Vanguard®

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

February 13, 2012

Via Electronic Submission

The Honorable Timothy F. Geithner
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitutional Avenue, NW
Washington, DC 20551

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Mr. Robert Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable John G. Walsh
Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

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

Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (the "Volcker Rule" or "Proposal")

Ladies and Gentlemen:

Vanguard[1] appreciates the opportunity to submit comments to the above-referenced agencies ("Agencies") regarding the Volcker Rule. As an SEC-registered investment adviser unaffiliated with any Covered Banking Entity (as such term is defined in the Proposal), we are not subject to the proposed prohibitions on proprietary trading and investments in private equity or hedge funds. Our comments stem from our deep concern that the Proposal will adversely impact market liquidity and certain regulated mutual fund activities to the detriment of the investing public. We are also concerned that

[1] As of December 31, 2011, Vanguard offered more than 170 U.S. mutual funds with approximately $1.65 trillion in U.S. assets under management, serving more than 9 million shareholders.

the Proposal is underinclusive, as it would allow Covered Banking Entities to continue to issue pre-paid forward contracts, such as exchange traded-notes (ETNs). This omission may enable banks to continue to assume risks the Proposal seeks to eliminate, and may require taxpayer dollars, in the form of FDIC insurance, to bail out banks that become insolvent.

I. Concerns regarding the Proposal's Impact on Market Liquidity

As drafted, we believe the Proposal will have a widespread, negative impact on fixed income securities,[2] thereby impacting millions of individual investors, pension funds, 401(k) plans, and non-profit organizations that currently invest in such securities, either directly or through mutual funds. The Proposal will impact the fixed income market in three significant ways: (a) by curtailing the availability and depth of liquidity; (b) by increasing transaction costs; and (c) by limiting price discovery. The Proposal will have this negative impact because of the limitations found in the exemption for market making activity and the narrow definition of Government Securities. We will discuss each of these limitations in more detail below.

A. The market making exemption will negatively impact the fixed income market.

The Volcker Rule prohibits Covered Banking Entities from engaging in proprietary trading, with few exemptions. One such exemption exists for market making activity. Covered Banking Entities seeking to engage in market making activities must design such activities to generate revenue primarily from fees, commissions, bid/ask spreads or other income not attributable to the appreciation in value of the financial positions they hold. In practice, the Proposal compels market makers to trade securities on an agency basis, rather than a principal basis. The fixed income market today is fairly liquid and has depth because market makers transact primarily on a principal basis. Requiring this market to shift to an agency basis simply cannot be done without impacting both the availability and depth of liquidity. The decrease in liquidity will, in turn, impair price discovery, which is important for mutual funds to price their shares. The decrease in liquidity also is likely to result in higher transaction costs, as market makers charge a premium for the liquidity they are willing to provide. Higher transaction costs directly impact the returns shareholders receive through their mutual fund investments. In the case of bond funds, the investors, who are often retirees already strapped for yield, will shoulder the burden of the Proposal's imposed transaction costs.

In keeping with Congressional intent to permit market making, the Agencies should revise the Proposal to ensure market makers can conduct trading on a principal basis, as it exists today. To discourage banking entities from holding securities too long, which could increase the possibility a firm realizes a loss on a position, regulators could consider increasing bank capital requirements for longer-held positions. This approach allows a banking entity to internalize the cost of continuing to hold certain positions on its books at the expense of its ability to take on additional positions. We understand some banks already take this approach in managing risk on their market-making desks.

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[2] Our comments primarily address our concerns about the Proposal's impact on the fixed income market, but we note that the Proposal could have the same impact on the liquidity, transaction costs, and price discovery for thinly traded stocks.

B. The definition of Government Securities is overly restrictive.

Another exemption to the general ban on proprietary trading is given for trades involving Government Securities. As drafted, the exemption would permit Covered Banking Entities to engage in proprietary trading of Treasury and municipal general obligation bonds, but would not permit proprietary trading of Treasury futures and other municipal securities, such as agency bonds. We believe this exemption is overly restrictive in that Treasury futures and municipal agency bonds are among the least risky investments a bank may hold. To reduce the Proposal's impact on market liquidity, we propose that the definition of Government Securities be revised to include Treasury futures and all municipal securities, including agency securities.[3] This would allow banking entities to trade these securities, would preserve their existing liquidity and price transparency, and not increase their transaction costs.

If the definition of Government Securities is not amended to include all types of municipal bonds, we are particularly concerned that the Proposal will have a significant impact on the municipal bond market. The municipal bond market consists of approximately $2.7 trillion in outstanding bonds and 60,000 municipal issuers. These issuers range from the large, well-established states that access the municipal market frequently, such as California and New York, as well as smaller municipal issuers that access the market infrequently, such as smaller school districts or various water and sewer treatment facilities. The exclusion of these smaller agency bonds from the definition of Government Securities will force market makers to trade such holdings pursuant to the market making exemption, which means on an agency basis. Trading on an agency basis may cause the smaller municipal issuers to lose or have diminished access to the bond market, as dealers may be unwilling to transact in these bonds because counterparties may not be readily available. The inability for banking entities to engage in proprietary trading in the municipal market, which is already less liquid than the taxable market, will undoubtedly raise the cost of capital for municipal issuers. We understand the SEC has been evaluating the municipal market closely over the past two years, and had expressed an interest in increasing liquidity in these markets by increasing pre-trade price transparency.[4] We believe the Proposal, as drafted, will only serve to decrease price transparency, as it will make price discovery all the more difficult.

C. Liquidity is Crucial to Mutual Funds.

Having deep, liquid markets is particularly important for mutual funds, which must liquidate holdings to accommodate shareholder redemptions. Index funds, by their nature, hold very little cash to accommodate shareholder redemptions. This is because holding uninvested cash has a significant impact on a fund's ability to track its index. Many investors select an index fund based upon its tracking error. Index funds,

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[3] We note that this approach would be consistent with the definition of "municipal securities" as set forth in section 3(a)(29) of the Securities Exchange Act of 1934: "The term 'municipal securities' means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond…."

[4] *See* Speech by SEC Commissioner Elisse Walter, Statement at SEC Field Hearing on the State of the Municipal Securities Market, Birmingham, AL, July 29, 2011 (http://www.sec.gov/news/speech/2011/spch072911ebw.htm).

therefore, must depend on well-functioning liquid markets to raise cash to accommodate shareholder redemptions. If unaltered, the Proposal may require bond index funds to choose between holding more cash (and therefore, taking on tracking error) or being fully invested and taking on higher transaction costs. In either case, it is the mutual fund investor who bears the cost of the Volcker Rule.

Actively managed mutual funds also require deep, liquid markets to accommodate shareholder activity, which can be more significant than the shareholder activity in index funds. For example, in September and October of 2008 some of our actively managed bond funds experienced notable shareholder redemption activity, only to receive significant cash flows in December 2008 and January 2009. During this time, liquidity was scarce, and our funds were forced to pay well in excess of 200 bp in transaction costs.[5] One fund lost 9% of its assets over a one-month period. Applying a conservative 200 bp in transaction costs to 9% of the portfolio would have resulted in approximately 18 bp of transaction costs for this fund during this one month. Another fund experienced cash flow equivalent to 33% of its total assets during the December 2008 to January 2009 time period. Applying 200 bp in transaction costs to 33% of this portfolio would have resulted in 67 bp of transaction costs for this fund during this one-month period. Although we cannot say with certainty how many basis points in transaction costs the Proposal will impose on the fixed income investor, we do know that if the next liquidity crisis occurs while the Proposal is in effect, transaction costs will be higher.

II. Concerns regarding the Proposal's Impact on Certain Regulated Mutual Fund Activities

Our concerns about the Volcker Rule's impact on certain regulated mutual fund activities stem from the narrow exemption for market making activity and the overly broad definitions of Covered Fund and Covered Transactions. As proposed, the exemption for market making activity may impede the trading of exchange-traded funds ("ETFs"). The overly broad Covered Fund definition would capture all non-US mutual funds and all US mutual funds that have exposure to commodities, including financial futures, which would prohibit banking entities from seeding ETFs for these funds. The Covered Transactions definition could impede certain custodian bank services and activities. We discuss each of these issues in detail below.

A. The Proprietary Trading Prohibition May Impede the Creation and Distribution of ETFs.

The unique process of creating and distributing ETFs raises some concern under the prohibition on proprietary trading. Most Authorized Participants ("APs") that seed ETFs are banking entities, and would be subject to the Proposal's restriction on proprietary trading.[6] In certain circumstances, normal AP activity could appear to be proprietary trading, which would raise compliance concerns among the banking entities acting as APs. For example, APs that transact with an ETF to create or redeem shares but do not engage in market making for that ETF would not qualify for the market making exemption. Such activity, therefore, may be classified as proprietary trading, even if the AP undertakes such activity as a matter

[5] This estimate is based upon information provided to us by a third-party vendor.

[6] According to our internal data, creation and redemption activity by APs that are also banking entities can represent as much as 90% of Vanguard ETF creation and redemption activity on any given day.

of customer facilitation. Consequently, some banking entities may be discouraged from entering into the ETF market and others may exit. If this were to occur, the impact on the ETF market could be significant, as the sole mechanism for minimizing differences between an ETF's market price and the fund's NAV would be impaired. The Proposal's exemption for market making is insufficient to address these concerns. To qualify for the market making activity exemption, a banking entity must demonstrate that its trading was designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties. Predicting the near-term demands of clients for new ETFs may be difficult, and the consequences of getting it wrong could result in a Volcker Rule violation.

The underwriting exemption is also inadequate for many APs that are not also market makers. The Proposal states that in determining whether a banking entity is engaging in underwriting activity, the Agencies will consider the extent to which the entity is (i) performing due diligence, (ii) advising the issuer on market conditions and assisting in the preparation of a registration statement, and (iii) participating in or organizing a syndicate of investment banks. APs may not wish to engage in these activities, as they may not be paid to perform these types of functions, or an AP may not be willing to accept the regulatory liability associated with underwriting activity.

The exemptions for market making and underwriting activity, as currently drafted, would be a significant barrier for banking entities to be willing to act as APs or market makers for new or existing ETFs. ETF market making and seeding activity, however, does not involve the risk-taking activity of other types of proprietary trading, nor was ETF-related activity the cause of any bank failure during the financial crisis. For these reasons, we believe the Proposal should explicitly designate the trading activities of APs as a permitted form of market making activity.

The broad definition of Covered Fund would prohibit Covered Banking Entities from acting as APs and seeding ETFs offered through non-US mutual funds. This is because the seeding process involves the AP delivering cash and/or securities to the ETF, which in turn delivers fund shares to the AP for distribution to end-users, namely retail investors. The seeding process may involve holding ETF shares for an extended period of time until the ETF has established liquidity in the secondary market. The holding of fund shares could be deemed to be taking an interest in the non-US mutual fund, and prohibited under the current Proposal. To address this concern, the Proposal should exempt non-US mutual funds from the definition of a Covered Fund.

B. The Proposal May Reclassify Certain Mutual Funds as Covered Funds.

A mutual fund that uses futures or has other commodities exposure could also be a commodity pool, and may be required to register with the CFTC. The Proposal's definition of a Covered Fund would capture US mutual funds, including exchange-traded mutual funds, that are commodity pools because of their investments in commodities or futures.[7] A Covered Banking Entity would be prohibited from creating or redeeming ETF shares of a mutual fund that was also a commodity pool, even if the commodity exposure was solely as a result of the fund's investment in Treasury futures. To limit the impact that the Proposal will have on registered US mutual funds, the Covered Fund definition should be revised to exclude all US mutual funds, whether or not they are also registered as commodity pools.

C. The Proposal May Impede Certain Custodian Bank Activities.

The definition of Covered Transactions is overly broad for purposes of the Super 23A provision of the Volcker Rule. The definition, as drafted, would capture various activities provided by bank-affiliated custodians to non-US mutual funds. These activities would include normal settlement services, such as providing credit or liquidity for securities settlement, and similar custody-related transactions. These transactions do not raise a risk of undue credit support for Covered Funds, as custodian banks are adequately protected by having recourse to a fund's assets. Normal settlement services for Covered Funds, therefore, should be exempted from the definition of Covered Transactions for purposes of the Super 23A provision of the Volcker Rule.

III. Concerns regarding the Proposal's Impact on the Availability of Tender Option Bonds

The Proposal prohibits banking entities from sponsoring, investing in, or taking an ownership interest in Covered Funds, which is defined to include collective investment vehicles that rely on the 3(c)(1) or 3(c)(7) exemptions under the Investment Company Act of 1940. Securitizations of municipal bonds in the form of tender option bond programs ("TOBs")[8] rely on these exemptions. By our estimate, approximately 25-30% of municipal money market fund assets are invested in TOBs. Some municipal bond funds also invest in TOBs. We are particularly concerned that the Proposal would eliminate a significant source of safe, liquid investments for municipal money market and bond funds.

TOBs, which are the municipal market equivalent of repurchase agreements,[9] provide money market and municipal bond funds with a safe, tax-exempt, short-term (i.e., daily or weekly) investment with access to a dedicated liquidity source. The availability of this product is more important post-2008, now that money market funds are required to maintain 30% of their assets in weekly maturities and maintain a weighted average maturity of 60 days. TOBs also offer money market funds an important source of diversification since the underlying municipal securities held in the TOBs would typically extend beyond Rule 2a-7's maturity requirements. We note that TOBs provide an important benefit to state and local governments, too, which often receive higher demand for their securities as a result of these structures. Greater demand often translates into lower funding costs for these issuers.

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[7] The proposed definition of Covered Fund would capture almost all of the Vanguard funds, which often use financial futures to equitize cash.

[8] There is approximately $80B of outstanding TOBs.

[9] We note that the Proposal specifically excludes repurchase agreements from the provisions of the Volcker Rule.

Importantly, TOBs do not present the types of risks typically associated with securitizations. For example, the underlying assets are high quality municipal securities. Unlike other types of securitizations, a TOB's underlying holdings are transparent and typically include a single municipal issuer. TOBs contain no traunches and do not engage in credit default swaps, which are common in other types of securitizations. For these reasons, we believe TOBs should be excluded from the Covered Fund definition. The Agencies could do this by broadening the definition of Government Securities to include all municipal securities, as mentioned above. The Covered Fund definition could then be revised to exclude any securitizations where the underlying assets consist solely of Government Securities.

IV. Concerns regarding Volcker Rule Omission of Pre-paid Forward Contracts

The purpose of the Volcker Rule was to prevent banks from taking on risks associated with proprietary trading, and to prevent the sponsorship of or ownership in vehicles that could expose the bank's balance sheet to significant risk. We believe that the Proposal misses an opportunity to stem such risk by not addressing a banking entity's ability to engage in certain pre-paid forward contracts, such as ETNs. ETNs are exchange-traded securities whereby a bank promises to pay the return of a specified security, commodity or index (including leveraged or hedged indices) over a specified, typically long-term, period of time. ETNs are not collective investment vehicles, but simply notes with a bank's promise to pay upon the note's maturity. Under the Proposal, banking entities would be permitted to continue to issue these products, notwithstanding the fact that an ETN could expose a bank to the same type of risk present in a hedge fund. In this context, we encourage the Agencies to consider if the Proposal goes far enough to deter this type of risk-taking in the banking industry.

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We appreciate the opportunity to comment on the Proposal and look forward to continuing to work with you to address the issues we have identified in this letter. If you have any questions about Vanguard's comments or would like any additional information, please contact Laura Merianos, Principal, at (610) 669-2627.

Sincerely,

/s/ Gus Sauter
Chief Investment Officer
Vanguard

/s/ Bob Auwaerter
Head of Fixed Income
Vanguard