**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

We make home possible℠

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

July 11, 2011

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

Re: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants; RIN 3038-AC97

Dear Mr. Stawick:

Freddie Mac is pleased to submit these comments in response to the Notice of Proposed Rulemaking regarding Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, published by the Commodity Futures Trading Commission (the Commission) on April 28, 2011 (the Proposal).[1] The Proposal is issued under Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which requires the Commission to adopt rules to establish initial and variation margin requirements for non-cleared swaps entered into by those swap dealers and major swap participants for which there is no Prudential Regulator[2] (collectively, Covered Swap Entities or CSEs).

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 (FHFA) as our Conservator.

Summary and Recommendations

Freddie Mac supports the efforts of the Commission to implement the Dodd-Frank Act and its objective of enhancing stability and transparency in the swaps markets, and strongly supports the efforts of the Commission to effectuate the Dodd-Frank Act's mandatory clearing requirements. We recognize that the Dodd-Frank Act requires the Commission and the Prudential Regulators to establish initial and variation margin requirements for uncleared swap transactions and appreciate the opportunity to comment on the Proposal.

---

[1] 76 Fed. Reg. 23,732.

[2] The Prudential Regulators consist of the Federal Housing Finance Agency, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Farm Credit Administration, and the Federal Deposit Insurance Corporation.

Freddie Mac is prudentially regulated by FHFA and, as such, is not itself a CSE directly subject to the Commission's proposal. Rather, Freddie Mac's swaps activities will be subject to the proposed regulations issued by FHFA and the other Prudential Regulators. Nonetheless, as a significant "buy-side" participant in the interest rate swaps markets that will enter into interest rate swaps with Commission-regulated swap dealers, Freddie Mac believes it has a valuable perspective to provide to the Commission regarding the effects of the Proposal on Freddie Mac and other end users that will be required to post margin to such CSEs.

Freddie Mac believes that it would likely be considered a "financial entity" under the Commission's Proposal and therefore Freddie Mac's Commission-regulated swap dealer counterparties will be obligated to impose on Freddie Mac initial and variation margin. We also note that the margin regulations separately proposed by FHFA would require all entities regulated by FHFA (Regulated Entities) to collect initial and variation margin when entering into swaps with "swap entities" in a manner equivalent to the margin requirements applicable to prudentially regulated swap dealers and major swap participants. If the FHFA proposal is adopted as proposed, Freddie Mac will be required to both collect and deliver margin when entering into interest rate swaps with swap dealers. For this reason (and because Freddie Mac's swap dealer counterparties will almost certainly transfer much of the economic cost of the mutual margin requirements to Freddie Mac), Freddie Mac will be especially affected by mandatory margin requirements and its business operations would be particularly harmed by rules that are unduly burdensome or that fail to provide for an orderly transition to clearing.[3] Therefore, we believe it is absolutely critical that implementation of margin requirements be carefully considered and measured to minimize the expected effects on liquidity and disruption to the swaps market and the mortgage and housing markets.

In particular, Freddie Mac has the following recommendations, which are discussed in greater detail below:

- Freddie Mac strongly believes the best way to avoid significant market disruption is to implement the margin requirements on a schedule that is coordinated with the introduction of wide-scale clearing for interest rate swaps.

- The Commission should provide a methodology for calculating initial margin that is a modified version of the "lookup table" approach proposed by the Prudential Regulators and permit CSEs to choose between such a method and its proposed "alternative approach" as appropriate. The categories provided in the applicable lookup table should be significantly expanded from the those proposed by the Prudential Regulators to handle the various types of swap transactions that would likely be grouped under "interest rate swaps."

- With respect to variation margin and related credit support arrangement documentation requirements, the Commission should not require parties to a swap to agree to a

[3] While the Proposal would primarily impact Freddie Mac by affecting the conduct of Freddie Mac's swap dealer counterparties, the Commission's approach to margin may also indirectly impact Freddie Mac as a result of the interagency coordination mandated by Section 731 of the Dodd-Frank Act insofar as it will likely influence the approach taken by Prudential Regulators in regulating entities under their jurisdiction.

Freddie Mac is separately submitting a comment letter in response to the margin regulations proposed by the Prudential Regulators.

particularized valuation model for the swap in advance, but rather simply require them to agree to terms sufficient to establish the right of a CSE to collect variation margin as required by applicable law, subject to reasonable terms for the resolution of disputes.

- The Commission should permit netting of variation margin among pre- and post-effective date swaps without requiring that pre-effective date swaps comply with the Proposal's requirements.
- The Commission should clarify that mortgage-backed securities guaranteed by Fannie Mae or Freddie Mac (Agency MBS) are eligible collateral for initial margin.
- The Commission should provide CSEs greater flexibility to establish thresholds and minimum transfer amounts based on approved policies and procedures for establishing such threshold and minimum transfer amounts, including the counterparty credit assessments made by the CSEs.
- Finally, the Commission should adopt a standards-based approach to custodial risk that permits the parties to use a custodian in a reasonable jurisdiction of their choosing. At a minimum, the Commission should clarify that any custodian located in the United States satisfies the eligible jurisdictional requirements under the Proposal.

## Discussion

### I. Implementation Timing

Under the Proposal, initial and variation margin requirements would apply to swaps entered into after the effective date of the final regulation. While the Proposal does not indicate when the margin rules are likely to be finalized, Freddie Mac has concerns about this proposed implementation schedule to the extent it does not coordinate margin implementation with an orderly transition to clearing.

The Proposal authorizes CSEs to adopt initial margin models that are currently in use by a derivatives clearing organization (DCO) or are licensed to market participants generally, provided the initial margin models satisfy certain authentication standards set forth in the Proposal. The Proposal also suggests an "alternative method" in which the CSE will calculate initial margin for uncleared swaps based on the margin requirements for related cleared products, multiplied by a factor of 2.0 (or 4.4 if the cleared product is a futures contract). The Proposal states that the rationale for allowing non-proprietary models is the belief that proprietary initial margin models are not widespread among CSEs and that the Commission lacks the resources to approve specific models prior to implementation. Implicit in the Commission's discussion is the belief that reliance on non-proprietary models will be much quicker and easier to implement for many CSEs.

While Freddie Mac appreciates that the Commission is seeking to avoid unnecessary burdens on the industry, Freddie Mac does not believe that speed of implementation should be the primary consideration. The proposed implementation should relate closely to the likely timeline for building out capacity for the safe clearing of swaps on a broad basis, given the significantly heightened costs associated with uncleared swaps. The margin model and "alternative method" provisions proposed by the Commission clearly contemplate that initial margin requirements for uncleared swaps will be substantially higher than for cleared swaps. As such, implementation

of margin requirements for uncleared swaps prior to the development of capacity to clear swaps on a broad basis will create very substantial liquidity and funding implications for market participants, will indirectly increase costs for mortgage providers and homeowners, and will have a negative effect on the financial markets. Recent estimates indicate that aggregate initial margin requirements for only one year could total in excess of $2.5 trillion.[4]

In this regard, we note that interest rate swaps are by far the largest segment of the swaps market and that industry efforts are well advanced to establish a robust capacity for customer clearing of such swaps. As such, it is generally expected that interest rate swaps will be the first category of swaps subject to mandatory clearing. Given that work on clearing of interest rate swaps is well advanced and the strong legislative and regulatory preference for clearing as expressed in the Dodd-Frank Act, Freddie Mac believes that an approach to implementation of margin requirements that synchronizes the effective date for mandatory margining of uncleared swaps with the development of a robust clearing capacity for interest rate swaps would be appropriate for balancing the goal of systemic risk reduction with the imperative of avoiding unnecessary shocks to the financial markets. Thus, Freddie Mac encourages the Commission to select an effective date that closely coincides with the development of such robust clearing capacity.

II. Initial Margin Alternative Method

Freddie Mac is concerned about the usability of the "alternative method" for initial margin. As noted above, under the Commission's proposed alternative method, the initial margin for an uncleared swap is determined by reference to the margin imposed on a swap cleared through a DCO "for which the terms and conditions most closely approximate the terms and conditions of the uncleared swap." If no comparable cleared swap can be found, reference can be made to a comparable cleared future. To determine the initial margin requirement applicable to the uncleared swap, the initial margin imposed on the cleared swap is then multiplied by a factor of 2.0 (or a factor of 4.4, if the comparable cleared instrument is a future).

While the "alternative method" may be appropriate for uncleared swaps which closely resemble cleared swaps in structure and kind, Freddie Mac does not believe that the "alternative method" would provide a reasonable approximation of risk for many uncleared swaps. First of all, swaps are complex instruments and risk can be highly sensitive to particular terms. Therefore, swaps can be very similar as to most of their terms and still present very different risk characteristics due to differences in one or more variables. Thus, without referring to precisely the kinds of models that the "alternative method" is supposed to replace, it would not be meaningful or practicable to identify a cleared swap "for which the terms and conditions most closely approximate the terms and conditions of the uncleared swap" in many cases. Even if that were feasible, significant differences would likely remain, and thus the margin imposed by the DCO would be a very poor proxy for the appropriate margin for the uncleared swap.

Any alternative to models-based margin requirements will necessarily establish margin at levels that only roughly correlate to risk. Therefore, we believe that the primary requirement for mitigating negative effects on liquidity and the marketplace is the provision of adequate time to

---

[4] *See* Matt Cameron, *US Margin Proposals Could Lock Down $2 Trillion in Assets,* RISK MAGAZINE (June 2, 2011) (citing an Office of the Comptroller of the Currency estimate on the annual average growth in notional swap amounts).

develop models and provide for clearing. Nevertheless, we also believe that some alternative to models will be necessary for the foreseeable future to cover highly structured and/or bespoke swaps for which no model is readily available.

In this regard, and given that there is no single alternative to models that is likely to provide reasonable results in all cases, Freddie Mac recommends that the Commission expand the alternative options available to CSEs by also providing for a "lookup table" approach similar to that proposed by the Prudential Regulators. For this purpose, the lookup table should include a much wider variety of categories than those provided in the table proposed by the Prudential Regulators in order to handle the various types of swap transactions that would likely be grouped under "interest rate swaps."[5] CSEs and counterparties would be permitted to use this table when they reasonably conclude that cleared swaps do not provide a reasonable reference for modeling the risk of the relevant uncleared swap.

III. Variation Margin

Freddie Mac generally supports the Proposal's provisions regarding daily posting of variation margin. However, we are concerned with the proposed requirement that the parties execute trading documentation setting forth a valuation methodology, which "must be stated with sufficient specificity to allow the counterparty, the Commission, and any applicable Prudential Regulator to calculate the margin requirement independently." Freddie Mac believes that this aspect of the Proposal will be very difficult to implement and will have several adverse and unintended consequences.

In Freddie Mac's experience, while the parties to interest rate swaps endeavor to eliminate subjective elements from valuation computations, eliminating all discretion of the parties to compute valuations both assumes a level of precision which may not be possible and, effectively, may produce a commercially unreasonable result based upon application of a predetermined and unvarying formula. Moreover, Freddie Mac believes such contractual precision, and the elimination of all discretion in valuations, is simply unnecessary.

Currently, when parties to a swap enter into a trade under standard ISDA documentation, the transaction documentation generally establishes which party or parties to the trade will determine the value of the swap for purposes of collecting margin, imposes on that party a duty to act in good faith and in a commercially reasonable manner, and provides mechanisms for non-judicial dispute resolution.[6] Further, ISDA documentation permits parties to a swap to value the transaction "dynamically," meaning that they may adjust their valuation models during the term of the transaction. Although the ability to change a valuation model does give rise to the possibility of valuation disputes, this dynamic approach more significantly allows the parties to

---

[5] In the absence of such changes, we believe that the look-up table approach would suffer from the same flaws as the CFTC's "alternative approach" – the lookup table would be too broad and imprecise to accurately reflect the risk associated with a specific swap transaction and thus the appropriate initial margin to be required. For a detailed discussion of Freddie Mac's view on the need to improve the look-up table approach as proposed by the Prudential Regulators, see our comment letter to the Prudential Regulators' margin proposal dated July 11, 2011.

[6] However, swap counterparties do not ordinarily lose the right to litigate unless they have agreed to binding arbitration, which is unusual.

adjust their valuations in light of changes to market conditions and their understanding of the markets.

Freddie Mac typically uses the 1992 version of the ISDA agreement, which provides for valuations based on the specified valuation agent's estimate of the mid-market quote for replacement transactions.[7] When Freddie Mac's counterparty is the valuation agent, the counterparty provides daily valuations, which we understand are generally derived from the counterparty's internal models. Freddie Mac's practice is to validate these valuations by obtaining and averaging multiple market quotes from leading third-party dealers.[8] In the event of a material disagreement, Freddie Mac retains the contractual right to dispute the relevant valuation through an agreed-upon procedure using additional quotes from third parties. The foregoing methodologies have served Freddie Mac well over the years both for administering the movements of margin for performing counterparties and for calculating the close-out amount for defaulting counterparties.[9] To the extent the Proposal effectively requires the parties to agree on a fixed valuation model established at the initiation of a swap and to maintain that model through the term of the swap, the Proposal is dramatically inconsistent with Freddie Mac's and the industry's current practices.

While the establishment of a fixed and inflexible valuation methodology arguably would eliminate the possibility of subsequent disputes over valuation (and hence disputes over the amount of variation margin required), such a standard would likely result in substantial obstacles to the negotiation and execution of final swap documentation by the counterparties. To begin with, parties would almost certainly use different valuation methodologies in the ordinary course, and each party would likely favor its own methodology over the methodology proposed by the counterparty. Given the enormous complexity of valuation models, negotiating "agreed" models (in reality, compromise models) for each swap would be extremely difficult and time consuming. The difficulty of negotiating a valuation model would likely result in a take-it-or-leave-it approach by CSEs, with swap dealers simply requiring counterparties to adopt the dealer's methodology. End users such as Freddie Mac therefore would face the likelihood of having to "agree" to numerous different valuation models from its swap dealer counterparties, each one of which would likely differ from Freddie Mac's actual valuation of a given swap.

Moreover, valuation models by their nature should not be fixed and unvarying, but rather should be flexible and dynamic. Swap valuations necessarily involve making ongoing judgments about external factors and using inputs and economic assumptions that reflect the best knowledge and technology available at the time of each valuation. As external factors and assumptions change, valuation models must be adjusted. To require parties, at the initiation of a trade, to specify a model to properly value the trade throughout its term is thus to expect the parties to anticipate all potential future market conditions during the term of the trade, and to adhere to existing economic assumptions that may later prove unrealistic. In fact, agreeing to a fixed and

---

[7] The 2002 ISDA version of the agreement affords the parties additional discretion in the calculation of swap valuations.

[8] In some cases it is necessary to interpolate between observed quotes to accurately value a position or to use an internal estimate of expected losses.

[9] Freddie Mac's current swap valuation methodology provides a level of verification and validation assurance that is fully sufficient for both financial and regulatory reporting purposes.

unvarying valuation model will likely result in the use of valuation models that do *not* properly reflect the market's value of the swap over time.

Freddie Mac believes that, for purposes of calculating variation margin, a more adaptive approach is required. Consistent with ISDA practices, trading documentation should specify the general principles for calculating swap valuations and the resulting variation margin, and should designate the party (or agent) responsible for the calculation. The documentation should further provide the counterparty with reasonable dispute rights and for procedures to resolve disputes promptly. Requiring the regulatory reporting of aged disputes above a reasonable materiality threshold can mitigate regulatory concern with unresolved disputes.

IV. Netting of Variation Margin

Freddie Mac believes it is critical that the margin requirements apply only prospectively and are not imposed on previously executed swaps. Any other approach would improperly upset the benefits of freely struck bargains between the parties, would retroactively impose unanticipated and material liquidity requirements on parties to the previously executed swap, and would likely result in significant disruption to the swaps markets and market participants. In this regard, Freddie Mac applauds the Commission's general undertaking to impose margin requirements only with respect to swaps entered into after the effective date of the final regulations.

That being said, Freddie Mac is concerned that the Commission's proposed conditions for netting of variation margin for pre- and post-effective date swaps substantially undermines the otherwise prospective application of the margin regulations. The Proposal would permit a CSE to calculate and net the amount of variation margin required by the counterparty only if the CSE "complies with these variation margin requirements for all uncleared swaps governed by such agreement regardless of whether the uncleared swaps were entered into on or after the effective date." The result is that netting simply would not be permitted between pre-effective date swaps and post-effective date swaps unless the pre-effective date swaps were subjected to the Proposal's variation margin requirements, including the existence of agreed valuation models. The Proposal articulates no specific rationale for this condition.

As discussed above, the Proposal imposes documentation requirements that are not consistent with industry standards, and Freddie Mac believes that few pre-effective date swaps will satisfy the Commission's proposed documentation requirements. Thus, the Proposal would theoretically have the effect of prohibiting the netting of variation margin requirements for *any* pre-effective date swaps unless the CSE and the counterparty engage in the costly and time-consuming exercise of re-documenting pre-effective date swaps.

The inability to net pre-effective date and post-effective date swaps would create an unnecessary liquidity strain on counterparties and would temporarily increase the overall costs of post-effective date swaps until netting could be fully realized across the entire swaps book. Freddie Mac believes that a more appropriate approach would be to allow netting of pre- and post- effective date swaps, provided only that the swaps are subject to a legally enforceable netting agreement.

Moreover, the proposed requirements with respect to pre-effective date swaps appear to be largely unenforceable. Given that variation margin is not subject to a segregation requirement, a party receiving variation margin with respect to one swap could always simply re-post that same collateral as variation margin for another swap. Netting simply achieves the same

economic result. Under the circumstances, Freddie Mac believes that the eminently more reasonable approach is simply to allow netting between pre-effective date and post-effective date swaps.

V. Eligible Collateral

With respect to transactions between a CSE and either a swap dealer, a major swap participant, or a financial entity, the Proposal would limit eligible initial margin to: (1) cash; (2) direct obligations of, or obligations guaranteed as to principal and interest by, the U.S. Government; (3) senior debt obligations of Fannie Mae, Freddie Mac, Farmer Mac, or any Federal Home Loan Bank; and (4) an insured obligation of a Farm Credit System bank.[10] Because the scope of what constitutes "senior debt obligations of" Fannie Mae and Freddie Mac (the "Agencies") is somewhat unclear, it appears Agency MBS may be excluded.

Freddie Mac believes that Agency MBS should be included within the category of eligible collateral. Agency MBS is widely accepted as eligible collateral in the current OTC market, is guaranteed by Fannie Mae and Freddie Mac and is therefore effectively *pari passu* with the Agencies' senior debt obligations.

We also note the significant commitment from the Department of the Treasury (Treasury) to support the Agencies through the Senior Preferred Stock Purchase Agreements entered into between Treasury, Freddie Mac and Fannie Mae (the Purchase Agreements).[11] The support provided by Treasury enables Freddie Mac to maintain access to capital markets and ensures liquidity to facilitate normal business activities. As noted in a letter opinion of the Principal Deputy Assistant Attorney General, the Purchase Agreements create enforceable rights against Treasury for the holders of debt securities referred to therein and beneficiaries of Mortgage Guaranty Obligations issued by the Agencies.[12]

VI. Thresholds

The Proposal would differentiate the amount of permissible threshold based on the nature of the counterparty. With respect to a counterparty that is neither a swap dealer, a major swap participant, nor a financial entity, the Proposal would permit fully discretionary thresholds. With respect to a counterparty that is a financial entity but (i) is subject to prudential capital requirements, (ii) uses swaps predominantly to hedge the risk of its business activities, and (iii) does not have "significant uncleared swaps exposure" as defined by the Proposal, the Proposal would permit limited thresholds (potentially up to the lesser of $45 million or 0.3% of the financial entity's regulatory capital). A zero threshold would be required with respect to a counterparty that is a swap dealer, a major swap participant, or a financial entity that fails to satisfy the preceding requirements. The Commission explains these differing treatments by

---

[10] The Proposal imposes no restrictions on the form of eligible initial margin collateral for transactions between a CSE and a non-financial entity.

[11] *See* U.S. Department of the Treasury press release dated December 24, 2009 at http://www.treas.gov/press/releases/2009122415345924543.htm.

[12] *See* "Enforceability of Certain Agreements Between the Department of the Treasury and Government Sponsored Enterprises," Letter Opinion for the Secretary of the Treasury (September 26, 2008) at http://www.justice.gov/olc/memoranda-opinions.html.

asserting that financial counterparties are more risky than non-financial counterparties because they "are not using swaps to hedge or mitigate commercial risk." With respect to differentiation among financial entities, the Commission appears to have concluded that financial entities with larger swaps books necessarily pose greater risk than other counterparties.

Although Freddie Mac arguably is engaged in activities that are "financial in nature" (as defined by Section 4(k) of the Bank Holding Company Act) and therefore is a "financial entity" as defined in the Proposal, it does not follow that Freddie Mac is using swaps for reasons other than to hedge or mitigate commercial risk, or that Freddie Mac's swaps activities are inherently more risky than those of a non-financial entity. In fact, Freddie Mac enters into interest rate swaps *exclusively* for the commercial purpose of hedging or mitigating the risk of its mortgage loan and mortgage securitization activities, not for investment or speculative purposes. Consequently, we do not believe that Freddie Mac should be treated as if it were engaged in inherently risky activities in that regard.[13]

Similarly, we disagree that credit risk can be assessed by looking at a portion of a counterparty's balance sheet (*e.g.,* its derivatives book) in isolation. A comprehensive approach to assessing the credit risk posed by a given counterparty depends on the totality of the counterparty's balance sheet and activities because any credit assessment is necessarily a detailed and holistic exercise.

Moreover, Freddie Mac does not believe that the practice of allowing moderately sized thresholds to financial counterparties poses meaningful systemic risk. By definition, the potential counterparty exposure presented by the application of a threshold is limited to the threshold amount. As such, a threshold amount is little different than a credit facility, and it is unclear why such facilities should be prohibited in this context. Appropriate policies for the sizing of threshold exposures in light of available capital and for avoiding highly correlated exposures across counterparties should adequately address risk in this context.

In light of the foregoing, Freddie Mac believes that it is unwarranted to impose a zero threshold on a counterparty merely because it is a swap dealer, a major swaps participant, or a financial entity with a swaps book that exceeds arbitrary limits. Determination of an appropriate threshold should reflect the considered judgment of a CSE regarding the acceptable level of counterparty-specific credit exposure in light of the same considerations and analysis that govern credit policies generally.

We also note that the proposed approach to thresholds is not consistent with the rest of the Proposal. In general, the Proposal contemplates an approach to managing credit risk that recognizes that CSEs generally have counterparty-specific risk information that is superior to that of the Commission, and enables CSEs to utilize that superior information through the

---

[13] Nor does engaging in activities that are "financial in nature" make an entity inherently risky. Section 4(k) of the Bank Holding Company Act was enacted by Congress as part of the Gramm-Leach-Bliley Act of 1999 to define the permissible scope of activities for a financial holding company; Section 4(k) was never intended to classify those activities that are inherently risky. Section 4(k) encompasses such mundane activities as financial data processing, tax planning, insurance agency, trust operations, issuing travelers' checks or money orders, real estate appraisal, mutual fund management, and loan processing. It is simply incorrect to presume that engaging in activities captured by Section 4(k) is inherently more risky than, for example, engaging in agricultural, mining, or manufacturing activities.

implementation of relatively flexible, models-based initial margin and valuations approaches. The Proposal therefore encourages CSEs to establish counterparty-specific initial and variation margin methodologies, subject to Commission supervision and oversight. Such an approach is also appropriate for establishing thresholds.

VII. Minimum Transfer Amounts

The Proposal provides that no initial margin (or variation margin) is required to be transferred if the amount of initial margin (or variation margin) otherwise required to be transferred is less than $100,000. No flexibility is afforded to CSEs to establish higher minimum transfer amounts.

Freddie Mac believes that CSEs should be given some ability to establish higher minimum transfer amounts when circumstances warrant. The appropriateness of a given minimum transfer amount is highly dependent on the CSE, the creditworthiness of the counterparty, and the size and volatility of the swap. As with thresholds, the balancing of the credit risk associated with minimum transfer amounts against other considerations (in this case, the operational benefits of avoiding frequent small transfers) is best left to the discretion of the parties, subject to regulatory review and oversight.

VIII. Custodial Arrangements

With respect to custodial arrangements, the Proposal requires that (i) a CSE must offer each counterparty the opportunity to select an independent custodian to hold the counterparty's collateral; (ii) a CSE must hold any collateral received *from* a swap dealer or major swap participant at an independent custodian; and (iii) each CSE that is required to post collateral *to* a counterparty that is a swap dealer or major swap participant must require that the collateral is held at an independent custodian. The Proposal further requires that the independent custodian "shall be located in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the" CSE.

While Freddie Mac appreciates that the apparent objective of this requirement is to provide certainty regarding the CSEs' rights to the collateral in the event of the insolvency of the custodian, the requirement itself is somewhat vague. Moreover, in certain circumstances, the requirement becomes unworkable, as explained below.

First of all, it is unclear exactly how the requirement is to be applied. The Proposal merely requires that the custodian be in a jurisdiction applying the same insolvency regime as would apply to the CSE, but it is not clear whether this requirement applies when the CSE is receiving collateral, posting collateral, or both. If both, such a result would lead to impossible results – for example, when both counterparties are CSEs and are located in two different insolvency jurisdictions, the independent custodian would need to be governed simultaneously by two different insolvency regimes.

Moreover, the phrase, "in a jurisdiction that applies the same insolvency regime to the custodian as would apply to the covered swap entity," is ambiguous. If the phrase is construed literally to require that the exact same insolvency laws must apply to the custodian as to the CSE, the requirement would not be practicable. For example, for the most part, the insolvency of CSEs subject to the Proposal (*i.e.*, swap dealers and major swaps participants that are not prudentially regulated) would be governed by the U.S. Bankruptcy Code, to the extent the CSE is organized under U.S. law. The phrase therefore would appear to prohibit the use of a custodian that is an

FDIC-insured bank – the insolvency of which would be governed instead by the Federal Deposit Insurance Act.

Assuming the phrase was intended to refer simply to custodians located in the same geopolitical jurisdiction as the collateral provider, the standard would still raise significant difficulties in connection with cross-border swap transactions. For example, if a U.S. CSE and a German CSE were to enter into a swap transaction, arguably, *two* custodians would be required – one governed by U.S. law holding the U.S. entity's margin, and the other governed by German law holding the German entity's margin.

The inherent flaw with the Proposal's approach is that it takes an improperly one-sided view of the problem of custody risk. *Both* parties to a swap transaction have exposure to the insolvency of the custodian. For example, as a provider of collateral to an overseas CSE, Freddie Mac would have a compelling interest in understanding the custody risk when dealing with an overseas custodian, particularly as the risk of insolvency of such a custodian might be significantly correlated with the insolvency risk of the CSE counterparty. Indeed, if adopted in its current form, the Proposal could create significant disincentives for Freddie Mac to transact with certain non-U.S. CSEs because Freddie Mac would be legally *obligated* to post its collateral abroad.

Freddie Mac believes that the parties to a swap transaction should have discretion to choose custodians in non-U.S. jurisdictions subject to reasonable diligence as to custody risk including, as necessary, obtaining appropriate legal opinions. Moreover, for swaps subject to U.S. regulation, any custodian located in the U.S. should always satisfy the acceptable insolvency jurisdiction requirement under the margin rules without regard to the location of the CSE.

* * * * *

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

Sincerely,

Lisa M. Ledbetter