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February 22, 2013

Ms. Melissa Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: RIN 3038-AD88 – Notice of Proposed Rulemaking ("NPR"), Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations

Dear Ms. Jurgens,

Vanguard[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") with our views on proposed new rules and rule amendments[2] to provide greater protections to customers and to the funds deposited by customers with futures commission merchants ("**FCMs**") and clearing organizations with respect to exchange traded futures, listed options (collectively, "**futures**") and cleared swaps.[3]

As a part of the prudent management of our mutual funds and other portfolios, we enter into derivatives contracts, including swaps and 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 the derivatives title ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") to bring much-needed transparency and regulation to the derivatives markets including subjecting derivatives to regulatory oversight and requiring the clearing of standardized swaps.

We commend the Commission for its efforts to enhance protections afforded to customer assets in the context of both margin for cleared swaps as well as margin for futures. These issues are of utmost importance to our shareholders and we have been consistent vocal supporters for enhanced protections through our long series of comment letters and vocal participation in public Roundtables on the topic.

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[1] Vanguard offers more than 170 U.S. mutual funds with total assets of more than $2 trillion. We serve approximately 9 million shareholder accounts.

[2] Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations 77 Fed. Reg. 67866-971 (Nov/ 14, 2012) (to be codified at 17 C.F.R. Pts. 1, 3, 22 et al.).

[3] 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**".

The basis for Vanguard's support for the current proposals can be summarized as follows:

- **Current proposals must be informed by present practices and market experience**
  - The OTC swaps market has strong protections for customer margin
  - The futures market has significantly weaker protections and a number of existing practices may serve to mask the adequacy of margin in the system
- **Proposed enhancements add much needed transparency and protection**
  - Added transparency will better inform customers in their choice of an FCM
- **The benefits of public disclosure greatly exceed any marginal cost of implementation**
- **"Run on the bank" concerns are inappropriate in context of segregated margin**
- **Tighter margin rules will provide LSOC-like protections to margin for futures**
  - Accelerated capital charges will serve to control an FCM's "lending" of margin
  - Maintaining segregation "at all times" will ensure one customer's margin is not used to secure another customer's obligations

I. Current proposals must be informed by present practices and market experience:

Ahead of addressing the current proposals in greater detail, we believe it is important to set forth the foundational background on which we have built our position.

In terms of cleared swaps, our arguments in support of enhanced customer protections spring from the long-established, highly protective and largely market consistent regime applied to the margin for over-the-counter swaps ("**OTC swaps**"). At present, OTC swaps used by Vanguard are fully margined on a ***bilateral*** basis with net exposures calculated ***daily*** by both our dealer and ourselves, margin exchanged on a ***same-day*** basis, and a ***two-day grace period*** for margin defaults (with all swap payments stopping during such grace period). Margin from both the dealer and the fund is ***held by the fund's custodian*** in accordance with a collateral control agreement. Under these arrangements ***there is either no or very limited fellow customer risk, fraud or malfeasance risk, investment risk or operational risk***.

The tight controls applied to margin for OTC swaps inform our support for tight controls to also be applied to margin for cleared swaps.

In terms of futures, our arguments spring from the disconnect between the even tighter terms related to margin which our FCMs have demanded from us (and which we believe to be consistent with market practice) and the more problematic reality as demonstrated by the recent high-profile defaults involving other FCMs where segregation was not maintained and customer assets were lost. In our futures agreements, our FCMs value our portfolios at least ***daily,*** with margin exchanged on a ***same-day basis***, and a ***one-day grace*** period for margin defaults ***only in the event of an administrative error***.

Under existing rules, we understand that although we have long expected that each customer immediately posts margin to cover the risk presented by its net portfolio, in actuality, the FCMs are only required to maintain segregation with respect to the net exposure presented by

all customer portfolios (with excess margin from some customers applied to cover the margin deficits of other customers). In addition, it is not uncommon for an FCM to front its own margin to cover tardy customers and FCMs need not reserve a capital charge for such margin "loans" for five days. We are concerned that these and other currently permitted arrangements effectively serve to "mask" the true adequacy of the actual margin supporting the overall, aggregate, gross exposures across the futures market. When coupled with the limited reporting requirements FCMs must make to the clearing house, self-regulatory organizations ("**SROs**") and the CFTC, the existing framework affords ***a significantly greater level of fellow customer risk, fraud or malfeasance risk, investment risk or operational risk***.

As representatives of both the Futures Industry Association ("**FIA**") and the International Swaps and Derivatives Association ("**ISDA**") noted in their comments at the February 5, 2013 CFTC Roundtable[4], the new order embodied in the proposed rules, if enacted, will effect a fundamental change in the futures business model – more fundamental than any other change seen over the past 30 years.[5] We have no doubt that customers of the two failed FCMs would applaud the CFTC for proposing such a fundamental change, and only wish these reforms had been enacted several years ago. Although the FIA and ISDA representatives presented enormous, and conflicting, estimates of the amount of ***new margin*** which may be required through the application of these proposed rules[6], we'd like to echo the observation of Robert B. Wasserman, Chief Counsel of the CFTC's Division of Clearing and Markets, that there are only three sources of margin - customer margin to secure such customer's own positions, excess margin from customers used to cover other customers' deficits, and margin "lent" to a customer by its FCM - and that ***such estimates of new margin required by the proposed rules may actually reflect the amount of the margin deficits in the current system that are otherwise covered by other customers' excess margin***.[7] We expect that even if those customers that maintain excess margin with their FCMs receive some nominal return on such excess (and we believe many, if not most, do not), none would sanction the use of their excess margin toward meeting the risks presented by other customers (and their portfolios) which maintain a margin deficit.

While we have full confidence in the health and compliance of our own FCMs, we are supportive of these enhanced protections for the benefit of all customers and believe them to be essential for the long-term stability and strength of the futures and swaps markets.

II. Proposed enhancements add much needed transparency and protection:

To date, we have welcomed the diligent efforts of the CFTC and applicable SROs to enhance customer protections in the following areas:

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[4] A video recording of the Roundtable is available at: http://www.youtube.com/watch?v=vqL3OS8Ot9o&feature=youtu.be ("Roundtable Recording Part 1") and http://www.youtube.com/watch?v=_g3f77DsE7U&feature=youtu.be ("Roundtable Recording Part 2")

[5] See Roundtable Recording Part 2: 1:42:25, 1:45:10, 1:51:28.

[6] ISDA provided an estimated requirement for additional initial margin of between $200bn and $250bn. The FIA's estimate for additional initial margin totaled $80bn. See Roundtable Recording Part 2: 1:27:45.

[7] See Roundtable Recording Part 2: 1:28:45.

- **Investment risk**: amendments to Rule 1.25 to narrow the scope of investments which an FCM can make with customer margin;
- **Operational risk**: amendments requiring FCMs to transfer gross margin to clearing houses;
- **Fellow customer risk**: for cleared swaps, new rules requiring customer margin to be held in legally segregated, operationally commingled accounts ("**LSOC**"); and
- **Fraud and malfeasance risk**: new best practices to achieve greater transparency into FCM compliance with segregation and other rules.

Nevertheless, for both cleared swaps and, particularly, futures, risks remain and the best protection for customers remains their own due diligence with respect to the health and compliance of their FCMs with the unfettered ability to transfer or "port" their trades to an alternative FCM for any reason, including in response to doubts as to the viability of their existing FCM.

The proposed additional enhancements add significant, and much needed, protections and transparency in the following areas:

- **Overall protections**: amendments to Parts 1, 22 and 30 to provide greater certainty that customer funds will be protected;
- **Risk management**: new rules to require FCMs to establish robust risk management programs;
- **Account transparency**: new rules and amendments to provide the CFTC and SROs better transparency into accounts holding customer funds;
- **Capital adequacy**: amendments to ensure an FCM's capital and liquidity are adequate to safeguard overall operations;
- **Auditing**: amended rules to require enhanced auditing of FCM compliance with margin and other rules; and
- **Disclosures**: amended rules to require FCMs to provide additional disclosures to customers to facilitate customer due diligence.

The CFTC's previously enacted protections, coupled with the new proposed rules, serve to significantly mitigate a broad array of risks remaining in the futures and cleared swaps market and, most importantly, also serve to provide greater transparency into the financial health and rule compliance of FCMs.

Porting trades from a weak FCM to a strong FCM remains the ultimate protection for customers. With the goal of enhancing customers' ability to make an informed decision on whether to port, it is imperative that in addition to requiring enhanced reporting to the CFTC and appropriate SROs, ***such information must also be immediately made public for customers to assess the health of their FCMs on a real-time basis***. If such information is not made available, or is available with a significant delay, the CFTC and SROs could find themselves in the untenable position of knowing of actual defaults and/or compliance breaches while watching unknowing customers clear ever increasing volumes of trades through a weakened FCM. Although the market may have functioned on that basis to this point, having learned from the recent FCM failures, the CFTC is to be commended for the new rules to increase transparency

and ***now must go further to make such information available to customers on as close as possible to a real-time basis***.

Among the FCMs' current and proposed reporting requirements, the following ***should be made publically available simultaneous with reporting to the CFTC and/or the appropriate SRO*:**

- **Daily report of segregation calculations**[8] – customers must have a live window into whether FCMs are holding adequate funds to cover each customer's equity;
- **Monthly report of residual interests**[9] – customers must be informed as to when and at what level an FCM has used its own funds to meet a customer's margin requirements,
  a) note the report should also include either ***daily levels or a monthly average*** with reports to be made public on ***a rolling 12 month period***;
- **Monthly (unaudited) and annual (audited) financial statements**[10] - while the proposed rule makes the annual statement public, customers should also see the monthly report,
  a) note that these reports should also reflect the ***balance sheet leverage ratio***;
- **Immediate public reporting of certain events**[11] – customers must have immediate access to reports that FCMs have failed to comply with a host of mandates, including both current reporting requirements (capital levels, books and records and segregation) and also the newly proposed reporting with respect to:
  a) compliance with Rule 1.25 margin investment limits;
  b) a failure to hold "targeted residual interest";
  c) a material adverse change for the FCM, its parent and its key affiliates; and
  d) a material change in an FCM's operations or risk profile;
- **Twice monthly reports on an FCM's actual investment of customer assets** - customers must have access to their FCMs' actual investments to assess whether they are concentrated in the more or less liquid assets allowed under Rule 1.25.

While Vanguard currently has access to important information on a voluntary basis due to its strong relationships with its FCMs, the CFTC should move to create a more level playing field where all customers are ensured full and immediate access to critical information about their FCMs. In so doing, not only will customers be able to make fully informed decisions, but FCMs are likely to improve their behavior as their compliance will constitute yet another differentiator customers may use in assessing their relationships.

III. The benefits of public disclosure greatly exceed any marginal cost of implementation:

The benefits to be derived from such public disclosure – in terms of allowing customers to make fully informed decisions to select and maintain relations with an FCM, or to move positions to a new FCM if their existing relationship presents unacceptable levels of risk – greatly exceed any additional costs associated with such enhanced public disclosure. Indeed we understand that most of the information we believe should be made public will have been

[8] See Proposed Reg. 1.55(o).
[9] See Proposed Reg. 1.11.
[10] See Proposed Reg. 1.55(o)(v).
[11] See Proposed Reg. 1.12.

delivered to the CFTC and/or the appropriate SRO in electronic form utilizing the CFTC's "Windjammer" filing system. While some of that information is also already made public on a voluntary basis on the National Futures Association's ("**NFA**") "BASIC" system, ***public dissemination must be mandatory and, in many cases, more frequent, if customers are to participate in the market fully informed of the risks presented by their FCMs***.

IV. "Run on the bank" concerns are inappropriate in context of segregated margin:

One criticism of the public disclosure of such information voiced by the representative of the Financial Industry Regulatory Authority ("**FINRA**") at the Roundtable is the fear of a potential "run on the bank" scenario which suggests customers would be better off if the regulator, once informed of a fatal weakness, has adequate time to either work with the FCM to restore its health or arrange for an orderly transfer of the business to a healthier FCM.[12] While that logic may apply to banks, which lend customer deposits and may have inadequate reserves should panicked depositors seek redemption; under the proposed rules, FCMs must always hold customer funds in full segregation and thereby ensure margin is always available for positions to be ported to a new FCM. The more appropriate way to consider the issue is that ***afforded full disclosure, customers with strong due diligence procedures and low risk appetites will port early as an FCM declines*** with the regulator able to step in and arrange for a successor FCM for those remaining customers if the decline becomes malignant.

V. Tighter margin rules provide LSOC-like protections to margin for futures:

Turning attention to another highlight of the proposed rules, Vanguard also welcomes the tighter protections afforded to customer margin for futures to bring the treatment closer to the LSOC protections now afforded to margin for cleared swaps. Such clarifications and enhancements include:

- **Prohibiting an FCM from commingling futures customer funds with**:
  - a) the FCM's own proprietary funds;
  - b) funds deposited by customers trading foreign futures and options; and
  - c) funds deposited by cleared swaps customers;
- **Prohibiting an FCM from**:
  - a) using one customer's funds to secure another customer's obligations; and
  - b) using a customer's funds to extend credit to any other person;
- **Prohibiting a clearing organization from commingling**:
  - a) futures customer funds with the clearing organization's proprietary account or the proprietary accounts of any FCM; and
  - b) futures customer funds with funds deposited on behalf of cleared swaps customers.

The discipline required to comply with these rules is highly likely to mitigate not only fellow customer risk with respect to futures customers, but also fraud and operational risk and to allow for the prompt porting of customer positions and related margin should an FCM fail.

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[12] Roundtable Recording Part 1: 1:53:20, 2:43:50.

Key to the effectiveness of these rule changes are the new mandates to maintain intra-day segregation, to accelerate the capital charges applicable to an FCM with respect to undermargined customers and to require the maintenance of an FCM's residual interest for such accounts.

With respect to the accelerated capital charge, we strongly support the CFTC's move to replace the existing five day delay with a one day delay whereby an FCM calling for collateral on a Tuesday (based on a valuation at the close on Monday) will accrue a capital charge on Wednesday instead of on the following Friday as required by existing rules. This accelerated timetable makes complete sense given modern trading and asset transfer timing. It will become more transparent when an FCM is extending credit to a customer for an extended period. We strongly believe that ***each customer must stand up for its trades by promptly posting margin and believe the overall market may be weakened to the extent an FCM is extending significant amounts of credit over an extended period to cover a customer's margin deficit***.

We are particularly supportive of the CFTC's proposed changes to Rule 1.20 whereby subsection (a) is amended to clarify that an FCM must maintain segregation of customer margin "at all times", and thereby avoid using one customer's excess margin to secure another customer's margin deficit. The proposed changes to Rule 1.20(i)(4), are also welcomed as going forward, an FCM will be required to maintain sufficient funds in segregation to cover all margin deficits and to ensure customer accounts aren't undersegregated. ***The combined effect of these changes is likely to require either an FCM's customers to pre-fund margin requirements for pending trades, or the FCM to "lend" margin ahead of a customer's margin transfer*** (and thereby hold a "residual interest" in the customer accounts). In so doing, the proposed changes correctly shift the risk to customers in deficit and away from any excess margin transferred by other customers.

We were surprised by comments from the FIA, the Chicago Mercantile Exchange ("CME") and ISDA at the Roundtable which suggested same-day margin transfers were overly complicated to achieve and the accelerated capital charge would therefore impose significant added costs to an FCM and, by extension, to its customers.[13] As noted previously, same-day margin transfer is required in Vanguard's futures and options agreements, consistent with the long-standing market practice. Such protestations of operational complexity seem overstated, particularly as we know that same-day margin transfer is also the norm in the OTC swap market (with some dealers calling for intra-day margin transfers with respect to particularly risky customers and/or trades). It seems unexpected that FCMs would suggest challenges in achieving same-day margin transfers given their futures agreements require such treatment and their swap dealer affiliates have for many years met such an accelerated timetable for margin transfers involving OTC swaps.

While at the Roundtable, the CME suggested the requirement to maintain segregation on a "live" basis may prove too operationally complex given the volume of trading in the market[14], ***we encourage the CFTC to avoid a weakening of this clause*** – at least a weakening beyond the need to maintain segregation on no less than a once-a-day basis, with the possibility for clearing house initiated intra-day calls (and corresponding segregation maintenance) as needed in periods

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[13] See Roundtable Recording Part 2: 1:47:50, 1:48:25, and 2:08:44.

[14] See Roundtable Recording Part 2: 1:49:40.

of market stress. Also as discussed at the Roundtable, it may be helpful to clarify that proposed rules do not actually require a double counting of the "residual interest".

In sum, Vanguard enthusiastically endorses the CFTC's move to extend many of the new protections created for the cleared swaps market to also apply to the futures market. Not only will protections for the futures margin be significantly enhanced, but we also believe the increased discipline and controls will make it much more likely there is adequate margin in the system to secure all portfolios. While customers may be required to pre-fund their margin requirements for new trades, such a result is far superior than relying on other customers' excess margin to secure such trades. Finally, the significantly enhanced disclosure to be provided by FCMs will help to encourage best practices across the industry. We urge the CFTC to make as much of that disclosure as possible immediately available to the public so that customers can make fully informed decisions when deciding to clear through a particular FCM.

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In closing, we thank the Commission for the opportunity to comment on the proposals to enhance customer protections involving both swaps and futures 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/ Tim Buckley

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 Wetjen