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November 4, 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-AD60, RIN 3038-AC96, RIN 3038-AC97 – Compliance and Implementation Schedules for Clearing, Trade Execution, Documentation and Margin

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 on the compliance and implementation schedules for swaps clearing and trade execution[2] and for swap documentation and margin[3] (together, the "**Proposals**") with respect to 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**").

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. As a part of the prudent management of our mutual funds and other portfolios, we enter into over-the-counter 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.

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[1] Vanguard is a Securities and Exchange Commission ("**SEC**") registered investment adviser with more than $1.5 trillion in assets under management. Vanguard offers more than 170 U.S. mutual funds and serves approximately 9 million shareholders.

[2] Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA, 76 Fed. Reg. 58,186 (proposed Sept. 20, 2011) (amending 17 CFR Parts 37, 38 and 39).

[3] Swap Transaction Compliance and Implementation Schedule: Trading Documentation and Margining Requirements under Section 4s of the CEA, 76 Fed. Reg. 58,176 (proposed Sept. 20, 2011) (amending 17 CFR Part 23).

The Proposals recognize that to be effective, aspects of reform must be implemented in a logical sequence, and that swap[4] users other than swap dealers and major swap participants ("**MSPs**") will need an extended period to complete the process. However, we are concerned that the degree of sequencing needs greater granularity, that the overall process will take considerably longer than proposed and that a premature mandate for central clearing and/or exchange trading may have unexpected negative consequences for the market.

For the reasons outlined below, Vanguard supports a phased implementation schedule over a thirty month period following rule finalization based on the following objectives:

- **Prioritize risk reduction over changes to trading practices and market transparency.**
- **Prioritize data reporting to inform future rulemaking related to trading practices and market transparency (to minimize a negative impact on liquidity).**
- **Harmonize overlapping U.S. and global regulatory efforts.**
- **Phase in required compliance based on mandate type, participant type and asset type with voluntary compliance open to all participants to facilitate contributions to the development of market infrastructure.**

I. Prioritize risk reduction over changes to trading practices and market transparency.

While risk reduction and increased transparency are dual objectives of the Dodd-Frank Act, given the significance of the market dislocations experienced in 2008, tools to mitigate perceived risks in the swaps markets must receive prioritization with respect to rule implementation. Issues related to counterparty risk and margin levels figured heavily in the causes of the crisis and deserve expedited reforms.

Initiatives aimed at achieving enhanced market transparency are valuable both to level the playing field with respect to product availability and pricing as well as to provide regulators a window to assess market weaknesses, however these goals must be viewed as secondary to those addressing the sources of potential systemic risk. Moreover, the proposed tools to enhance transparency, such as mandated exchange trading and public reporting of trades, also present significant risks to the liquidity of certain parts of the swaps market.

For these reasons, implementation sequencing should commence with risk mitigation techniques.

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[4] 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 of 1934) shall be referred to collectively as "**swaps**."

II. Prioritize data reporting to inform future rulemaking related to trading practices and market transparency (to minimize a negative impact on liquidity).

Significant concerns regarding the potential negative impact on market liquidity argue strongly for the delayed implementation of futures-like trading approaches and the public reporting of trade details. Recent studies have outlined the material differences in liquidity between the swaps and futures markets.[5] While futures trading is characterized by high volumes of a limited range of trade types of small size and short duration, the swaps market has an almost unlimited range of trade types of much larger size and longer duration. Swaps liquidity varies dramatically with two-year U.S. dollar interest rate swaps being highly liquid, while credit default swaps on emerging market corporate entities may trade very infrequently.

The potential negative impact on liquidity and pricing is best demonstrated in the context of the premature public reporting of large-sized bunched or block trades. When quoting a price for a block trade, dealers typically charge a slight premium to the then current market price for a similar trade of a more liquid size. Once the block trade is completed, the dealer executes one or more liquid-sized mirror trades at current market prices to lay-off its position and to flatten its market exposure.

The premature public dissemination of block trade details will provide the market with advance knowledge of the dealer's imminent trading and move the market against the dealer. Consequently, dealers will either have to raise their block price in anticipation of this risk, or counterparties will have to disaggregate their block trades to seek better pricing – but incur less efficient and more costly execution. As bunched or block trades aggregated across multiple accounts are not unusual for large fund complexes, individual fund investors will ultimately have to bear either the higher prices for the block, or the increased costs of establishing positions using multiple trades of liquid sizes. There is also a fear that uncertainty on hedging costs could lead dealers to withdraw from quoting on blocks.

Vanguard has previously submitted detailed comments conveying our concerns with respect to both the CFTC[6] and the Securities and Exchange Commission's ("**SEC**")[7] trading practices proposals. The CFTC's proposed test for block trade size, and the CFTC and SEC's proposed time delay for the public dissemination of block trade data risk a significant negative impact on market liquidity.

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[5] An Analysis of CDS Transactions: Implications for Public Reporting, Federal Reserve Bank of New York Staff Reports, September 2001, available at: http://www.newyorkfed.org/research/staff_reports/sr517.html.

[6] Letter from Gus Sauter and John Hollyer to David A. Stawick, Secretary. CFTC (February 7, 2011) (discussing Vanguard's views on the CFTC's proposed rules on Swap Data Recordkeeping and Reporting and Real-time Public Reporting of Swap Transaction Data), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27634.

[7] Letter from Gus Sauter and John Hollyer to Elizabeth M. Murphy, Secretary, SEC (January 18, 2011) (discussing Vanguard's views on the SEC's proposed Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information), *available at:* http://www.sec.gov/comments/s7-34-10/s73410-22.pdf.

The only prudent approach would be to first establish the reporting mechanics of the swap data repositories ("**SDRs**") and then to allow time to gather information to make informed decisions based on a thorough analysis of market data. Vanguard expects that based on the review of such data, larger block trade sizes and more prompt public reporting will be appropriate for the most liquid products with smaller sizes and delayed reporting applicable for less liquid products. Such mandates will further benefit from ongoing data collection efforts as they must be refreshed regularly to reflect changing market liquidity.

III. Harmonize overlapping U.S. and global regulatory efforts.

While in the long term, the harmonization of global derivatives regulatory efforts will help to maintain a level playing field and avoid a migration of business to the weakest regulatory regime, implementation should also be coordinated to provide participants with a clear roadmap of their compliance responsibilities. As many swap dealers act through branches in diverse jurisdictions, and large fund complexes may perform management functions both inside and outside the US for offshore funds, the absence of clear directions could have a chilling effect on the market as participants are unwilling to act within conflicting regulatory regimes.

Therefore, fundamental to any implementation plan is the resolution of regulatory intent across the globe with adequate time for the development of the relevant infrastructure before the application of fixed mandates.

IV. Phase in required compliance based on mandate type, participant type and asset type with voluntary compliance open to all participants to facilitate contributions to the development of market infrastructure.

In view of the time needed to digest the final rules and develop industry infrastructure; to implement complex operational connections required for reporting, clearing and exchange trading; to educate clients on the changes and obtain their consent to trade in the new paradigm; and to negotiate new trading agreements across all trading relationships, Vanguard supports the following implementation schedule:

- **Six months from final rules**:
  - SDRs, derivatives clearing organizations ("**DCOs**"), futures commission merchants ("**FCMs**"), swap execution facilities ("**SEFs**") and middleware providers must complete the build-out of their respective infrastructures.
  - Swap dealers and MSPs should be mandated to report trades to SDRs so that information is available to the Commission to inform relevant future rulemaking.
  - All participants may voluntarily engage in reporting, clearing and trading platforms.

- **Twelve months from final rules**:
    - Through an analysis of the SDR data, the CFTC and DCOs can assess the first list of "standardized swaps" for central clearing. Such list is likely to include only the most liquid types of interest rate swaps and credit default swaps.
    - Swap dealers, MSPs and "active funds" (private funds with a significant (200+) monthly average of trades) should be mandated to clear the first list of "standardized swaps" and also apply margin mandates for uncleared swaps.

- **Eighteen months from final rules**:
    - Non-fund "financial entities" that are not swap dealers or MSPs and private funds that are neither "active funds" nor "third party sub-accounts" (managed accounts that are not funds) should be mandated to clear the first list of "standardized swaps" and also apply margin mandates for uncleared swaps.
    - Through an analysis of SDR data, the CFTC can assess liquidity across trade types to make informed determinations of block trade size and related public reporting delays for the first list of "standardized swaps" "made available for trading" on SEFs for mandated SEF or designated contract market ("DCM") trading. Such list is likely to include a narrow subset of the most liquid types of interest rate swaps and credit default swaps identified as "standardized swaps".
    - Swap dealers, MSPs and "active funds" should be mandated to trade the first list of "standardized swaps" "made available for trading" on a SEF or DCM.

- **Twenty-four months from final rules**:
    - Non-financial end-users, "third-party subaccounts" and funds other than private funds should be mandated to clear the first list of "standardized swaps" and also apply margin mandates for uncleared swaps.
    - Non-fund "financial entities" that are not swap dealers or MSPs and private funds that are neither "active funds" nor "third party sub-accounts" should be mandated to trade the first list of "standardized swaps" "made available for trading" on a SEF or DCM.

- **Thirty months from final rules**:
    - Non-financial end-users, "third-party subaccounts" and funds other than private funds should be mandated to trade the first list of "standardized swaps" "made available for trading" on a SEF or DCM.

In considering the above timeline, the Commission should be mindful that a revolutionary new paradigm will need to be created within which the swaps market will have to operate going forward. While market participants have commenced development of the infrastructure to support this paradigm based on both current tools available in the inter-dealer

market and a best guess as to where Commission rulemaking might conclude, a host of final rules are critical to significantly advance the effort.

As noted in our recent comment letter regarding customer clearing documentation,[8] one key element on which market participants are focused is the methodology for an FCM's individual customer clearing limits to be monitored and enforced. For the SEF and DCM trading mandate to work, clearing limits for each market participant must be policed on a millisecond basis to provide confidence that positions traded will not have to be cancelled for a failure to clear. Although certain segments of the market have existing tools to adequately address this issue, the challenge will be to scale these solutions across all DCOs, FCMs, customers, SEFs and DCMs to accommodate all mandated SEF and DCM trading. A joint FIA / ISDA working group on clearing infrastructure is assessing the approaches with the aim for the market to focus on implementing the most robust solution.

In addition to the need for swap dealers, MSPs, SDRs, DCOs, FCMs, SEFs and DCMs to establish fully functional platforms, the central clearing of derivatives will require the negotiation (and possibly renegotiation) of all existing master trading agreements to establish the required clearing relationships for swaps.

For example, in any given year, Vanguard might enter into a dozen or so new trading agreements between a limited number of managed funds and their trading counterparties. To be able to clear swaps, each managed fund will have to (a) enter into new futures agreements (or upgrade existing futures agreements to cover cleared swaps) with each FCM, (b) sign a cleared swaps addendum for each such futures agreement, and (c) execute a Tri-party Agreement with each FCM and Executing Party. Assuming 200 managed funds each with 2 FCMs and 10 Executing Parties, a minimum of 4800 contractual relationships will need to be negotiated and executed within whatever period is mandated for implementation. Even uncleared swaps are likely to require new or upgraded ISDA Master Agreements, Credit Support Annexes and Custody Agreements to reflect the new market paradigm.

This process is so time intensive partly because there is no market standard form of futures agreement and the agreements differ dealer to dealer and change from time to time. Contrast this with the bilateral swaps market where the parties globally can execute a single form of documentation protocol which would serve to amend the standard form of ISDA Master Agreement entered into by every protocol adherent. It is yet to be seen if FCMs, with limited resources and negotiation bandwidth, will be able to execute new suites of documents with every client desirous of trading swaps in the cleared world. Absent such documentation, parties risk being shut out of clearing and SEF trading – thereby raising the significant risk of diminished market liquidity.

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[8] Letter from Gus Sauter and John Hollyer to David A. Stawick, Secretary. CFTC (September 30, 2011) (discussing Vanguard's views on the CFTC's proposed rules on Customer Clearing Documentation and Timing and Acceptance for Clearing), *available at:* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48439.

Given the multitude of variables, we caution the Commission that the above proposed timeline could need further adjustment if unexpected systemic challenges are encountered in the implementation process. Systems development delays, global regulatory disharmony, market disruptions or other events could impair the industry's best efforts to implement change.

For all of these reasons, we urge the Commission to reconsider its proposed timeline to allow adequate opportunity for the many interlocking elements to coalesce following final rulemaking. Far from any desire to slow the move toward change, we earnestly believe that without adequate time and global coordination, the overall risk-reducing elements of the swaps market could be irreparably damaged. Time for both infrastructure development and informed rulemaking is the best answer to achieve the overall objectives of Title VII: namely to open access to derivatives markets for all parties with robust clearing and trading methodologies designed to minimize market and credit risk and provide best execution and ample liquidity across products.

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We'd like to thank the Commission for the opportunity to comment on the proposed implementation timeline for swaps regulatory reforms 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 Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott D. O'Malia
The Honorable Mark P. Wetjen