac.com

8200 Jones Branch Drive
MS 211
McLean, VA 22102-3110

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

March 21, 2011

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

Re: Notice of Proposed Rulemaking: Risk Management Requirements for Derivatives Clearing Organizations; RIN 3038-AC98

Dear Secretary Stawick:

Freddie Mac is pleased to submit these comments in response to the Notice of Proposed Rulemaking regarding risk management requirements and core principles for derivatives clearing organizations (DCOs), published by the Commodity Futures Trading Commission (the Commission) on January 20, 2011 (the Proposal)[1] pursuant to Titles VII and VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

Freddie Mac was chartered by Congress in 1970 with a public mission to stabilize the nation's residential mortgage markets and expand opportunities for affordable homeownership and 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.

Freddie Mac supports the goal of mitigating systemic risk through central clearing of swaps and appreciates the Commission's efforts to combine rigorous oversight of DCOs with a principles-based approach to regulation that affords appropriate discretion to develop efficient operational and business models. We are concerned, however, with three aspects of the Proposal.

I. First, we are concerned with the proposed requirement that DCOs impose heightened margin requirements on customers for "non-hedge positions". We recommend that the Commission should (i) clarify that, for purposes of proposed § 39.13(g)(8)(ii), "hedge" positions include all swaps that hedge or mitigate commercial risk, and (ii) consider eliminating the requirement for increased initial margins for "non-hedge" positions entirely.

II. Second, we are concerned with the broad discretion that would be given to DCOs to determine the sequence in which financial resources are applied in the event of a clearing member default. We recommend that DCOs should be required to place

---

[1] 76 Fed. Reg. 3698.

non-customer resources (*e.g.*, clearing member guaranty funds and their own capital) ahead of non-defaulting customer collateral in the "risk waterfall".

III. Third, we are concerned with the possible implications of proposed limitations on permitted investments. We recommend that the Commission clarify that proposed § 39.15(d) relating to permitted investments for customer funds does not imply that the Commission disfavors allowing DCOs to accept assets other than those permitted under § 39.15(d) and § 1.25 as initial or maintenance margin.

The reasons for our recommendations are set forth below.

I. The Commission should clarify that "hedge" positions include all swap positions that hedge or mitigate commercial risk and should consider eliminating the requirement for increased initial margin for "non-hedge" positions entirely.

Proposed § 39.13(g)(8)(ii) would require DCOs to require clearing member firms to collect increased amounts of initial margin for customer swaps that are "non-hedge positions." However, the Proposal does not define "hedge positions," creating uncertainty as to how the term will be interpreted by DCOs and Futures Commission Merchants. Such uncertainty is of particular concern to end users of derivatives, such as Freddie Mac, that use interest rate swaps to hedge risks in connection with routine business and financial transactions.[2]

In light of this uncertainty, Freddie Mac recommends that the Commission clarify that "hedge positions" covered by proposed § 39.13(g)(8)(ii) include all swaps that hedge or mitigate any form of a customer's business risks. The Commission should further clarify that such swaps may qualify as "hedge positions" under proposed § 39.13(g)(8)(ii) regardless of whether they qualify as a "bona fide hedging transactions" under the Commodity Exchange Act as defined by the Commission in regulation § 1.3(z), or whether such transactions also qualify as hedges under applicable accounting standards, and that such swaps may qualify as "hedge positions" regardless of the nature of the entity that holds such positions (*e.g.*, whether it is a financial entity or a non-financial entity). Such treatment would be consistent with Commission proposals for defining hedging for purposes of other Dodd-Frank Act rules, including the definition of "major-swap participant" and rules relating to the availability of the end user exception to mandatory clearing.[3] As recognized in those proposals, effective hedges of business risk are not limited to those swaps that qualify as accounting hedges or that satisfy the technical requirements of "bona fide hedging transactions."

We also respectfully submit that the Commission should consider eliminating the blanket requirement for increased initial margin for non-hedge positions entirely. From Freddie Mac's perspective, such a requirement, which the Commission views as necessary to prevent risk from frequent margin calls, is unduly rigid and unnecessary for proper risk management. DCOs

---

[2] Freddie Mac uses interest rate swaps exclusively for the purpose of hedging interest rate risk. Increased margin requirements would unnecessarily burden Freddie Mac's normal business activities as a result of the need to raise and commit additional capital to support such increased margin requirements, potentially resulting in increased costs and decreased liquidity for Freddie Mac and its related mortgage and capital markets activities.

[3] <u>See</u> 75 Fed. Reg. 80173, 80195 (Dec. 21, 2010); 75 Fed. Reg. 80747, 80757 (Dec. 23, 2010).

and clearing member firms should have flexibility to design risk systems that are tailored to the specific requirements of particular products and the credit and operational characteristics of individual customers. Freddie Mac believes effective risk management requires a flexible and comprehensive approach.

Further, we do not believe there is a valid basis to apply increased margin to customers based on whether individual swap transactions are for hedging purposes. Customers with non-hedge positions at a particular DCO are not inherently riskier or more likely to miss margin calls than customers with "hedge" positions at that DCO. Counterparty credit risk cannot be assessed in a vacuum based on whether individual positions are hedged. A highly capitalized customer trading in liquid products may be far less risky than a thinly capitalized customer assuming significant market risk that happens to be hedging a trading position with a particular swap. Credit exposure depends on the credit of the counterparty as a whole, as well as the use of credit risk mitigants (such as margin) that are adequate in light of the volatility of a swap portfolio. Imposing a blanket requirement for increased margin based on whether a position is a "hedge" risks being both ineffective and unduly restrictive.

II. DCOs should not be permitted to place non-defaulting customers above others in the "risk waterfall."

Under Core Principle G, relating to DCO default management rules, the Commission proposes to grant each DCO discretion to determine the sequence in which it would use the funds and assets of a defaulting clearing member and the resources maintained by the DCO in the event of a default. While the proposed rules would provide that customer margin posted by a defaulting clearing member could not be used to satisfy proprietary obligations of the clearing member, "the proposed regulation would not specify the sequence in which a DCO would be required to apply its own resources" [4] (*i.e.*, its own capital and clearing member guarantee funds) versus non-defaulting customer collateral.

As Freddie Mac has previously recommended to the Commission in a prior letter, in the event that the Commission does not provide for mandatory individual segregation of customer collateral,[5] we believe that the Commission should require DCOs to place non-defaulting customers at the bottom of the risk waterfall. Freddie Mac does not support permitting DCOs to place non-defaulting customers at risk ahead of clearing member guarantee funds and DCO capital. Non-defaulting customers are not at fault for clearing firm failures or the failure of a DCO to properly risk manage its clearing member firms, and should not bear the burden of such failures ahead of the responsible DCO. While we believe that the Commission should defer adoption of § 39.16(c) until after adoption of rules relating to customer segregation, at a minimum, the Commission should provide in the current rulemaking that DCOs are required to place their own assets ahead of non-defaulting customer collateral in the default management sequence.

---

[4] See 76 Fed. Reg. 3712 and proposed § 39.16(c)(2)(iv).

[5] See Letter to David Stawick dated January 18, 2011, responding to the Commission's Advanced Notice of Proposed Rulemaking relating to protection of cleared swaps customers (the "January Letter") in which we advocated for individual segregation of customer collateral.

III. The Commission should clarify that DCOs may accept collateral types beyond those specified as permissible investments under Commission regulation §1.25

Proposed § 39.15(d) would require DCOs that invest customer funds and assets on behalf of such customers to comply with Commission regulation § 1.25, which limits permissible investments to enumerated assets. Although the proposed rule would be limited by its terms to *investments* made by a DCO, and would not directly limit what a DCO could otherwise accept as collateral for customer positions, Freddie Mac is concerned that the proposal could be read as implying that the Commission disfavors allowing DCOs to accept assets other than those permitted under § 1.25 as initial or maintenance margin. While Freddie Mac does not believe that the Commission intended such an inference, we believe it would be helpful for the Commission to clarify that DCOs may accept other assets from customers as margin, and that § 39.15(d) is intended primarily to protect customers from incurring unexpected risks when their assets are invested by regulated intermediaries.

* * * * *

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,

Lisa M. Ledbetter