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September 06, 2012

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-AD86 – Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act, 77 Fed. Reg. 47170 (August 7, 2012)

Dear Mr. Stawick,

Vanguard[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") with our views regarding the clearing requirement determination for certain swaps under section 2(h) of the Commodity Exchange Act [2] (the "**Proposal**") 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 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.

As noted in our comment letter to the CFTC dated November 4, 2011,[3] time for infrastructure development is imperative to achieve the overall objectives of Title VII, and without adequate time to complete the needed reforms, the market could be negatively impacted. For the reasons outlined below, Vanguard believes the Commission's mandatory clearing proposal should follow a determination that the requisite infrastructure reforms have been implemented and have proven robust against the demands presented by voluntary clearing.

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[1] Vanguard is a Securities and Exchange Commission ("**SEC**") registered investment adviser with more than $2 trillion in assets under management. Vanguard offers more than 170 U.S. mutual funds and serves approximately 9 million shareholders.

[2] Notice of Proposed Rulemaking on "Clearing Requirement Determination Under Section 2(h) of the CEA", 77 Fed. Reg. 47170 (August 7, 2012).

[3] Letter from Gus Sauter and John Hollyer to David A. Stawick, Secretary, CFTC (November 4, 2011) (discussing Vanguard's views on the CFTC's proposed implementation schedules for swaps clearing and trade execution), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=49935.

I. The mandate for swaps clearing should not apply until the full benefits of the Commission's margin protection rule are operational and tested.

While the Commission's final rule implementing the "legally segregated, operationally commingled" ("**LSOC**") model is mandated for compliance on November 8, 2012, notwithstanding intensive industry effort (with active Commission involvement), it is clear that full LSOC protection for all customer margin is unlikely to be available by that date. Efforts to clarify the scope of LSOC protections are far from complete as market participants grapple with the realities of multiple product categories, clearing houses, and time zones. Vanguard endorses the list of buy-side concerns with respect to LSOC implementation submitted to the Commission on or about August 7, 2012, a copy of which is included with this letter.

Absent such clarification, it is highly unlikely market participants will be able to build systems to provide such protections within the next two months. Once such systems are built, there should be an adequate testing period to ensure the robust reporting, recordkeeping and audits needed to protect customer margin are capable of supporting the full range of swaps mandated for clearing.

Partial protection, or a phase-in of protection, will not be acceptable for even voluntary, let alone mandatory, swaps clearing. Particularly in light of the recent defaults in the futures market, swap market participants such as Vanguard strongly prefer the existing robust level of margin protection afforded in the over-the-counter swap market until such time as full LSOC protection can be assured for cleared swaps.

For these reasons, Vanguard believes that the CFTC should approve swaps for mandatory clearing only after LSOC is fully operational and capable of being tested for at least three months with respect to trades cleared on a voluntary basis.

II. The mandate for swaps clearing should not apply until market participants have adequate time to negotiate and execute the required documentation including futures agreements, cleared swaps addendums and execution agreements.

Following an unprecedented level of cooperation across the buy and sell-sides, on August 29, 2012, the FIA and ISDA published the market standard form of the futures agreement addendum for cleared swaps. Market participants who intend to trade swaps mandated for clearing can now begin negotiations of the necessary documentation.

For those participants who have not previously executed exchange-traded futures and listed options, this will entail the negotiation of both a futures agreement (for which there is no market standard) and the new market standard addendum. As it is not uncommon for market participants to take a year or more to negotiate the market standard ISDA Master Agreement for over-the-counter swaps, there needs to be an adequate lead time for ALL market participants to execute new cleared

swaps documentation. Especially as the thousands of market participants will now converge their negotiations on the limited staff at the relatively few clearing members, there is a significant risk of a bottle-neck either foreclosing market participants from trading cleared swaps, or forcing their execution of non-negotiated terms, should the clearing mandate apply ahead of adequate time for document negotiation.

For these reasons, Vanguard believes the Commission should approve the list of swaps for mandatory clearing only after market participants have had at least six months, from the date of the addendum's publication, to execute required contracts. Moreover, such delay should be revisited based on further assessments of market readiness which could be based on an analysis of voluntary clearing levels for both dealers and clients.

In sum, while we have been staunch supporters of the rulemaking related to non-public reporting, margining and clearing of swaps, and we have been highly engaged in market efforts to effectuate the new market paradigm, we have serious reservations about the potential impact on cost, liquidity, and heightened margin risk which could result from the premature roll-out of the clearing mandate. The above considerations are not meant to be unjustified delays, rather they are meant to avoid the risk of a freeze in liquidity should the clearing mandate apply before the market is ready. While it is hoped that LSOC clarifications will be expedited, and many market participants will complete the necessary documentation in short order, given these known impediments, the Commission will best serve the market by allowing adequate time for the market transition.

We'd like to thank the Commission for the opportunity to comment on the clearing requirement determination for certain swaps under section 2(h) of the Commodity Exchange Act 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, Senior 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

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LSOC: Buy-Side Concerns with Implementation
ICI, SIFMA AMG, MFA and IAA
August 7, 2012

Buy-Side Expectations of LSOC:

- All Customer margin (including all variation margin ("**VM**"), initial margin ("**IM**"), including "excess" or "unattributed" IM above the value required by the DCO ("**Excess IM**") and accruals thereon (collectively, "**Margin**")) must be protected from "fellow-customer risk".
- Neither the DCOs nor the FCMs may use any Margin of one Customer to secure or satisfy the obligations of another Customer.
- FCMs must be required to report to DCOs the identity, positions and Margin of each Customer to both support LSOC protections and to mitigate operational and fraud risk.
- Ambiguities and inconsistencies identified in LSOC implementation must be addressed by the CFTC through rule revisions, interpretative guidance and/or FAQs, with public notice and comment, as appropriate.

Buy-Side Concerns with LSOC Implementation:

- A non-defaulting Customer's VM gains could be used to satisfy a Defaulting Customer's VM losses.
- A non-defaulting Customer's Excess IM could be used to secure or satisfy the obligations of a defaulting Customer (or be delayed in a return to the non-defaulting Customer), including a DCO netting the Excess IM of one of the FCM's Customers against an IM amount owed by another of the FCM's Customers.
- The FCM reporting obligations to the DCO with respect to a Customer's Excess IM may be optional instead of mandatory.

Examples of Customer Margin Potentially Not Protected by LSOC:

- Non-defaulting Customer's VM.
- Non-defaulting Customer's Excess IM:
  - Excess IM arising from changes in a Customer's positions (***e.g.***, when changes in a Customer's positions decrease the DCO-required IM below that already held by the DCO).
  - Excess IM arising from changes in value of posted IM (***e.g.***, the value of a Customer's IM increases over time).
  - Excess IM arising from the extra 10% IM required for speculative trades (***i.e.***, non-hedge positions), which should not be viewed as "excess" as it is required by the DCO.
  - Excess IM arising from an FCM's credit requirements, which must be protected whether held at an FCM or a DCO.
  - Excess IM arising from IM that is greater than the DCO's or FCM's requirements and is "voluntarily" transferred by the Customer (***See*** Rules 22.13(c)(1) and (2)).
  - Excess IM arising from the transfer of an FCM's property to cover an individual "Cleared Swaps Customer Account" (***See*** Rule 22.2(e)(4)).
  - Excess IM arising from the transfer of an FCM's property as "buffer" to cover all Cleared Swaps Customer Accounts (***See*** Rule 22.2(e)(3)(ii)).

Rules Targeted for Clarification:

- **22.1 Cleared Swaps Customer Collateral**: confirm in interpretative guidance that (a) the definition of collateral which "**secures a cleared swap**" ***includes all of a Customer's property received by an FCM or DCO*** (*i.e.*, all Margin of the Customer), and (b) all other references to "collateral" and "margin" in the Rule are to "Cleared Swaps Customer Collateral" as defined or confirm an alternative meaning.

- **22.2(d) Limitations on FCM Use**: if the CFTC clarifies the definition of "Cleared Swaps Customer Collateral" as requested above, it will be clear that the prohibition on an FCM using one Customer's "**Cleared Swaps Customer Collateral**" to secure or satisfy another Customer's positions applies to all Margin.

- **22.11(c)(2) Information on Cleared Swaps FCM Must Provide to DCO**: (a) confirm in interpretative guidance that the FCM's report of Customer's "**portfolio of rights and obligations arising from the cleared swaps**" includes all Customer positions ***and*** *Cleared Swaps Customer Collateral* (clarified as requested above to include all Margin); and (b) issue a new rulemaking to ***require:*** (1) such FCM's report be made "**as frequently as technologically feasible**"; and (2) DCOs to take "**all steps necessary**" to confirm that such FCM's compliance is "accurate and complete".

- **22.12(c)(1) Information on Cleared Swaps Customer Collateral**: (a) confirm in interpretative guidance that the DCO's calculation and record of the amount of "**collateral required**" ***includes all Cleared Swaps Customer Collateral*** (clarified as requested above to include all Margin), and (b) issue a new rulemaking to ***require*** such DCO's report be made "**as frequently as technologically feasible**".

- **22.13(c)(2) Additions to Cleared Swaps Customer Collateral**: confirm in interpretative guidance that: (a) DCOs are ***required*** to provide a mechanism "**by which...the FCM is required to identify each business day, for each Customer, the amount of collateral posted in excess of the amount required by the DCO**"; (b) that such collateral is ***included in the definition of Cleared Swaps Customer Collateral*** (clarified as requested above to include all Margin); and (c) that such collateral is fully protected from fellow-customer risk.

- **22.15 Treatment of Cleared Swaps Customer Collateral on an Individual Basis**: confirm in interpretative guidance that the requirement for the DCO to protect the value of **"collateral required with respect to the portfolio of rights and obligations"** includes all Cleared Swaps Customer Collateral (clarified as requested above to include all Margin).

Additional Customer Protections:

- **Adopt FIA and NFA-Proposed FCM Best Practices** (including, but not limited to):
  - daily reporting to NFA of each FCM's segregation calculations,
  - twice-monthly reporting by each FCM of its compliance with Rule 1.25 investment limitations (as well as when investment profile changes), and
  - annual FCM certification that there are "no material weaknesses" in its capital computation and customer protection controls.

- **Publish FCM Compliance Results on CFTC Website**: (***e.g.*,** compliance with CFTC segregation requirements, FCM financial data, FCM stress tests and results, etc.).