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

September 6, 2012

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

Re: Notice of Proposed Rulemaking Regarding Clearing Requirement Determination Under Section 2(h) of the CEA; RIN 3038-AD86

Dear Mr. Stawick:

Freddie Mac is pleased to submit these comments in response to the notice of proposed rulemaking regarding regulations to establish a mandatory clearing requirement for certain classes of credit default swaps and interest rate swaps (IRS), published by the Commodity Futures Trading Commission (the Commission) on August 7, 2012 (the Proposal).[1] The Proposal is issued under Section 2(h) of the Commodity Exchange Act (CEA), added by Section 723 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 currently operates under the direction of the Federal Housing Finance Agency (FHFA) as our Conservator.

Summary and Recommendations

Freddie Mac supports the Commission's goal to reduce systemic risk through central clearing of swaps where appropriate. Freddie Mac uses IRS extensively to hedge large-scale commercial risks in connection with its ongoing activities purchasing and securitizing mortgages in accordance with its statutory mission. As such, it is among the largest U.S. end users in the IRS market. Freddie Mac recognizes the potential benefits of central clearing and, going forward, expects to clear the vast majority of its IRS used to hedge its commercial activities.

The move to mandatory clearing will have a significant impact on Freddie Mac both economically, and in terms of its activities. We very much appreciate the Commission's efforts to establish a safe and robust system for clearing swaps. However, we urge the Commission to recognize that the specific terms of any mandatory clearing determination will have very

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[1] 77 Fed. Reg. 47170.

significant and far reaching economic, risk, and liquidity consequences for market participants. If implemented without due consideration for these consequences, mandatory clearing could, in fact, make the use of swaps for risk management *more costly and less safe* in a variety of ways. With those concerns in mind, we urge the Commission to make the following clarifications to the Proposal.

- **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, and does not void swaps that are submitted for clearing but fail to clear (or require parties to break such swaps). To reduce uncertainty for market participants in cases where swaps fail to clear despite good faith efforts of the parties, the Commission should clarify that it is permissible to maintain such swaps as valid over-the-counter derivatives contracts.

- **Other clarifications**. If the Commission does issue a class-based mandatory clearing determination for IRS, the Commission should clarify by rule or interpretation: (i) the treatment of any swaps that fall within the scope of any class subject to mandatory clearing, but which no derivatives clearing organization (DCO) will actually clear; (ii) that an IRS that varies from a similar clearable IRS in one or more material contract terms is not required to be submitted for clearing, provided that such variation is for legitimate business purposes; (iii) that the Commission would conduct a review and take account of relevant factors specified in Section 2(h)(2)(D)(ii) of the CEA prior to allowing any additional DCO to clear IRS within any class subject to mandatory clearing; and (iv) whether end-users will be subject to a reasonable inquiry or strict liability standard for failing to submit a swap for clearing when it is within scope of a class subject to mandatory clearing.

I. Clarified Status for Good Faith Clearing Failures

The Commission has adopted various rules to develop straight-through processing of swaps in order to enhance certainty that swaps submitted for clearing will be cleared.[2] However, creating the market-wide infrastructure for such processing is an enormous undertaking, and it is not certain that the required infrastructure will be in place fully in accordance with the Commission's timetable for mandatory clearing. Even if such infrastructure were in place, clearing failures inevitably may occur from time to time due to operational or credit issues unrelated to the actions of customers (*e.g.*, credit limits imposed by DCOs on futures commission merchants). Consequently, "fail risk" remains a significant concern, and one that is heightened by the imposition of mandatory clearing requirements. Therefore, Freddie Mac requests that the Commission clarify (in its rules or in an interpretive statement) that when a counterparty of a swap dealer has made a good faith effort to clear a swap within the scope of a mandatory clearing determination and has a reasonable expectation that such swap will be cleared, it is not necessary for the corresponding swap to be terminated in the event that it fails to clear. Instead, the Commission should clarify that the swap that is submitted for clearing – but fails to clear – may be maintained as a bilateral over-the-counter (OTC) swap. Such OTC swaps are still subject to enhanced regulation under the Dodd-Frank Act.

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[2] *See e.g.*, CFTC Regulations §§ 1.72, 1.73, 23.506, and 23.608.

This clarification is necessary because the Dodd-Frank Act requires that certain swaps be submitted for clearing, but (in contrast to the regulation of futures) does not require that such swaps actually clear. 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 statement that swaps must be successfully cleared. By contrast to the regime for futures contracts, a clearing failure does not void a swap under the Dodd-Frank Act, and the statute does not declare an uncleared swap illegal or require the parties to such a swap to terminate the swap. Indeed, Section 739 of the Dodd-Frank Act amends Section 22(A) of the 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 transaction 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 provides the Commission with the ability to impose civil liability on a swap dealer or major swap participant that "knowing 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, Congress indicated that parties to a swap should be deemed in compliance with the mandatory clearing requirement at least where they have submitted a swap for clearing in good faith and have a reasonable expectation of clearing.

Notwithstanding the above, we believe that uncertainty about the legality of uncleared swaps that are subject to a mandatory clearing determination may be used as a basis for executing swap dealers or other market participants to insist on contractual rights to terminate swaps that fail to clear. As the Commission may be aware, the Futures Industry Association (FIA) and International Swaps and Derivatives Association (ISDA) currently are developing a form of "Cleared Derivatives Execution Agreement" purportedly intended to set the industry standard for terms relating to OTC swaps executed with the intent to clear. That document would provide the executing swap dealer with a unilateral option to terminate an OTC swap that fails to clear. In Freddie Mac's view, uncertainty regarding the permissibility of maintaining swaps that fail to clear as valid OTC contracts may be used as a justification for this unilateral option.[3] Indeed, we are aware of at least one major swap dealer that has insisted on characterizing OTC swaps that have been executed with the intent to clear as mere "risk positions" rather than actual swaps. Thus, the lack of legal certainty regarding this issue is effectively creating an uneven playing field in negotiations between swap dealers and their customers regarding the allocation of risk for a clearing failure.

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[3] We note that the imposition of a dealer's unilateral option to terminate an OTC swap that fails to clear directly contravenes certain DCO rules that clearly state that acceptance for clearing constitutes the novation of an existing OTC swap between the relevant counterparties, as well as the optional treatment of such a swap as a bilateral trade under the FIA-ISDA proposed form of standard Execution Agreement. *See e.g.*, CME Rule 8G05.

Unless the Commission clarifies the status of uncleared swaps, end users could face substantial risks and uncertainties, as such users would not be certain of their economic position with respect to a swap until it has been both submitted and accepted for clearing. For entities such as Freddie Mac that use swaps to hedge large commercial risks, even an intra-day period of uncertainty would be unacceptable, as the unexpected termination of a large hedge position could generate substantial losses. Moreover, this risk would largely be outside of the control of Freddie Mac (and buy-side market participants generally) since a swap could fail to clear for a multitude of reasons, many of which are unrelated to the good faith efforts or credit of the end-user.

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 promptly in good faith, it is almost certain that instances of clearing rejections would not rise to a level where the volume of uncleared trades could create systemic risk. 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.[4]

II. Additional Issues for Clarification.

In the event that the Commission does issue a mandatory clearing determination for IRS based on a specified set of classes rather than IRS that are currently cleared, Freddie Mac requests clarification of the following issues:

- **Treatment of swaps that no DCO will clear.** The Commission should provide an explicit statement within § 50.2 to clarify that swaps that are within a class specified by the Commission as being subject to mandatory clearing but that are not available for clearing at a DCO may be executed and maintained on a bilateral basis. As currently written, § 50.2 appears to require all swaps meeting the specifications provided in § 50.4 to be submitted to a DCO for clearing, even when no DCO will clear such a swap.

- **Treatment of swaps that vary for legitimate business purposes.** The discussion in the Proposal of "mechanical" variables, and the discussion of evasion generally, create some ambiguity as to the circumstances in which parties are required to submit IRS for clearing.[5] The Commission should not attempt to pre-judge when a clearable swap may

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[4] We note that the parties to a swap eligible for clearing will likely have a substantial economic incentive to pursue clearing to avoid increased capital and margin requirements for uncleared transactions. Accordingly, swaps that fail to clear can be expected to constitute merely incremental trades in a legal framework that already exists for non-cleared derivatives, and should not unduly alter the ultimate economic risks inherent in the market for cleared and uncleared derivatives.

[5] In footnote 97 of the Proposal, the Commission indicates that parties that wish to enter into a swap that no DCO clears because it has specifications that differ from the contract terms that the DCO provides for cleared swaps are permitted to enter into the swap on an uncleared basis. However, the Commission stipulates that some specifications may be merely "mechanical," rather than necessary for the "economic result the parties are trying to achieve," and that there are may be alternative ways to adjust for these situations. *See* text at 77 FR 47191. This appears to represent a Commission judgment that swaps that differ along "mechanical" terms may be sufficiently close substitutes that parties may be required to use the clearable swap.

be a close substitute for a bilateral swap. Instead, it should clarify that a bilateral IRS that varies from a similar clearable IRS in one or more material contract terms is not required to be submitted for clearing, provided that such variation is for legitimate business purposes.

- **Review of IRS clearing by additional DCOs**. The Commission is proposing a mandatory clearing determination based on classes of IRS, rather than IRS that are actually cleared by the DCOs that made submissions to the Commission (the Current DCOs) in response to its request for information on clearable swaps.[6] Therefore, a question arises as to how the Commission would review a proposal from a different DCO to clear IRS that are within the specifications provided in § 50.4. In particular, it is unclear whether the delegation of authority proposed in § 50.6 would allow the Commission's staff to approve the new DCO to clear the relevant IRS. However, Section 2(h)(D)(ii) of the CEA requires Commission consideration of a number of DCO-specific factors (*e.g.*, legal certainty in insolvency, operational capacity) before making a mandatory clearing determination. Because a proposal by a new DCO to clear IRS that are within scope of proposed § 50.4 but that are not cleared by the Current DCOs would effectively create a new requirement to clear such IRS, the Commission should clarify that it will conduct a further review of the DCO-specific factors enumerated in Section 2(h)(D)(ii) before permitting such an outcome.

- **Standard of Care**. In § 50.2(b), the Commission proposes to create a reasonable inquiry standard requiring persons to make reasonable efforts to ascertain whether a swap is required to be cleared. However, other aspects of the Proposal, and particularly the language of § 50.2(a), indicate that parties may be subject to strict liability for failing to submit a swap for clearing when it is included in the class of swaps identified in § 50.4. The Commission should clarify that parties that meet the reasonable inquiry standard are not liable for failure to clear a swap, or otherwise clarify how the reasonable inquiry standard in § 50.2(b) is intended to interact with the mandatory submission requirement in § 50.2(a).

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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,

Wendell J. Chambliss

Wendell J. Chambliss
Vice President and Deputy General Counsel
Mission, Legislative and Regulatory Affairs Department
Legal Division

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[6] These Current DCOs are: CME Group, the International Derivatives Clearinghouse Group, and LCH.Clearnet Limited. *See* 77 Fed. Reg. 47172, 47186.