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August 8, 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 – Protection of Cleared Swaps Customer Contracts and Collateral: Conforming Amendments to the Commodity Broker Bankruptcy Provisions; CFTC Staff Roundtable to Discuss Protection of Cleared Swaps Customer Collateral (June 3, 2011) (the "Margin Protection Roundtable")

Dear Mr. Stawick,

Vanguard[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") with our views on the Notice of Proposed Rulemaking (the "**NOPR**") on the preferred model for the protection of customer margin posted to Futures Commission Merchants ("**FCMs**") to secure obligations with respect to cleared swaps as a part of the new regulatory regime enacted by the derivatives title ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[2]

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 (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.

Vanguard is fully supportive of the mandate of Title VII to bring much-needed 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 protection 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

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

[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**".

Protection" in which Vanguard participated (the "**Collateral Roundtable**")[3], issuing the Advanced Notice of Public Rulemaking to seek public comment on a number of approaches to protect customer margin (the "**ANPR**")[4], and conducting the Margin Protection Roundtable also in which Vanguard participated[5].

The approaches addressed in the NOPR can be summarized as follows (using the names assigned in the NOPR):

- **"Futures Model"**: this is equivalent to the ***current futures model*** whereby customer margin is held by the FCM[6] 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 a defaulting customer ("**fellow customer risk**")[7];

- **"Legal Segregation Model"**: this is also the equivalent of the Futures Model but ***without fellow customer risk*** as the DCO is prohibited from using margin posted by non-defaulting customers to satisfy obligations of a defaulting customer;

- **"Legal Segregation with Recourse Model"**: 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***;

- **"Physical Segregation Model"**: 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) thereby eliminating ***fellow customer risk***.

In addition, the Commission has requested input on whether DCOs should be allowed to offer optional approaches to 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.

Consistent with the views we have expressed throughout this debate, Vanguard is strongly supportive of the Legal Segregation Model as providing the fullest protection to customer margin with the lowest costs. The basis for Vanguard's support can be summarized as follows:

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

[4] A copy of Vanguard's January 18, 2011 comment letter in response to the ANPR is available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27182&SearchText=

[5] A transcript of the Margin Protection Roundtable is available at: http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6_060311-transcri.pdf

[6] 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.

[7] 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).

- **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 strategies call for a reassessment of the appropriateness of aspects of the futures model for cleared swaps. Margin practices have developed in the OTC swaps markets that are highly sensitive to counterparty risk as well as to current and potential trade exposure.

- **While counterparty risk is effectively addressed by all four models, each of the Futures Model and the Legal Segregation with Recourse Model present "fellow customer risk" which is both impossible to manage and potentially limitless in scope.** While all of the four approaches insulate customer margin from claims of an insolvent FCM's creditors, the concept of "fellow customer risk" means that one is effectively responsible for the credit and trading risk presented by each of the FCM's other customers.

- **The Legal Segregation Model addresses both counterparty risk and "fellow customer risk" in a much more cost-effective manner than does the Physical Segregation Model.** Full physical segregation is unnecessary to address counterparty risk and adds significant costs to address the additional issues of investment risk and operational risk which are mitigated by other aspects of the Legal Segregation Model

- **Optionality with respect to margin protection models is undesirable given the potential for the concentration of risk in the model presenting the lowest costs.** DCOs are likely to have significantly greater challenges managing the risks if the relatively riskier clients and trading strategies elect to trade based on the cost savings presented by a model.

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 diversity in customer credit quality means that those with the best credit profile typically are required to only post margin to cover the market value of their swaps ("**Variation Margin**"), while those with a weaker credit profile must cover both the market value and the portfolio's volatility ("**Initial Margin**").

Given the benefits of netting of exposures and margin, the swaps market has focused on the counterparty risk related to any excess margin held by the secured party for which a pledgor would normally be an unsecured creditor in the event of the secured party's insolvency. Parties posting Initial Margin typically require it to be held in a fully-segregated account with a third-party custodian. Given the regulatory constraints on RICs, including the fund custody rules under the Investment Company Act

of 1940 (the "**ICA**"), all 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.

Thus, the OTC swaps market has developed highly sophisticated practices to address counterparty risk. Margin requirements for OTC swaps differ 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 the level of protection to be provided and 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.

II. While counterparty risk is effectively addressed by all four models, each of the Futures Model and the Legal Segregation with Recourse Model present "fellow customer risk" which is both impossible to manage and potentially limitless in scope.

The main benefit of central clearing is the elimination of counterparty credit risk. Whereas in the OTC swaps market each counterparty is exposed to the credit risk presented by its trading partner, in the cleared swaps market such risk is mitigated as the DCO is the counterparty to every trade. Central clearing risk mitigation tools including position margining (both Variation and Initial), access to the FCM's capital, access to the DCO's capital and access to a guarantee fund established by all of the DCO's members (other FCMs), and effectively serve to minimize, if not completely eliminate, counterparty credit risk.

Each of the four customer margin protection models considered in the NOPR is constructed so that customer margin is segregated from the FCM's assets and is not available to creditors of the FCM in the event of the FCM's insolvency.[8] This approach fared extremely well in the context of the Lehman insolvency where customer positions, and related margin, were promptly ported, or transferred, to another FCM without the need for bankruptcy court approval or access by Lehman's creditors.

However, each of the Futures Model and Legal Segregation with Recourse Model present a new risk to those present in the OTC swaps market. 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. The concept of "fellow customer risk" means that non-defaulting customers will receive the pro-rata amount of margin remaining after satisfaction of the margin shortfall related to the defaulting customer.[9] In the Legal Segregation with Recourse Model, the pool of

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[8] 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.

[9] 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).

customer margin can be accessed by the DCO only after the DCO has contributed its own capital and has accessed the guarantee fund maintained by its solvent FCM members.

"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's customers 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 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, both the Futures Model's and the Legal Segregation with Recourse'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.

In sum, neither the Futures Model nor the Legal Segregation with Recourse Model is appropriate for cleared swaps given their collective approach in assessing customer risk. In view of 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 and possibly unlimited risk if either of these models was applied to cleared swaps.

III. The Legal Segregation Model addresses both counterparty risk and "fellow customer risk" in a much more cost-effective manner than does the Physical Segregation Model. .

The Legal Segregation Model would eliminate counterparty credit risk as well as 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 – customer by customer.

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 not be as significant as might apply with respect to the creation and maintenance of individual, segregated client accounts under the 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. [10] As noted in the NOPR,

[10] In the existing futures model, FCMs can grant customers additional time for margin transfer (and transfer the FCM's own capital to the DCO in the interim) 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

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). Vanguard strongly agrees with the Commission's assessment that a consistent mandated approach whereby gross margin is segregated from risk both to the FCM and to the FCM's other customers is preferable to allowing varying levels of protection related to varying margin pools and unpredictable customer risk.

Mutualized risks addressed by the Physical Segregation Model but not by the Legal Segregation Model include both investment risk (involving the FCM's losses on the investment of customer margin) and operational risk (involving the FCM's failure to comply with the segregation mandate). As to investment risk, Vanguard is of the view that this risk is largely mitigated by the mandated limitations on the range of securities available for the investment of customer margin in accordance with regulation 1.25.[11] Again, in the context of the most recent market crisis, we are not aware of significant, if any, losses attributed to investment risk involved with the Lehman insolvency. As to operational risk, mitigation can take a number of forms including due diligence in assessing the relative capabilities presented by different FCMs, monitoring such FCMs and promptly porting positions and margin when concerns arise, selecting a strong DCO which can be relied on to monitor its FCMs, and monitoring one's account statement to check that positions and margin are being accurately tracked and reported.

Vanguard does not believe that the significant projected costs involved in establishing fully segregated accounts under the Physical Segregation Model are warranted to address the low level of remaining risks which remain under the Legal Segregation Model, especially given the mitigation tools mandated by the proposed rules. Nevertheless, Vanguard recommends that a number of additional protections be added to the Legal Segregation Model to more effectively protect customer margin including:

- **Recordkeeping.** Fundamental to the efficacy of the LSOC model, the avoidance of "fellow customer risk" and the portability of non-defaulting customer positions and margin is the provision of customer records from the FCM to the DCO. It is essential that such records are accurate and complete and, as noted at the Margin Protection Roundtable, there are concerns that such recordkeeping needs to be robust, especially as an FCM experiences financial stress.

  In that light, stringent and enforceable recordkeeping standards are critical and should be incorporated into the proposed rules.[12] Specifically, proposed Rule 22.11(e) should be amended to provide specific and concrete examples of steps a DCO must take to confirm such information is accurate and complete and produced on a timely basis, including the performance of regular or random independent audits of such records.[13] The phrase "appropriate steps" should be replaced with the phrase "all steps necessary."

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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.

[11] See CFTC, Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 75 Fed. Reg. 67,642 (Nov. 3, 2010): Proposed Rule 22.2(e)(1) (Permitting an FCM to invest cleared swaps customer margin in accordance with regulation 1.25, as such regulation may be amended from time to time); Proposed Rule 22.3(e) (Permitting a DCO to do the same).

[12] 76 Fed. Reg. at 33848.

[13] 76 Fed. Reg. at 33855.

In addition, the current drafting which requires FCMs to send DCOs requisite information "at least once each business day", should be replaced with "as frequently as technologically feasible."[14] Such an approach would be consistent with the timeframe for the reporting of swaps data more generally as specified in other rule proposals, and minimize the risk that a DCO would not have the complete records of all trading and margin positions.

- **Disposition of Customer Property**. The LSOC model is also dependant on the language confirming that one customer's property cannot be used to meet the obligations of either the FCM or the FCM's other customers. There should be a tightening of the proposed drafting so that there is a clear distinction between the approach applied to futures accounts and that applicable to cleared swaps accounts.
  - Proposed Rule 22.2(f)(4) addresses the FCM's segregation requirements[15] and it would be helpful if the Commission required the FCM to identify when the FCM has used its own capital to meet a customer's margin obligation and whether such FCM capital may be used by the DCO to cure a defaulting customer's margin obligations.
  - Proposed Rule 22.14 outlines the sequence of events applicable upon an FCM default and should be clarified to address simultaneous defaults in both the futures and cleared swaps account.[16] Particularly with respect to the application of FCM and DCO resources, it should be clarified how such resources will be allocated across such accounts.
  - Proposed Rule 22.15 provides that neither the DCO nor the FCM may use the property of one customer to cure the default of another customer.[17] It should be clarified that any initial misallocation related to delayed recordkeeping is to be rectified as promptly as possible with property of the non-defaulting parties to be fully restored.

IV. Optionality with respect to margin protection models is undesirable given the potential for the concentration of risk in the model presenting the lowest costs.

From a practical perspective, if optionality with respect to margin protection methods is allowed, we have concerns that more risky customers would opt in to the lowest cost approach while less risky customers would opt in to the most protective (and thereby more costly) approach. This would serve to concentrate the risk in the system and presumably raise additional challenges to the DCOs in terms of managing the relative risks.

If one of the optional models was either the Futures Model or the Legal Segregation with Recourse Model, and the DCO was effectively relying on the overall pool of customer margin to cure an individual customer default, 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.

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14 76 Fed. Reg. at 33854.
15 76 Fed. Reg. at 33852.
16 76 Fed. Reg. at 33855.
17 76 Fed. Reg. at 33856.

If one of the models was the Physical Segregation Model, and certain customers were prepared to pay the significant costs associated with establishing individually segregated accounts to address the low level of investment and operational risk present in the Legal Segregation Model, it is possible that such minimal additional protections could make the Physical Segregation Model the defacto standard notwithstanding that many participants do not believe the associated costs are justified by the minimal incremental benefits.

In conclusion, Vanguard supports the Legal Segregation Model as we believe it to conform to Dodd-Frank mandates, to provide full protection from counterparty credit and "fellow customer risk", 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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We'd like to 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