P.O. Box 2600
Valley Forge, PA 19482-2600

(610) 669-1000

February 22, 2011

Ms. Elizabeth M. Murphy
Secretary of the Commission
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

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

Via Electronic Submission

Re: RIN 3038-AD06 / RIN 3235–AK65 – Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant"

Dear Ms. Murphy and Mr. Stawick,

Vanguard appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**") and the Securities and Exchange Commission (the "**SEC**" and, together with the CFTC, the "**Commissions**") with our views on the joint Notice of Proposed Rulemaking regarding rules further defining "major swap participant", which the Commissions proposed under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). Vanguard also appreciates having had the opportunity to provide the Commissions with a pre-comment letter on this topic dated September 20, 2010.

Vanguard[1] is a SEC registered adviser with more than $1.5 trillion in assets under management. 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. Throughout the legislative process and debate that preceded the enactment of the Dodd-Frank Act, Vanguard has been supportive of provisions to bring much-needed transparency and regulation to the derivatives markets.

The Commissions' proposed rules further defining "major swap participant"[2] (the "**MSP Rules**") provide specific tests to enable parties to determine if their swap activity rises to a level requiring them to register with one or both of the Commissions and thereby be subject to

---

[1] Vanguard offers more than 170 U.S. mutual funds and serves approximately 23 million shareholder accounts.

[2] *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant", 75 FR 80174 (December 21, 2010) (amending 17 CFR Pts. 1 & 240) (the "**Release**"). Note that for the purposes of this letter, we will use the terms "**swaps**" to refer to both swaps and security-based swaps, and "major swap participant" and "**MSP**" to refer to both major swap participant and major security-based swap participant.

compliance with mandated capital, margin and business conduct standards. As noted in the Release, MSP status targets "entities whose swap or security-based swap activities do not cause them to be dealers, but nonetheless could pose a high degree of risk to the U.S. financial system generally."[3] The Commissions also cited the Senate colloquy noting that the goal of MSP regulation was to "focus on risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and a lack of information about the aggregate size of positions."[4]

While Vanguard appreciates the efforts of the Commissions to craft a test to target a highly select group of swap participants, concerns remain with respect to highly regulated entities such as Vanguard's SEC-registered investment companies ("**RICs**") for which swaps usage had nothing to do with the recent financial crisis. Absent a specific exemption from MSP status, such entities could be forced to perform the proposed complex and cumbersome MSP calculations on a daily basis. Such an effort would only serve to demonstrate the conservative and risk-sensitive use of swaps already mandated by existing regulations for RICs. As such regulations virtually ensure that RIC swap activity will never present a high degree of risk to the U.S. financial system, the Release should be clear in exempting highly-regulated entities such as RICs from MSP status.

In addition, the MSP test should be amended to more specifically focus on an assessment of uncleared, uncollateralized exposure with a clarification that the cumbersome test need only be performed as an entity reaches the threshold of MSP status. We agree with the Commissions' comments that few entities are likely to qualify as MSPs, and therefore it is important that the application of the test does not, in and of itself, create undue costs and burdens on those participants unlikely to qualify.

The discussion below presents Vanguard's recommendations and additional comments on the Commission's proposals.

- **Registered investment companies should receive a full exemption from MSP status given the existing significant level of regulations applicable to their investments, including their investments in derivatives.**

- **Daily assessment of trade portfolios against the MSP parameters should only be required once such portfolios approach the exposure levels targeted by the rules so as to minimize the burden of performing calculations.**

- **The MSP tests should be streamlined to focus more specifically on uncleared, uncollateralized exposure with full credit given for clearing, collateralization and existing assessments of potential exposure.**

---

3 *See* Release at 80, 185.

4 *See* Release at 80, 185, Note 69 citing the dialogue between Senators Hagen and Lincoln at 156 Cong. Rec. S5907 (daily ed. July 15, 2010).

I. **Registered investment companies should receive a full exemption from MSP status given the existing significant level of regulations applicable to their investments, including their investments in derivatives.**

Vanguard agrees with the Commissions' statement that the MSP definitions should not target asset managers or investment advisors and should instead "apply to the entities that actually "maintain" substantial positions in swaps or security-based swaps".[5] We also welcome the request for comment as to whether certain types of entities, including RICs, should be excluded from the MSP definitions "on the grounds that such entities do not present the risks that underpin the major participant definitions and/or to avoid the duplication of existing regulation."[6] On the basis of each of these tests, MSP status is inappropriate as RICs do not present the targeted risks and are already subject to extensive regulations.

As noted in the Release, the MSP tests "use terms – particularly "systemically important", "significantly impact the financial system" or "create substantial counterparty exposure" – that denote a focus on entities that pose a high degree of risk."[7] Although RICs may maintain large swap portfolios, swap exposures are fully collateralized with the parties conducting a daily assessment of risk and making daily collateral transfers to ensure such exposure is fully mitigated. Collateral is posted by both parties to address the actual market risk, however, heightened sensitivities to counterparty risk require the collateral transferred by the RIC be held not directly by the counterparty, but instead by the RIC's custodian in a segregated account. Segregation of collateral, as mandated by regulation, reflects the low relative risk posed by each party given the mandated highly conservative approach to swaps trading required of RICs (as discussed below).

MSP status subjects entities to strict capital and margin requirements, compliance with business conduct standards as well as recordkeeping and recording requirements.[8] Such issues are already addressed in the regulations applicable to RICs and their advisors under the Securities Act of 1933, the Securities and Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisors Act of 1940. RICs are already subject to stringent regulation, address market risk through collateralization and asset segregation, and are subject to tight limitations on the use of leverage. Such existing regulations serve to protect RIC shareholders as well as counterparties to RIC swap transactions and thereby obviate the need to address such risks through redundant regulation as an MSP.

The Dodd-Frank Act serves to establish a number of new safeguards to mitigate risks presented by swaps trading and to which RICs will be subject. In particular, the mandate for the central clearing of standardized swaps will serve to address a number of issues related to counterparty risk. While most swaps trading is not currently centrally cleared, we expect the majority of swaps traded by RICs to be cleared going forward. Such a mandate will add an additional level of protection to a RIC's swap trading above and beyond the existing RIC

---

[5] *See* Release at 80, 201. See also Letter from Gus Sauter, Chief Investment Officer, Vanguard, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A Stawick, Secretary, Commodity Futures Trading Commission, dated September 20, 2010 ("**2010 Vanguard Letter**").

[6] *See* Release at 80, 202-203. Arguments in support of such an exclusion for RICs were also included in the 2010 Vanguard Letter.

[7] *See* Release at 80, 185, note 69.

[8] *See* Section 731 of the Dodd-Frank Act.

regulatory framework and represents a significant contribution by the Dodd-Frank Act toward market stability. With swaps trading by RICs to be either centrally cleared and margined or bilaterally traded and fully collateralized going forward, it is even less likely that such trading could ever pose a level of risk relevant for MSP regulation. Given the relative high level of existing and new regulations applicable to RIC swap trading and the low level of risk achieved thereby, Vanguard believes it completely appropriate to establish a full exemption for RICs from MSP status.

II. Daily assessment of trade portfolios against the MSP parameters should only be required once such portfolios approach the exposure levels targeted by the rules so as to minimize the burden of performing calculations.

Subject to the recommended clarifications to the proposed tests outlined below, Vanguard agrees that the determination for MSP status should focus on both current outward and potential future exposure. Likewise, we are comfortable that the exposure levels specified in the Release will serve as a useful indicator of a swaps portfolio which could pose a high degree of risk to the U.S. financial system generally.

Notwithstanding such agreement, and on the basis of having applied the proposed tests to an actual swaps portfolio traded by a Vanguard RIC, it is clear that the burden of performing such tests is unwarranted when they will clearly yield a negative result. While we firmly believe that highly regulated entities such as RICs should be completely exempt from MSP status, we have also concluded that unless the level of an entity's swap trading approaches the proposed threshold, performing such tests on a daily basis is not appropriate.

We expect that for a large part of the industry which regularly trades swaps on a fully collateralized basis using market standard master netting agreements, test results will never approach the MSP thresholds. Once standardized swaps are mandated to be centrally cleared, it is even less likely that most market participants could reach the specified uncleared, uncollateralized levels.

In reviewing the Release, we were gratified to see that the Commissions are also sensitive to this dynamic. With respect to the calculation of potential future exposure, we note the Commissions' observation that "we do not believe that an entity would need to calculate its potential future exposure for the purposes of the test unless the entity has large notional positions."[9]

This sentiment is expressed more broadly in the discussion of the costs associated with assessing whether an entity qualifies as either a major swap participant or a major security-based swap participant ("**MSBP**"). For MSPs, the CFTC notes that "because the quantitative thresholds are high, only a very few market participants would have to conduct a detailed analysis to determine whether they are encompassed by the proposed definition."[10] For MSBPs, the SEC is even more specific noting "we estimate that no more than 10 entities that are not otherwise security-based swap dealers would have either uncollateralized market-to-market positions or a combination of uncollateralized current exposure and potential future exposure of a magnitude

[9] *See* Release at 80, 193

[10] *See* Release at 80, 204.

that may rise close enough to the levels of our proposed thresholds to necessitate monitoring to determine whether they meet these thresholds."[11]

We agree with the Commissions' views, both as to the limited number of entities expected to meet the thresholds and that such thresholds are set at the appropriate level of risk for Commission regulation. That being said, we believe that the Release should directly state that unless swap activity nears the mandated thresholds, performance of daily calculations will not be required for the purposes of the test. We recommend that the Commissions include a rule to clarify such responsibility on the following basis:

A. unless an entity has a swaps portfolio with a gross notional amount in an individual major swaps category (or in aggregate across relevant categories) equal to or greater than the applicable exposure threshold for such category[12], such entity need not perform the calculations to determine MSP status with respect to such category (the "**Gross Notional Test**"); and

B. once such entity's swaps portfolio has a gross notional amount at least equal to the applicable threshold for the applicable category, it need only perform the calculations on a month-end basis until such time as the calculations yield a result equal to or greater than 50% of the applicable threshold, at which time such calculations must be performed on a daily basis (the "**Monthly Performance Test**").

We believe the Gross Notional Test is compelling as on even a worst case basis, an entity will not have exposures close to the threshold if the aggregate notional amounts of all of its trades in a major swap category (or across relevant categories) are less than the applicable MSP exposure threshold. Likewise, the daily performance of such tests is unwarranted if they yield a consistently low result. While we have recommended a 50% exposure level, we would also be comfortable with a higher threshold for daily computations.

Especially as the Commissions quite rightly expect that MSP status is unlikely to apply to more than a dozen or so entities, it is especially compelling to clearly specify the basis upon which the overwhelming majority of the market need perform such complex, burdensome and costly calculations.

III. The MSP tests should be streamlined to focus more specifically on uncleared, uncollateralized exposure with full credit given for clearing, margin and existing assessments of potential exposure.

In addition to our recommendations as to an exemption for RICs and limits on the need to perform the MSP calculations, we believe that the Commissions should take steps to more clearly reflect the targeted risk – namely uncleared, uncollateralized exposure. Having performed the

[11] *See* Release at 80, 207 – 208.

[12] For these purposes, we recommend using the thresholds for daily average aggregate uncollateralized outward exposure plus daily average aggregate potential outward exposure applicable to the second test for "substantial position" of USD6bn for rate swaps and USD2bn for each other category, as well as the test for "substantial counterparty exposure" of USD8bn across all swaps categories and USD4bn across all security-based swaps categories.

test on both a mock and actual swaps portfolio, we have identified the following areas for which we recommend further clarification:

A. <u>Current Uncollateralized Exposure ("CUE") Calculations:</u> The focus for this test must be uncleared, uncollateralized exposure. While full recognition is given to the benefits of netting in accordance with a master netting agreement, the Release must more clearly explain the impact of overnight risk, minimum collateral transfer amounts and collateral thresholds.

1. **<u>Impact of Netting</u>**:

   a. <u>Clarify that net in-the-money portfolios are excluded from the calculation</u>. Such portfolios present no current outward exposure and should be ignored in the calculations.[13] Notwithstanding this, the Release notes that collateral thresholds (effectively the exposure level above which collateral must be transferred) must be considered regardless of the actual exposure.[14] This portfolio profile illustrates the potential confusion with the approach regarding collateral thresholds which should be irrelevant if positions are net in-the-money. For this reason, we recommend that rather than target thresholds regardless of exposures, the rule should instead focus on uncollateralized exposure from whatever cause.

   b. <u>Clarify that fully collateralized net out-of-the-money positions are excluded from the calculation</u>: Again, the issue is whether exposures are covered and the threshold should not matter if the exposure is collateralized. Full collateralization of net out-of-the-money positions should be recognized by the test regardless of the size of the threshold, provided there is excess collateral of sufficient quantity to at least equal the net out-of-the-money position.

2. **<u>Cleared Trades</u>**: We recommend that the Commissions clarify that cleared trades are excluded from the analysis. Although the Commissions state in the Release that cleared positions are effectively excluded for the purposes of the current outward exposure test,[15] language should be added to the MSP Rule to specify the exclusion of cleared trades. Such an approach will also serve to encourage central clearing to reduce the likelihood of achieving MSP status.

3. **<u>Allocation of Under-Collateralization</u>**: In performing the calculations for aggregate uncollateralized outward exposure for each swap dealer we note the MSP Rules provide no guidance on the appropriate approach to allocate the collateral shortfall to specific swap categories with net out-of-the-money exposures. While the Commissions included a helpful formula in a footnote to the Release[16], we recommend that the formula is included directly in MSP Rules to minimize the possibility for confusion. Moreover, we also believe this formula should be included in the section addressing umbrella agreements covering more than one master netting

[13] *See* CEA rule 1.3(sss)(2)(iii) and Exchange Act rule 3a67-3(b)(3)(A).
[14] *See* CEA rule 1.3(sss)(3)(iii)(b) and Exchange Act rule 3a67-3(c)(3)(ii).
[15] *See* Release at 80, 189 at note 92.
[16] *See* Release at 80, 190 at note 102.

agreement. The Commissions state that netting of exposures between two parties across swaps, securities lending, securities margin lending, and repurchase agreements is permissible to the extent permitted by the applicable master netting agreement. This formula could first be applied to allocate the collateral shortfall among individual master netting agreements where the net exposure for such master netting agreement is out-of-the-money. Once the collateral shortfall is allocated to the relevant master netting agreements, the formula can be applied again to perform the allocation to the appropriate swap category.

4. **Overnight Risk**: We recommend that the Commissions clarify that the analysis excludes exposure during standard market collateral transfer periods. While the Commissions state in a footnote that overnight risk (effectively the uncollateralized exposure accruing between the time exposures are calculated and the time collateral is transferred) is not relevant, such treatment should be specified in the MSP Rule.

5. **Minimum Collateral Transfer Amounts ("MTAs")**: We recommend that the Commissions reconsider the existing language that if the MTA is in excess of USD1mm, then "the entirety of the minimum transfer amount shall be added to the person's aggregate uncollateralized outward exposure."[17] The language is unclear in that it is located in the section related to potential outward exposure and that it suggests that an MTA of greater than USD1mm must be included in the exposure calculations notwithstanding the actual amount of under-collateralization or even that the trades are net in-the-money. We recommend that the Commissions clarify that MTAs are only relevant in assessing de minimis collateral shortfalls equal to or less than USD1mm per master netting agreement. The MSP Rule should be clarified to state that for all purposes, if the uncollateralized net exposure is less than the MTA, and such MTA is equal to or less than USD1mm for the relevant master netting agreement, then the net exposure under such master netting agreement should be considered fully collateralized for the purposes of the MSP test.

6. **Thresholds**: As noted above, references to the treatment of collateral thresholds are potentially confusing and should be unnecessary for the purposes of a test targeting uncleared, uncollateralized exposure. Under-collateralization can arise from a number of situations, only one of which could relate to the impact of a collateral threshold. If, notwithstanding such a threshold, the exposure is net in-the-money, or the net out-of-the-money exposure is fully collateralized, the existence of a threshold should be ignored for the purposes of the test.

B. **Potential Future Exposure ("PFE") Calculations**: It is this test with which we have the most concerns. While we recognize that PFE is a relevant measure for the purposes of the MSP test, we believe that it should target position volatility over the shortest period between the occurrence of an event of default and the time the non-defaulting party can close out positions and liquidate and apply the collateral.

1. **Potential Future Exposure**: The Commissions state that PFE is meant to address "an estimate of how much the value of a swap or security-based swap might change

[17] *See* CEA rule 1.3(sss)(3)(ii)(B) and Exchange Act rule 3a67-3(c)(3)(ii).

against an entity over the remaining life of the contract."[18] We believe this focus is misdirected as the volatility of a position could be extremely high if applied to its remaining life. The more appropriate measure would target a much shorter period as the non-defaulting party would naturally aim to avoid such extreme volatility by closing out trades as soon as practicable following a default. For this reason, we believe the preferred approach should be the potential position volatility for the shortest period within which a non-defaulting party can close out trades, liquidate collateral and apply proceeds to exposures.

2. **Recognition of Independent Amounts**: The Commissions acknowledge the lack of granularity in the tests specified in the Release, with the PFE for some positions expected to be overstated while that for other positions expected to be understated. We agree with the Commissions' expressed rationale in seeking to use such a generic test[19] on the basis of cost effectiveness, however, the Commissions should give full credit to more granular approaches if actually applied in specific trading relationships. Where swap dealers are most sensitive to counterparty risk, they presently employ a highly granular PFE analysis and collect initial margin ("**Independent Amounts**" as defined in the ISDA Credit Support Annex) to address position volatility. While we agree that it would be counterproductive to attempt to reconstruct such an approach within the MSP Rules, we believe that the Commissions should give full credit both to such existing PFE calculations as well as to the collateral transferred in the form of Independent Amounts. Only where such an approach is not currently applied should the Commissions' more generic conversion factors be used, and an entity should also be given full credit against such generic calculation for the value of excess collateral (collateral in excess of current exposure) held by or on behalf of the swap dealer.

3. **Categories for PFE Factors**: We recommend that the Commissions clarify how these categories relate to the major swap / security-based swap categories. There are 9 PFE categories with conversion factors across swaps and security-based swaps; however there are only 6 major swap and security-based swap categories for MSP testing and reporting purposes. The Commissions should clarify exactly how the 9 PFE factors map back to the 6 major categories to avoid potential confusion.

4. **Calculations of PFE:** We have a number of issues / questions with respect to the proposed test and formula:

    a. Effective Notional: The references to "effective notional" are confusing and must be clarified in the final rule. While it may be possible to manipulate the notional amount of a trade to modify the outcome of the MSP test, we believe

[18] *See* Release at 80, 188.

[19] *See* Release at 80, 192 where the Commissions state "this proposal seeks to use a test that can be implemented by a range of market participants, and that can be expected to lead to reproducible results across market participants with identical swap or security-based swap portfolios, rather than relying on alternative tests (e.g., value at risk measures or stress testing methodologies) that may be costly for market participants to implement and that would not be expected to lead to reproducible results across participants."

such an approach would be both counterproductive to overall trading objectives and would run afoul of anti-avoidance regulations. That being said, it is possible that notional amounts could effectively be overstated with respect to multiple short-duration trades. If this situation is to be addressed in the MSP Rules (and not merely be left as a clean-up exercise between the trade parties), then it should be addressed with specificity.

b. PNet (PNet = (0.4 * PGross) + (0.6 * NGR * PGross)): We'd appreciate further guidance from the Commissions as to the rationale behind this formula. While we agree that a discount is appropriate with respect to the existence of a bilateral netting agreement, we don't understand how the Commissions arrived at this formula. With a better understanding of its source, we would be better able to provide meaningful feedback.

c. NGR: The Release states this is a ratio between the net current exposure and the gross current exposure. For positions in a specific category with a specific dealer we can understand how to calculate net current exposure, however we are wondering if gross current exposure is meant to be the sum of the absolute value of the exposures related to all positions in such category with such dealer. Alternatively, it could be the sum of the out-of-the-money positions without subtracting any amount related to the in-the-money positions. In any event, this needs to be clarified for assessment and comment.

d. Exclusions and adjustments: While we agree that in calculating PFE, positions where an entity has no further payment obligations should be excluded, we do not understand why PFE applies to a buyer of a credit default swap. Notwithstanding the cap on PFE set at the net present value of unpaid premiums, we believe the volatility associated with the payment of such premiums to be negligible (especially when compared to the value of the seller's performance) and therefore recommend that bought credit default swaps be excluded from the analysis.

5. **Discount for "Daily Mark to Market":** While we agree that an 80% discount is appropriate if the parties have a master netting agreement that provides for full collateralization of current outward exposure, as noted previously a 100% credit should apply with respect to positions for which potential exposure is being assessed and collateralized and with respect to any excess collateral held by or on behalf of the swap dealer (whether or not purposely held to address PFE). Such an approach would not only recognize existing market practice with respect to certain entity types, but also encourage such risk to be so addressed where appropriate.

6. **Discount for Clearing**: To encourage clearing and recognize that clearing houses assess potential exposure on a granular basis, cleared trades should be excluded from the analysis (and not simply receive an 80% discount). While we agree that clearing houses do not set initial margin levels to address potential risk for the remaining life of the trade, such risk is addressed for the appropriate period necessary to either liquidate positions or transfer them to another clearing member.

For the above reasons, we ask the Commissions to implement an exemption for RICs from MSP status, to confirm that MSP calculations need not be performed until an entity approaches the relevant thresholds and to add clarity to the proposed tests to more appropriately reflect risk and to give credit to entities to the fullest extent with respect to their netting, collateralization and clearing practices.

* * *

In closing, we thank the Commission for the opportunity to comment on the Swap Reporting Rules 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

Securities and Exchange Commission
The Honorable Mary L. Shapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A Aguilar
The Honorable Troy A Parades