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April 12, 2011

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-AD30 – Proposed Rules: Commodity Pool Operators and Commodity Trading Advisers: Amendments to Compliance Obligations

Dear Mr. Stawick:

Vanguard[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**") with our views on its proposal to modify its rules that exclude registered investment companies ("**RICs**") (e.g., mutual funds) from the definition of commodity pool operator ("**CPO**").

Vanguard is a Securities and Exchange Commission ("**SEC**") registered investment adviser with more than $1.6 trillion in assets under management. As a part of the prudent management of our mutual funds and other portfolios, we enter into over-the-counter derivatives contracts, such as swaps, including foreign exchange swaps and forwards (collectively, "**swaps**"), and exchange-traded futures and options (collectively, "**futures**") 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.

The CFTC has proposed to modify Rule 4.5, which permits RICs to claim an exclusion from requirements for registration as a CPO.[2] As noted in the Release, "the [CFTC] believes that it is necessary to rescind or modify several of its exemptions and exclusions to more effectively oversee its market participants and manage the risks that such participants pose to the markets."[3]

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[1] Vanguard offers more than 170 U.S. mutual funds and serves approximately 9 million shareholders.

[2] *See* Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 FR 7976 (February 11, 2011) (the "**Release**").

[3] *See* Release at 5.

In our view, the proposed changes to Rule 4.5 are neither specifically mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") nor are they necessary for the protection of the public interest or investors as RICs are already highly regulated investment vehicles subject to registration with, and oversight by, the SEC. Such modifications will either unduly limit a RIC's already well-regulated use of futures and swaps or require RICs to register with the CFTC as CPOs, which will be costly, and will subject them to, in some cases, redundant and inconsistent regulations without commensurate benefits.

If changes to Rule 4.5 are made, we believe that rather than requiring RICs to register with the CFTC as CPOs, the appropriate approach should be to instead require enhanced SEC-administered public disclosure of such RIC's trading and investment activity. Moreover, given the absence of market experience with respect to initial margin levels for each of cleared and uncleared swaps, we believe that the Rule 4.5 criteria should be clarified to exclude consideration of swaps and instead maintain the historic product focus relating to the well-understood initial margin levels associated with exchange-traded futures and options.

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

- **The existing Rule 4.5 exclusion for highly regulated RICs should be retained as CPO registration with the CFTC will subject shareholders in such funds to significant additional costs above those associated with existing SEC registration and oversight regulations.**
- **If modifications to Rule 4.5 are made, a RIC's trading in excess of applicable thresholds or marketing with respect to investments in swaps or futures should result in enhanced SEC-administered public disclosure rather than regulation by the CFTC as a CPO.**
- **The Rule 4.5 thresholds should be clarified to exclude consideration of swaps given the absence of experience with initial margin for cleared and uncleared swaps.**
- **Swaps and futures activity used to reduce RIC risk should not be included in the trading condition initial margin test.**
- **The proposed marketing condition is overly broad and should be eliminated or substantially narrowed.**

Arguments in support of each of these recommendations are set forth below.

I. Rule 4.5 Background

Under the proposed modifications to Rule 4.5, a RIC may only claim an exclusion from the requirement to register as a CPO if, among other things, it represents that it:

A. uses commodity futures, commodity options and/or swaps[4] (1) solely for bona fide hedging purposes,[5] or (2) if used for other purposes, the total initial margin and premiums required to establish such positions, which may be held by the qualifying entity only do not exceed 5% of the RIC's liquidation value (after accounting for unrealized profits and losses on such contracts) (the "**Trading Condition**"), and

B. will not market the RIC to the public as a commodity pool or as a vehicle for trading in (or otherwise seeking investment exposure to) commodity futures, commodity options or swaps markets (the "**Marketing Condition**" and together with the Trading Condition, the "**4.5 Conditions**").[6]

The proposed amendments to Rule 4.5 stem from concerns asserted by the National Futures Association (the "**NFA**") in a petition (the "**NFA Petition**") [7] to the CFTC requesting amendments to Rule 4.5 to "stop the practice of registered investment companies offering futures-only investment products[8] without CFTC oversight."[9] In response to the NFA Petition, the CFTC is proposing to amend Rule 4.5 to reinstate and expand the pre-2003 operating criteria consistent with language proposed by the NFA in its petition. The CFTC asserted that it "believes that imposing such restrictions would limit the possibility of entities engaging in regulatory arbitrage whereby operators of otherwise regulated entities that have significant holdings in [swaps or futures] would avoid registration and compliance obligations under the CFTC's regulations."[10]

Since 2003, RICs have been able to claim the Rule 4.5 exclusion from CPO status without having to comply with CFTC imposed limitations on their futures or swaps trading or restrictions on how the RIC is marketed. Prior to 2003, RICs were required to comply with a condition similar to, but less restrictive than, the proposed Trading Condition. The previous condition was less restrictive, in part, because it was limited to consideration of initial margin

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4 Section 721 of the Dodd-Frank Act defines foreign exchange swaps and foreign exchange forwards ("**FX Transactions**") as swaps. However, the United States Department of the Treasury (the "**Treasury Department**") is permitted to make a written determination that either foreign exchange swaps or foreign exchange forwards or both should not be regulated as swaps under the Dodd-Frank Act. As of the date of this letter, the Treasury Department has not made any determination respecting FX Transactions; thus FX Transactions are considered to be swaps. To that end, for purposes of this letter, references to swaps include FX Transactions.

5 "Bona fide hedging" is defined in CFTC Rule 1.3(z)(1).

6 Given that RICs enter into both swaps and "security-based swaps", we believe that it would be appropriate for the CFTC to confirm that it does not consider "security-based swaps" to be within its regulatory purview when assessing CPO status and applying the Rule 4.5 Conditions. We note that "security-based swaps" are defined in Section 3(a)(68) of the Securities Exchange Act of 1934 and pursuant to the Dodd-Frank Act, the SEC has jurisdiction over securities-based swaps.

7 *See* NFA Petition to amend Rule 4.5, dated August 18, 2010.

8 According to the NFA Petition, "[t]hese mutual funds are marketed to customers, including retail investors, as commodity futures investments and are indirectly invested substantially in derivatives and futures products." Moreover, "although these funds are structured differently than public commodity pools and conduct the futures trading through a subsidiary for tax and mutual fund regulatory purposes their aim is the same – targeting retail investors . . . who want exposure to actively managed futures strategies." NFA Petition at 2.

9 *See* Release at 32.

10 *Id.*

levels related to futures and did not consider such levels related to swaps. The marketing condition in place prior to 2003 focused exclusively on marketing as a commodity pool or a vehicle for trading in futures and did not require RICs to represent that they will not be marketed as "otherwise seeking investment exposure to" swaps or futures.

II. The existing Rule 4.5 exclusion for highly regulated RICs should be retained as CPO registration with the CFTC will subject fund shareholders to significant additional costs above those associated with existing SEC registration and oversight.

A. CFTC CPO registration will add significant shareholder costs.

Any additional regulation of RICs by the CFTC is highly unlikely to further investor protection or protect the public interest in any material way. Instead, such new regulation will either limit a RIC's flexibility in utilizing swaps or futures to achieve its shareholder-disclosed and SEC-regulated investment objectives or become subject to CFTC regulation. Subjecting RICs to CFTC regulation will entail significant costs and additional regulatory burdens, including increased compliance and related personnel costs (to be borne by RIC shareholders), without any apparent additional benefit to such RICs, their shareholders or the public. For these reasons, we urge the CFTC not to make any changes to the Rule 4.5 exclusion for RICs.

B. Existing regulations adequately target investor protections.

RICs operate in a highly regulated industry and are subject to comprehensive regulation by the SEC. They are subject to rules and regulations adopted under multiple federal statutes including the Investment Company Act of 1940 (the "**Investment Company Act**"). Investment advisers to RICs are also highly regulated under the Investment Advisers Act of 1940 (collectively, with the Investment Company Act, the "**Acts**"). The fundamental tenet of the Acts is investor protection and the rules adopted under the Acts provide significant and robust protections to investors. The Acts also provide a mechanism for oversight of RICs and their investment advisers by the SEC through the inspection process.

Under the Investment Company Act, RICs are subject to, among other things, strict limitations on their ability to use leverage; restrictions on their ability to make fundamental changes without a shareholder vote; recordkeeping requirements; conflicts of interest/affiliated transaction rules; anti-fraud and anti-pyramiding rules; rules mandating that RIC assets be held with a qualified custodian; as well as corporate governance requirements.

Importantly, RICs are required to prepare, maintain and annually update a registration statement.[11] The purpose of the registration statement is to provide shareholders and prospective investors with all material information (e.g., the RIC's investments, strategies, risks, fees as well as past performance) that they need to know to assist them in making an investment decision. RICs are also required to issue shareholder reports on a semi-annual basis, which provide detailed information about the RIC and its performance over the applicable reporting period.

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[11] The registration statement must be prepared in accordance with the appropriate SEC-prescribed form (e.g., Form N-1A in the case of open-end funds; Form N-2 in the case of closed-end funds).

C. Regulating RICs as CPOs will subject them to redundant and inconsistent rules.

If RICs are required to register as CPOs they will be subject to rules that are redundant and inconsistent with certain rules already applicable to them. Similar to RICs, CPOs are subject, among other things, to: recordkeeping requirements; disclosure document preparation requirements (including fee, risk, litigation and performance disclosures); account statement and disclosure document delivery requirements; requirements to prepare audited financial statements; and rules prohibiting commingling of assets. Like SEC rules applicable to RICs and their advisers, we believe that CPO rules are aimed at investor protection.

While certain rules applicable to CPOs are comparable to rules already applicable to RICs (e.g., rules requiring the offering documents to describe the investment program, risks of the fund and fees), others are inconsistent. For example, rules applicable to CPOs require, in certain circumstances, the inclusion of past performance of other pools operated by the CPO (and by the trading manager if the offered pool has a trading manager) in the offering document,[12] whereas SEC rules generally prohibit such past performance disclosures. Moreover, CPOs are generally required to provide monthly account statements to shareholders,[13] while RICs must provide shareholder reports on a semi-annual basis and typically provide account statements on at least a quarterly basis. Absent harmonization, it would be difficult and costly for RICs to comply with both current CFTC and SEC rules.

Taken together, existing regulations applicable to RICs effectively protect their shareholders as well as the public regardless of the types of investments made by the RIC, whether in securities or – to the extent permitted – in swaps and futures. Such regulations obviate the need to subject RICs desiring to use swaps and futures to redundant or inconsistent regulation by the CFTC.

III. If modifications to Rule 4.5 are made, a RIC's trading in excess of applicable thresholds or marketing with respect to investments in swaps or futures should result in enhanced SEC-administered public disclosure rather than regulation by the CFTC as a CPO.

A. Substantial majority of RICs engage in limited trading in swaps or futures.

As noted in the NFA Petition, only a handful of "futures-only" RICs have raised the concern of the NFA and CFTC. The NFA Petition asserts that certain "futures-only" RIC prospectuses failed to include important information[14] that would otherwise be required by the CFTC's rules for CPOs.

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12 *See* CFTC Rule 4.25.

13 *See* CFTC Rule 4.22.

14 According to the NFA Petition at 3, "[a]mong other things, the ["futures only" RIC] prospectuses do not include detailed information about the fund's futures commission merchants and potential conflicts of interest, and performance information for the fund . . . or other funds operated by the investment adviser.

B. Additional SEC-administered disclosure is a more measured, cost-effective approach to address heightened trading in swaps or futures.

Rather than mandate CFTC CPO registration where RIC trading or marketing meets prescribed conditions, heightened investor protection concerns can be effectively and efficiently addressed by the CFTC working with the SEC to craft enhanced SEC-administered disclosure rules applicable to RICs unable to comply with the 4.5 Conditions (e.g., futures-only RICs).[15] Under this approach, RICs would be subject to the 4.5 Conditions (modified as we propose below), and if such trading or marketing conditions cannot be met, the relevant RICs would be required to make additional public registration statement disclosures as to their futures and swap market activities. These additional disclosures are intended to address the deficiencies of the futures-only fund prospectuses as noted in the NFA Petition.

While we believe that RIC shareholders are adequately protected by the existing regulatory framework, such enhanced SEC-administered disclosure rules can achieve the goals of providing shareholders with additional information while avoiding the significant costs and potential redundant and inconsistent regulations CFTC CPO registration would inevitably raise. Under our approach, the SEC would maintain oversight of RICs, vehicles that it has primary expertise overseeing whereas the CFTC would continue to have oversight of the instruments that it has expertise overseeing (e.g., futures). It would be efficient and economical for the SEC to consider the enhanced disclosures that we recommend in this comment letter concurrently with any other enhanced swaps- and futures-related disclosure rulemaking.[16]

C. If CPO registration is mandated, the CFTC and SEC must first establish harmonized rules to avoid inconsistent compliance mandates relating to RIC trading and marketing activities.

If the proposed changes to Rule 4.5 are finalized, we recommend that before implementation and any requirement for RICs to register as a CPO, the CFTC jointly undertake an initiative with the SEC to harmonize their respective rules so those applicable upon CPO registration are not inconsistent with the SEC rules applicable to RICs.[17]

IV. The Rule 4.5 thresholds should be clarified to exclude consideration of swaps given the absence of experience with initial margin for cleared and uncleared swaps.

Additionally, to the extent the funds' prospectuses state that the fund and/or subsidiary will invest in other actively managed futures trading programs, the prospectuses provide little information about these managed futures trading programs, these programs' fee structures, and past performance results of their trading managers."

[15] We note that CFTC and SEC disclosure rules would need to be harmonized in certain areas (e.g., prior performance disclosures).

[16] We note that the American Bar Association's Task Force on Investment Company Use of Derivatives and Leverage has recommended that the SEC mandate enhanced derivatives related disclosures for funds. *See* Report of the American Bar Association Task Force on Investment Company Use of Derivatives and Leverage dated July 6, 2010.

[17] *See* Section II.C above.

A. Initial margin levels related to swaps should not be considered in the Trading Condition.

It is premature to consider initial margin levels related to swaps in the Trading Condition. With respect to the existing bilateral over-the-counter swaps market, RIC trading practices have developed significantly since the 2003 amendments to Rule 4.5. Even so, most RICs that enter into swaps on a bilateral basis with dealers are not required to post initial margin. Among the reasons for such treatment is that the type of swaps entered into by well-regulated RICs tend to present moderate levels of volatility. In addition, given the heightened regulations for RICs particularly with respect to limitations on transactions involving leverage, dealers have few concerns of a RIC default. Absent a history of initial margin levels for RIC swaps, it is presently difficult, if not impossible, to predict initial margin levels for swaps that may be required in the uncleared market going forward.

The cleared swaps market to which RIC swaps trading will be subject under relevant provisions of the Dodd-Frank Act is yet to be formulated. As it is still unclear which swaps will be required to be cleared under the Dodd-Frank Act, applicable initial margin levels have not yet been finalized by clearing houses, clearing members, the CFTC or SEC.[18] In addition, as the Treasury Department has yet to determine if FX Transactions will be excluded from the definition of swap, it is unclear if such trades will also be required to be cleared and, if so, the initial margin levels that will apply.[19]

In view of the above, RICs cannot accurately project whether their swaps trading will be above or below the proposed 5% initial margin level for non-bona fide hedging transactions.

Vanguard is of the firm view that including initial margin for swaps in the Trading Condition, without the benefit of knowing what levels will apply going forward in either the cleared or uncleared swap markets, is entirely inappropriate. Such rulemaking could result in adverse and unexpected consequences for RICs. As CPO registration will entail significant costs, RICs will want to know whether their swaps trading activity could require them to register as a CPO well ahead of the time they would exceed the 5% level mandated in the proposed Trading Condition. That way, RICs will be able to change their trading activity, and perhaps their investment program, so as to stay under the 5% test. On that basis, we recommend that the CFTC postpone any decision to include swaps in the 5% test until such time that a market practice develops for initial margin for cleared and non-cleared trades.

B. The Dodd-Frank Act's additional safeguards regarding swaps trading obviate the need for swaps to be considered in the test for CPO status.

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. Swaps transactions will be reported to a swap data repository ("**SDR**"), which will allow the CFTC and other regulators to monitor RIC swap positions and the risks such positions pose to the market. In addition, the

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[18] Certainly, initial margin for cleared products will vary, and may vary significantly (e.g., initial margin for a long dated commodity swap will likely be higher than initial margin for a short dated interest rate swap).

[19] *See* supra note 4.

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 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 collateralized as well as reported to an SDR, it is even less likely that such trading could ever pose a high level of risk. Given the high level of existing and new regulations applicable to RIC swap trading and the risk reduction achieved thereby, Vanguard believes it is completely appropriate to exclude consideration of swaps from the Trading Condition.

C. If initial margin for swaps is to be included in the Trading Condition, the 5% test must be increased to levels appropriate for combined swaps and futures trading.

If the CFTC concludes that it is appropriate to include initial margin for swaps as part of the Trading Condition, the threshold related to the initial margin committed to a RIC's futures and swaps interests for non-hedging purposes must be increased above the proposed 5% of the RIC's liquidation value. We note that the Trading Condition in effect prior to 2003 applied only to initial margin respecting futures and did not include swaps. While, as we note above, there is no established market practice with respect to initial margin for swaps (cleared or uncleared), combined levels of initial margin for even a very modest level of swaps and futures activity could breach the 5% Trading Condition absent a scale-back in trading. Such a scaling-back could have a significant impact on RIC performance and costs, all of which would negatively impact shareholders while achieving minimal, if any, benefits.

On that basis, if the CFTC adopts a Trading Condition that includes swaps, in our view it is appropriate for the CFTC to set the maximum amount that may be committed to swaps or futures at a level greater than 5%. Given the absence of market data, we are unable to recommend an appropriate threshold and recommend that the CFTC commission a study to identify a threshold which balances performance and costs against added shareholder protections.

V. Swaps and futures activity used to reduce RIC risk should not be included in the Trading Condition initial margin test.

The definition of "bona fide hedging" set forth in CFTC Rule 1.3(z)(1) is narrow and fails to capture a number of transaction strategies used by RICs to mitigate risk. National futures exchanges allow exemptions to speculative position limits for "bona fide hedging positions" as well as certain types of transactions that do not qualify as "bona fide hedging" (e.g., "risk management positions") which are appropriate for managing RIC risk.[20]

Vanguard believes that risk management positions are bona fide hedge-like positions (and not speculative in nature or effect) and should qualify for the same treatment as bona fide

[20] *See* CME Group Rule 559B (Risk Management Positions).

hedge positions under the Trading Condition.[21] Therefore, we recommend that the CFTC adopt rules whereby a RIC would not have to count initial margin attributable to risk management positions in the initial margin Trading Condition test.

VI. The proposed Marketing Condition is overly broad and should be eliminated or substantially narrowed.

The Marketing Condition is so expansive that it could capture RICs that are using swaps and futures solely to hedge their risk or as part of a tactical asset allocation strategy. We believe that this result is not intended by the CFTC. An international bond fund, for example, that hedges its currency exposure related to its holdings of international securities using FX Transactions would be captured by the Marketing Condition unless neither its sales persons nor its marketing pieces disclosed its currency hedging strategy.[22] Such currency hedging activity might be deemed to be "seeking investment exposure to" swaps markets or the RIC might be deemed to be a vehicle for trading in swaps.[23] In addition, funds of funds (e.g., life-cycle and life-style funds) that offer small exposures to the commodity markets as part of their asset allocation strategy by using futures or swaps could potentially be captured by the Marketing Condition.

For all intents and purposes, a RIC that uses swaps or futures for hedging or risk management purposes, or devotes a small portion of its assets to swaps or futures for asset allocation purposes could be unable to avoid CPO registration unless the Marketing Condition is eliminated or narrowed.

On that basis, we recommend that the Marketing Condition should not apply if a RIC is using swaps or futures for hedging or risk management purposes. We also believe that the CFTC should clarify that the Marketing Condition relates to RICs engaged ***primarily*** in trading in, or seeking investment exposure to, swaps or futures markets. The following ***additional*** language could be added to the Marketing Condition to accomplish that objective:

> "A person will not market the fund to the public as a CPO or as a vehicle for trading ***primarily*** in (or otherwise seeking investment exposure ***primarily*** to) commodity futures, commodity options or swaps markets."

By requiring the primary activity of the RIC to comprise swaps or futures trading or exposure, trading incidental to the RIC's primary non-swaps or futures strategy would not be captured by the Marketing Condition.

To prevent any unintended consequences,[24] we believe that the CFTC should clarify that a RIC will not fail the Marketing Condition if it describes in its registration statement (including

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[21] We note that the CME also provides for an exemption from speculative position limits for arbitrage and spread positions (*see* CME Rule 559C), and we believe that the CFTC should also consider whether or not it would be appropriate to treat such positions similar to bona-fide hedge positions and risk management positions for purposes of applying the Trading Condition.

[22] Failure to disclose the currency hedging strategy would likely be a material omission.

[23] The Marketing Condition is so broad that the use of "hedged" in a fund name (e.g., hedged international bond fund) could also be problematic.

[24] As drafted, a fund could be unable to comply with the Marketing Condition if it describes its futures and swaps investments (and investment strategy related thereto) and their risks in its prospectus and

prospectus and statement of additional information), shareholder reports and any other documents required to be issued by the SEC (or other regulatory agency with authority over the RIC), its use of swaps or futures and their attendant risks. Clarification should also be made that making these documents available via the Internet including the sponsor's website will not cause a RIC to fail the Marketing Condition.

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In closing, we thank the CFTC for the opportunity to comment on the Release and appreciate the CFTC'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

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shareholder reports. Each of these documents is widely distributed to current shareholders and potential shareholders (upon request) and is normally available on the RIC sponsor's website. It is conceivable that such distribution as well as the availability of these documents via the Internet could be captured by the Marketing Condition.