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January 18, 2011

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

Re: RIN 3038-AD99 – Advanced Notice of Proposed Rulemaking ("ANPR"), Request for Comments: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies

Dear Mr. Stawick,

Vanguard[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") with our views on possible models for implementing new statutory provisions enacted by the derivatives title ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") concerning the protection of collateral posted by customers with respect to cleared swaps.[2]

As a part of the prudent management of our mutual funds and other portfolios, we enter into derivatives contracts, including swaps, to achieve a number of benefits for our investors including hedging portfolio risk, lowering transaction costs, and achieving more favorable execution compared to traditional investments. Vanguard is fully supportive of the mandate of Title VII to bring much-needed transparency and regulation to the derivatives markets including subjecting derivatives to regulatory oversight and requiring the clearing of standardized swaps.

While the Dodd-Frank Act directs that the approach for cleared swaps shall generally follow the existing futures-based model, one key area for clarification relates to the protections to be afforded to margin posted to secure a customer's obligations with respect to such cleared swaps. We commend the Commission for its efforts to seek input regarding this issue including holding meetings with relevant industry groups, conducting the October 22, 2010 public roundtable on "Individual Customer Collateral Protection" (the "**Collateral Roundtable**")[3] and issuing the ANPR to seek public comment on a number of approaches to protect customer margin.

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1 Vanguard offers more than 170 U.S. mutual funds with total assets of more than $1.5 trillion. We serve approximately 23 million shareholder accounts.

2 For the purposes of this comment letter, "swaps" (as defined at Section 1(a)(47) of the Commodity Exchange Act ("**CEA**")) and "security-based swaps" (as defined at Section 3(a)(68) of the Securities Exchange Act of 1934) shall be referred to collectively "**swaps**".

3 A transcript of the Roundtable is available at: http://www.cftc.gov/lawregulation/DoddFrank/OTC_6_SegBankruptcy.html

Such approaches can be summarized as follows (using the names assigned in the ANPR):

- **"Baseline Model"**: this is equivalent to the ***current futures model*** whereby customer margin is held by the FCM[4] in an omnibus account segregated from an FCM's creditors but available to the DCO to satisfy margin obligations in the event the FCM does not meet the failed margin requirements of another customer ("**fellow customer risk**")[5];

- **"Moving Customers to the Back of the Waterfall"**: this is also the equivalent of the current futures model with client margin subject to fellow customer risk ***only after exhaustion of the DCO's other financial safeguards***;

- **"Legal Segregation with Commingling"**: this is also the equivalent of the current futures model but ***without fellow customer risk***; and

- **"Full Physical Segregation"**: this would differ from the current futures model as customer margin would be ***held in individual customer accounts*** (either at the FCM or with a tri-party custodian) ***without fellow customer risk***.

In addition, the Commission has requested input on whether customers should be able to elect between the approaches when entering into a swaps clearing relationship with an FCM, as well as an assessment of the expected costs associated with a new approach.

In view of the significant differences between the over-the-counter ("**OTC**") swaps and futures markets, and the well-functioning, sophisticated approach that has historically been used with respect to the determination of customer margin and the protection thereof within the OTC swaps market, Vanguard is supportive of the "Legal Segregation with Commingling" approach as providing the best level of customer protection with the lowest likely costs.

Vanguard also recommends that the Commission press those arguing that costs will be excessive to provide evidence of their claims so that the industry can make a more fully formed assessment of the merits of each approach.

In assessing the issues, Vanguard encourages the Commission to consider the following points:

- **The OTC swaps market differs fundamentally from the exchange-traded futures market.** Differences in terms of product scope and risk, and client attributes and trading

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[4] For the purposes of this comment letter, "FCM" refers to a "futures commission merchant" acting with respect to listed futures or options on futures and/or cleared swaps, and "DCO" refers to a "derivatives clearing organization" or clearing house for derivatives.

[5] Generally, the DCO's "waterfall" of financial safeguards applicable upon the default of a member FCM includes, in the following order: (i) the FCM's capital commitment, (ii) margin posted by all of the FCM's clients, (iii) a portion of the DCO's capital, and (iv) the guarantee fund established by all of the DCO's members (i.e., FCMs).

strategies call for a reassessment of the appropriateness of aspects of the futures model for cleared swaps.

- **The OTC swaps market's sophisticated approach to margin provides heightened customer protections against which the approaches for cleared swaps should be assessed**. Given the variety of trade types and customers, margin practices have developed in the OTC swaps markets that are highly sensitive to risks with respect to client quality as well as current and potential trade exposure.

- **The Baseline Model would raise significant additional risks to customers with respect to cleared swaps.** While the Baseline Model effectively serves to insulate customer margin from claims of an insolvent FCM's creditors, each customer bears the risk that a failure of one of its FCM's other customers may cause its FCM to fail and the overall margin pool will be used to satisfy any resulting margin shortfall.

- **Legal Segregation with Commingling is the preferred approach as it provides segregation from FCM creditors without fellow customer risk and minimizes added costs.** The elimination of "fellow customer risk" coupled with a more tailored approach to risk assessment and differentiated margin regime is likely to produce an overall decrease of risk in the system.

- **While optionality may be appropriate with respect to account segregation, optionality should not apply with respect to exposure to fellow customer risk.** Once "loss mutualization" is eliminated, customers may opt for a range of account structures, provided each customer is responsible for the costs associated with the approach it selects.

- **Enhancing customer protection applicable to margin for cleared swaps should not present significantly greater costs compared to those associated with margin protections afforded by the OTC swaps market.** The yardstick is the existing OTC swaps market, and customers are generally comfortable with the costs associated with the heightened customer protection afforded thereby.

Arguments in support of these conclusions are set forth below:

I. The OTC swaps market differs fundamentally from the exchange-traded futures market.

The OTC swaps market has significantly greater breadth and depth than the futures market given the seemingly limitless ability to tailor individual transactions to meet customer needs. While the overall volume of trading in the OTC swaps market greatly exceeds the volume in the futures market, the tremendous diversity in products and trade parameters effectively results in a lower liquidity with respect to individual trade types than is experienced in the futures markets. The lower liquidity, particularly with respect to trades with longer-dated maturities and/or based on more exotic underlying assets, can mean that trade valuation is more complex and volatility can lead to more significant potential exposure.

Likewise, there is a much broader diversity with respect to customers both with respect to customer type and credit quality. Customer types range from commercial end-users looking to hedge specific risks to U.S.-registered investment companies ("**RICs**") with tightly regulated constraints on trading to leveraged funds using OTC swaps to create synthetic portfolios of highly speculative positions.

The added complexities of the OTC swaps market must be considered in assessing the appropriateness of the futures model for cleared swaps.

II. The OTC swaps market's sophisticated approach to margin provides heightened customer protections against which the approaches for cleared swaps should be assessed.

Customer margin for OTC swaps is governed by individually tailored agreements addressing issues related to customer type and credit quality as well as the risks arising from such customer's specific trading portfolio. While highly-rated commercial end-users with a portfolio of trades designed to closely hedge specific risks typically post margin above a credit ratings-based exposure threshold, leveraged funds with highly speculative portfolios are generally required to post margin equal to 100% of such portfolio's market value, together with upfront margin designed to address the potential exposure associated with such positions. In recognition of the highly regulated nature of OTC swaps trading by RICs, margin requirements are generally limited to 100% of portfolio market value.

Generally speaking, customer margin for OTC swaps is held in dealer accounts. Given the benefits of netting afforded by transaction documents and insolvency laws, customers are typically not concerned with the protection of margin, provided such margin values are equal to or less than the net market value of the OTC swaps portfolio with each dealer. Notwithstanding this comfort, given the regulatory constraints on RICs, including the fund custody rules under the Investment Company Act of 1940 (the "**ICA**"), 100% of margin posted by RICs for OTC swaps is held in fully-segregated accounts at a third-party custodian unavailable to dealer creditors in the event of the dealer's insolvency.

When customer margin for OTC swaps is held by the dealer, concerns arise with respect to margin values in excess of the net market value of the OTC swap portfolio with such dealer. In the absence of other protections, upon a dealer insolvency a customer would stand as a general unsecured creditor with respect to its claim for the return of such excess margin. Increasingly, it is becoming market practice for customers to insist that such excess margin (including upfront margin related to potential exposure) be held in a fully-segregated account at a third-party custodian (as is all margin posted by RICs).

Thus, the OTC swaps market has developed highly sophisticated practices to address customer margin. These practices are tailored to the specific risks presented by each individual customer and its trading portfolio and involve a significant investment on behalf of both dealers and customers in terms of trade valuation and potential exposure calculation; margin management involving both individual customer accounts and, in many instances, third party custody arrangements; as well as significant legal analysis and document drafting. The industry has also worked closely with lawmakers over the years to develop carefully crafted laws to clarify the enforceability of close-out netting of exposures related to OTC swaps, including netting with respect to customer margin, to enhance the protection afforded to customers in the OTC swaps market.

In sum, margin for OTC swaps differs greatly between customers based on individual customer type and credit quality and the specific level of risks presented by each customer's trading portfolio. In assessing the approach to be used to address margin for cleared swaps, including considerations as to the costs associated with alternative approaches, Vanguard is of the firm belief that the starting point is the sophisticated tailored approach and significant market investment with respect to customer margin for OTC swaps.

III. The Baseline Model would raise significant additional risks to customers with respect to cleared swaps.

Customer margin for futures is held by the FCM in an omnibus account which is not available to creditors of the FCM in the event of the FCM's insolvency.[6] However, if the FCM's insolvency is caused by the FCM's failure to meet the margin requirements attributed to a customer of such FCM (following such customer's failure to meet its margin requirements), then the pool of customer margin held in the omnibus account can be used by the DCO to satisfy the margin shortfall. Individual customers will receive the pro-rated amount of margin remaining after satisfaction of the margin shortfall related to the defaulting customer, and such risk is referred to as "fellow customer risk" in the ANPR.[7]

Even if customers require FCMs to hold margin for futures in a fully segregated account, the Part 190 Rules require that the customer's recovery cannot be enhanced relative to other customers of the insolvent FCM, thereby rendering ineffective the use of segregated accounts to avoid fellow customer risk. With respect to RICs, prior to the adoption of Rule 17f-6 under the ICA ("**Rule 17f-6**"), FCMs were not permitted to maintain custody of RIC assets and the Commission staff required RICs to maintain their margin in fully segregated accounts with a third party custodian. Without the ability to hold margin for RICs, FCMs needed to advance their own funds to meet the margin obligations owed to the DCO and, therefore, charged a higher price to the RICs to cover the cost to finance such margin transfers. While the adoption of Rule 17f-6 allowed unaffiliated FCMs to hold margin for RICs (and thereby avoid the need to charge the higher price related to margin financing), RICs remain exposed to fellow customer risk.

"Fellow-customer risk" is not a factor in the OTC swaps market and it is unclear how a customer could ever make an assessment of the magnitude of such risk presented by an FCM given the complete absence of transparency with respect to such FCM's other customers and their trading positions. Moreover, the concept of "loss mutualization" across all of an FCM's

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[6] As noted in the ANPR, Section 4d(a)(2) of the CEA provides that customer margin posted to an FCM shall not be commingled with the funds of such FCM or be used to guarantee trades of any customer other than the one for whom the same are held. The new Sections 4d(f)(2) and 4d(f)(6) of the CEA (as added by Section 724 of the Dodd-Frank Act) related to margin for cleared swaps specify similar protections to those provided for customer margin for futures and options on futures.

[7] In the event the liquidation of the FCM is governed by Subchapter IV of Chapter 7 of the Bankruptcy Code ("**Subchapter IV**") and the rules promulgated thereunder by the Commission at 17 CFR § 190 (the "**Part 190 Rules**"), "customer property" would be distributed ratably to the FCM's "customers" on the basis of, and to the extent of, their allowed net equity" claims with respect to each relevant "account class" (each as defined in Subchapter IV and the Part 190 Rules).

customers effectively allows for a less sophisticated analysis of the risk presented by individual customers and their trading portfolios as such individual risk can ultimately be covered by the overall pool of margin posted by all of the FCM's customers. On that basis, the Baseline Model's risk assessment is limited to the collective characteristics of the FCM's many customers, with riskier customers (and trading portfolios) likely to be under margined and safer clients (and trading portfolios) likely to be over margined relative to their actual level of risk presented to the system.

As noted in the Collateral Roundtable, the Baseline Approach is currently used by each of CME and ICE for cleared derivatives and results in lower initial margin levels than would otherwise be required if the risk presented by each customer was fully covered by its own margin.[8] In other words, the ability to address customer risk through "loss mutualization" currently reduces the overall initial margin requirement applicable to derivatives cleared on these platforms. Although the LCH model is presently used intra-dealer, it does not provide for "loss mutualization" to address risk across all customers, and such risk is instead addressed by LCH through the use of higher initial margin levels.

In sum, the Baseline Model is inappropriate for cleared swaps given its collective approach in assessing customer risk. Given the significantly larger volume and more diverse trading in the OTC swaps market, the relative risks between clients would be magnified. As there is no ability to assess fellow customer risk in selecting an FCM, customers would potentially be assuming significantly greater risk if the Baseline Model was applied to cleared swaps.

IV. Legal Segregation with Commingling is the preferred approach as it provides segregation from FCM creditors without fellow customer risk and minimizes added costs.

This hybrid approach would eliminate fellow customer risk and also allow the FCMs to avoid the costs associated with opening and maintaining individual segregated accounts. Customer margin would be held in an omnibus account, but the value of both margin and positions would be tracked by the FCM and reported to the DCO on a daily basis – customer by customer.[9]

Upon the insolvency of the FCM, caused by either a margin fail by an FCM customer or otherwise, the full value of margin held on behalf of each customer would be returned to the solvent customers (or would be used to satisfy such solvent customer's obligations in the event the DCO liquidates all positions maintained by the FCM). While FCM and DCO costs could increase (to track and report the value of margin posted by each customer), the added costs would

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[8] The impact on initial margin levels if the DCO no longer has access to the overall pool of customer margin upon an FCM's customer induced failure is discussed at pages 110 to 142 of the Collateral Roundtable transcript. Representatives of each of the CME Clearinghouse ("**CME**") and ICE Trust ("**ICE**") noted that initial margin rates would increase as present rates are only designed to address 99% of the applicable risk presented by an FCM's customers. Note that the representative of LCH.Clearnet ("**LCH**") explained that its initial margin levels would decrease if LCH had access to the overall pool of customer margin as its approach presently allows for full segregation of customer margin.

[9] An excellent description of the Legal Segregation with Commingling approach is set forth on pages 35 to 41 of the Collateral Roundtable transcript.

not be as significant as might apply with respect to the creation and maintenance of individual, segregated client accounts under the Full Physical Segregation Approach.

As DCOs will no longer have access to the overall margin pool to address individual customer fails, DCOs and FCMs would need to assess customer risk on a more granular basis, potentially resulting in higher initial margin levels for some clients and lower levels for other clients. As noted above, DCOs currently differ in their approaches to margin as to whether or not loss mutualization applies, as well as to the amount of margin subject to loss mutualization (gross margin, net margin or modified gross margin). A consistent mandated approach whereby gross margin is segregated from risk both to the FCM and to its other customers is preferable to allowing varying levels of protection related to varying margin pools and unpredictable customer risk. While DCOs may differ to gain competitive advantages, the level of protection afforded to customer margin should not be subject to competition as there will invariably be a trade-off between price and protection resulting in a "race to the bottom" and overall increased customer risk.

The ANPR also mentions concerns related to a certain "moral hazard" associated with alternative approaches as the FCMs could possibly take on more risky customers knowing that other FCMs will have a greater shared responsibility (given that the overall margin pool is no longer available), or that the FCM could reduce its capital to minimum levels to reduce its liability. In general, Vanguard believes such concerns are overstated, particularly as the opportunities for “moral hazard” are more likely to be decreased given the enhanced DCO oversight of FCMs and their clients and the tighter margin regime required if risk is to be addressed without the use of “loss mutualization”.

Indeed, the inclusion of “loss mutualization” in the existing futures model could be viewed as presenting similar opportunities for such “moral hazard”. An FCM could elect to take on risky customers knowing that the overall customer margin pool is available in the event of a single customer fail. In addition, the FCMs’ ability to grant margin concessions to customers (provided the FCM is prepared to meet the DCO minimum margin requirements for each customer) could also serve to add additional risk.[10] If a legally segregated approach is instituted for cleared swaps, the DCO will be required to have more robust rights to police FCMs with respect to their clients’ risk profiles and trading portfolios as each client’s margin will have greater importance in addressing the risk presented by such client (ahead of access to other DCO financial safeguards).

Vanguard firmly believes that the best approach to address such potential "moral hazard" is for DCOs to eliminate the use of the customer margin pool as a backstop, for FCMs to

[10] In the existing futures model, FCMs can grant customers additional time for margin transfer and can also accept poorer quality margin from customers, in each case on a more liberal basis than required by the DCO. Notwithstanding such concessions, as long as the FCM is able to satisfy the DCO’s actual requirements on behalf of its customers, no impact is apparent. However, should the customer to which such concessions have been granted ultimately default, and either the FCM has not yet received the required margin or there has been a significant decline in the value of any non-conforming margin, such FCM may have a greater challenge in “topping-up” the loss. Such concessions could serve to magnify the risk in the case of the FCM who may not ultimately be able to meet the difference between the DCO required margin and such concessions granted to the defaulting customer.

carefully monitor and report the credit risk related to customers, positions and margin levels and for initial margin requirements to be tailored to address such risks specific to each customer.

While Vanguard supports the Legal Segregation with Commingling approach, certain threshold issues will need to be fully worked out in the rulemaking exercise including:

- **Tracking and reporting of customer identity and trading**: the DCO will need to have a daily report of FCM customer activity so as to allow the assessment of tailored initial margin requirements;

- **DCO monitoring FCM compliance**: the DCO will need to be more actively involved in monitoring the FCM's practices and compliance with requirements;

- **Reporting to Customers**: FCM's must provide daily detailed reports of positions and margin details so that each customer has all the information it needs to recover the accurate value of the posted margin held in the commingled account or to port to a new FCM such margin together with the related positions; and

- **Part 190 Rules**: the rules will need to be amended to eliminate "fellow customer risk" and to confirm that customers have protections with respect to the value of the margin they have transferred to the commingled account.

V. While optionality may be appropriate with respect to account segregation, optionality should not apply with respect to exposure to fellow customer risk.

In assessing the merit of optionality, there needs to be a clear understanding of which aspects of the various proposals can be considered for optional treatment.

In general, Vanguard strongly believes that customers should not have the right to accept "fellow customer risk" regardless of where such risk could be placed in the DCO's waterfall of financial safeguards.

From a practical perspective, if optionality applied to "fellow customer risk", we can envision a situation where more risky customers would opt in to the "loss mutualization" approach and less risky customers would opt out. This would serve to concentrate the risk in the system and it is unclear how a DCO would manage a customer-related FCM failure without access to margin provided by the less risky customers. We expect that such concentrated risk would present the greatest "moral hazard" and FCMs generally would be unwilling to commit capital to support a venture presenting such concentrated risk.

From a structural perspective, it is unclear how a DCO could manage its financial safeguards including FCM capital, DCO capital and the guarantee fund if customers can opt in or out of accepting "fellow customer risk" as the customer margin available for "loss mutualization" would be subject to significant fluctuations.

If optionality is to be provided, it should be limited to whether a customer elects to opt in to the Legal Segregation with Commingling approach, or the Full Physical Segregation approach.

If a customer seeks greater protection than that afforded by the Legal Segregation with Commingling approach, such customer should bear sole responsibility with respect to any added costs.

VI. Enhancing customer protection applicable to margin for cleared swaps should not present significantly greater costs compared to those associated with margin protections afforded by the OTC swaps market.

As noted above, while adoption of the Legal Segregation with Commingling approach is likely to lead to an increase in costs compared to those applicable to the Baseline Model, we believe the appropriate comparison is to the level of costs associated with the OTC swaps market. It may be that the Legal Segregation with Commingling approach is actually more cost effective compared to the OTC swaps market given the use of a commingled account which will avoid the need for the opening and maintenance of individual customer accounts.

A more granular approach to risk assessment and margin calculation (similar to that used in the OTC swaps market) will likely add costs (compared to the Baseline Model) for both the FCM and DCO and lead to greater differentiation in customer initial margin levels, however such an approach is also likely to minimize overall risk to the system given customer margin will more appropriately reflect the actual risks presented by each customer instead of the collective risk presented by all FCM customers.

While Vanguard seeks to fully protect customer margin from the risks presented by both the FCMs and their clients, Legal Segregation with Commingling appears likely to provide such protection more efficiently than would an approach providing for Full Physical Segregation. We expect that the costs of opening and maintaining individual customer margin accounts at both the FCM and DCO levels may prove to be excessive relative to the modest additional customer protections, if any, compared to allowing commingling with effective legal segregation.

Note that our assessment assumes that the Full Physical Segregation approach allows customer margin to be on-posted by the FCM to the DCO, as it is likely that significant added costs may arise if a customer requires the use of a third party custodian to hold the margin and the FCM is required to meet DCO margin requirements without access to customer margin locked up in the tri-party custody account. As the Commission Staff evaluates other market comments supporting Full Physical Segregation, it will be important to determine if such comments merely call for segregated customer accounts at the FCM and DCO level, or if the comment advocates a tri-party relationship which could raise significant added costs to address the lock-up of customer margin.

In the absence of a more fulsome presentation of the anticipated costs associated therewith, Vanguard supports the Legal Segregation with Commingling approach described above as we believe it to conform to Dodd-Frank mandates, to provide full client protection, to allow for risk-appropriate initial margin levels and to most likely avoid the costs associated with establishing and maintaining individual, segregated margin accounts.

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In closing, we thank the Commission for the opportunity to comment in advance of their rulemaking on the segregation model chosen for the protection of cleared swap customers under Title VII and appreciate the Commission's consideration of Vanguard's views. If you have any questions about Vanguard's comments or would like additional information, please contact William Thum, Principal, at (610) 503-9823 or Michael Drayo, Associate Counsel at (610) 669-4294.

Sincerely,

/s/ Gus Sauter

Managing Director
and Chief Investment Officer
Vanguard

/s/ John Hollyer

Principal and Head of Risk Management
and Strategy Analysis
Vanguard

cc: Commodity Futures Trading Commission
The Honorable Gary Gensler
The Honorable Michael Dunn
The Honorable Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott D. O'Malia