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September 14, 2015

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D>C> 20581

Re: ***Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of Margin Requirements (RIN 3038-AC97)***

Dear Mr. Kirkpatrick,

Vanguard[1] appreciates the opportunity to write in support of the letters submitted to the Commodity Futures Trading Commission (the "**Commission**") dated September 14, 2015 by each of the Investment Company Institute ("**ICI**") and the Asset Management Group ("**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") identifying concerns with the Commission's proposal[2] on the cross-border application of its uncleared swap margin requirements for swap dealers and major swap participants that do not have a prudential regulator (collectively "**CSEs**" or "**Covered Swap Entities**")."[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 reporting, margining and central clearing of standardized swaps ("**Swaps**") and securities-based swaps ("**SB swaps**"), as these changes are well designed to mitigate risks and create a more stable swaps market.

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[1] Vanguard offers more than 170 U.S. mutual funds with total assets of more than $3 trillion. We serve approximately 9 million shareholder accounts.

[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross-Border Application of the Margin Requirements, 80 FR 41376 (July 14, 2015), available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2015-16718a.pdf ("**Proposal**").

[3] The CFTC re-proposed its margin requirements for uncleared swaps for swap dealers and major swap participants in October 2014. See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 (Oct. 3, 2014), available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-22962a.pdf ("**Proposed Margin Rules**"). We refer to "**Margin Rules**" to mean the margin rules that the CFTC will adopt as final rules.

The Commission's Proposal sets forth a complex and highly prescriptive regime for determining when the Commission's Margin Rules will apply based on an assessment of eleven specified elements, and includes a "U.S. Person" definition that differs from the definition which the Commission has applied to all other aspects of swaps reporting, clearing and exchange trading. Not only would such an approach require the development of yet another set of costly systems and operations to track the new definition of U.S. Person but, most importantly, in applying the substitute compliance test on a transaction-by-transaction basis, it would serve to further erode the fundamental risk mitigation tool of cross-transactional close-out netting. Historically netted and margined trades would be required to be separately netted and margined under different regimes in the absence of substitute compliance.

The Commission's proposed cross-border approach, coupled with its Proposed Margin Rules stand as perhaps the most problematic initiative in the entire swap regulatory reform exercise. Unlike the areas of reporting, clearing and exchange trading for which no well-developed precedent existed prior to the global financial crisis, and which therefore invited robust regulatory rulemaking, broad cross-transactional closeout netting and bilateral margining of the resulting net exposure have a decades-long history of successful risk mitigation. Indeed, the global financial crisis stands as an unquestionable validation of the efficacy of the existing netting and margining regime as market participants, like Vanguard-managed funds, were able to close out all trades governed by applicable master agreements, calculate the net amount owed across a broad range of transactions, and apply previously transferred margin to satisfy unpaid obligations.

While the global financial crisis raised no question whatsoever with respect to the robust strength of existing netting and margining market practices – it clearly demonstrated the profound impact of not applying such practices consistently when a single participant was allowed to amass an enormous level of swap exposure unfettered by the need to transfer margin to secure its performance. For the rest of the market, broad netting and bilateral margining worked perfectly; hence there is no need to "reinvent the wheel" with respect to margining uncleared swaps – rather regulators' focus should be on applying these tried-and-true market practices consistently across all participants.

Throughout our many comment letters to the Commission over the past five years, the one consistent theme is that global regulators must leverage existing successful market practices, such as the bilateral margining of swaps, rather than seek to create out of whole cloth parallel regimes that vary from the tried and tested. The second consistent theme is that global regulators must achieve a harmonious approach – especially in areas such as margin rules – in support of the vibrant cross-jurisdictional swaps market. Conflicting regimes raise the twin specters of market fragmentation and decreased liquidity as participants are forced to choose between competing approaches and concentrate trading based on preferred regulatory regimes.

In discussions with Commissioners and Staff, the question is often raised: "Why is global harmony so important for swaps when investment managers have to contend with differing regimes related to other types of investments?" The answer is quite simple: the swaps market, which frequently involves long-dated products, has from the start been globally harmonious from both a market structure and regulatory perspective. This consistency of approach – especially with respect to closeout netting and margining – has enabled the market to flourish, with banks and dealers around the world able to offer reasonably consistent pricing for consistent products.

Competition has been based on market forces and not on regulatory arbitrage. For this reason, a broad range of banks and dealers in many diverse jurisdictions have been able to make markets and thereby develop and sustain product liquidity. In terms of these swap reforms, global regulators also have the virtually unprecedented opportunity to work together to simultaneously develop new rules which target the same regulatory concerns.

If the opportunity for global consistency is missed, and banks and dealers in different jurisdictions (or possibly within the same jurisdiction) are hobbled with different rules and market structure, it is inevitable that pricing will be impacted as banks and dealers in some jurisdictions face challenging assessments as to whether the cost of regulatory compliance and increased competition from banks and dealers subject to preferred margin regimes renders products unsustainable.

With respect to margin for uncleared swaps, this prospect is disappointing not only due to the robustness of the existing market practice – but also given that global regulators have otherwise already come together on consistent global margin recommendations promulgated by the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") (the "**BCBS/IOSCO Framework**" or "**Framework**").

Therefore, rather than crafting complex, transaction-specific rules for assessing the applicability of one margin regime over another, we urge the Commission to harmonize its Proposed Margin Rules with the BCBS/IOSCO Framework and base its cross-border assessment for substitute compliance on an outcomes-based approach that targets overall compliance with the Framework.

It is against this background that our review of the Commission's Proposal has raised significant concerns illustrated at length in each of the ICI and SIFMA AMG comment letters referenced above. In this letter we'd like to highlight the following key concerns:

- **<u>Harmonization</u>: The Commission should prioritize the development of globally consistent margin rules.**

- **<u>Substitute Compliance</u>: Comparability determinations should consider the entirety of a jurisdiction's margin rules and not make assessments on an element by element basis or apply such determinations on a transaction by transaction basis.**

- **<u>U.S. Person</u>: This definition must be consistent across all the Commission's swap rules.**

I. <u>Harmonization</u>: The Commission should prioritize the development of globally consistent margin rules.

We have consistently endorsed the BCBS/IOSCO Framework as the most compelling global standard for the development of margin rules for uncleared swaps. Our reasoning is two-fold in that it: (a) is highly reflective of the existing market structure which was proven to provide robust risk mitigation during the global financial crisis, and (b) represents the consensus view of regulators across multiple jurisdictions.

For the past several decades, standard market practice in the OTC swap market is for participants to only enter into trades governed by a master agreement and collateral agreement using forms published by the International Swaps and Derivatives Association ("**ISDA**"). OTC swaps used by Vanguard are fully margined on a ***bilateral*** basis with net exposures calculated ***daily*** by both our dealer and ourselves and margin is exchanged on a ***same-day*** basis. Margin from both the dealer and the fund is ***held by the fund's custodian*** in accordance with a collateral control agreement. As a result of Vanguard's adherence to this long-standing market practice, Vanguard funds suffered limited swaps losses resulting from the global financial crisis.

The BCBS/IOSCO Framework reflects this practice by recommending, ***inter alia***: (a) bilateral variation margin, (b) bilateral initial margin (where aggregate notional amounts exceed a reasonable threshold), and (c) a broad range of liquid assets as eligible collateral. While the Commission's Proposed Margin Rules have moved closer to the BCBS/IOSCO Framework, as expressed in our comment letter dated November 14, 2014, there remain many areas of divergence, none of which, in our view, are compelling against the paramount goal of global consistency.

Especially as the existing market practice was proven to be so effective in the global financial crisis, and the BCBS/IOSCO Framework largely reflects that practice, regulators in each jurisdiction should have comfort in developing a rule set which reflects the Framework and thereby affords a more principles-based assessment of substitute compliance.

II. Substitute Compliance: Comparability determinations should consider the entirety of a jurisdiction's margin rules and not make assessments on an element by element basis or apply such determinations on a transaction by transaction basis.

In recognition of the fundamental risk mitigation benefits of broad close-out netting, the Commission should support the application of a single set of margin rules for all trades between a participant and a CSE. Especially as the Commission has advocated an element-by-element assessment for determining the applicability of substitute compliance, and proposes to apply the compliance determination on a transaction by transaction basis, there is the real possibility that individual transactions executed with a single Covered Swap Entity could, in the absence of substitute compliance, have different margin regimes apply with the need to establish different netting sets for the purposes of calculating margin transfers.

For example, if a swap is executed between a non-U.S. Person and a non-U.S. CSE, under the Proposal the Commission's margin rules could apply if the trade is executed with the U.S. branch of the non-U.S. CSE, whereas such rules would not apply to other trades with the same CSE executed with a non-U.S. branch. Historically, these two trades with two different branches would be subject to close-out netting under a single ISDA Master Agreement and the net market exposure of the two trades would be collateralized under a single ISDA Credit Support Annex. Under the Proposal, as different margin rules could apply based on the differing branches of the CSE, the parties could have to maintain two separate netting calculations to which the appropriate margin regime would be applied.

In addition to compromising the netting potential, such a complex analysis would require the cost of developing and implementing an entirely new system solely targeting application of

the substitute compliance assessment for each transaction to ensure compliance with the CFTC's Margin Rules.

Instead, the Commission should establish a test for substitute compliance based on a regime's overall consistency with the BCBS/IOSCO Framework and whether such regime achieves similar outcomes. While we have advocated full consistency with the Framework, it is possible that individual regulators, including the CFTC, may be compelled to adopt margin regimes with specific differences based on unique local legal or market structure issues. In so doing, the individual elements of a specific regime may fail a consistency test with the Commission's Margin Rules while the overall outcome is consistent with the Framework and produces a substantially similar outcome.

In such cases, full substitute compliance should apply so that all trades between a participant and a CSE are subject to the same netting and margining calculations.

III. U.S. Person: This definition must be consistent across all the Commission's swap rules.

To apply a unique U.S. Person definition to the Margin Rules that diverges from the definition applicable to the Commission's reporting, clearing and exchange trading rules introduces needless additional complexities and costs. Again, expensive system development and deployment would need to be established just for this single regulatory initiative – on top of all of the efforts already in place to assess the U.S. Person status of clients for the other swaps rules. There can be no pragmatic rationale for such a development, and we urge the Commission to reassess this proposal.

Indeed, we see this as an opportunity for the Commission to leverage its existing U.S. Person definition within the swap rules and, ideally, consolidate the definition across all swap rules with the Commission's existing guidance and incorporate the new clarifications raised in the proposed definition.

For example, in the harmonized U.S. Person definition, the Commission should clarify that, as stated in the Commission's cross-border guidance, a collective investment vehicle that is publically offered only to non-U.S. persons, and is not offered to U.S. persons, is not a U.S. Person. In addition, we welcome the Commission's removal of the majority ownership prong of the existing U.S. Person definition and recommend that this change be incorporated into the consistent final definition applicable to all of the Commission's swap rules.

In sum, Vanguard joins with the ICI and SIFMA AMG in their comments regarding the Commission's Proposal and, in particular, urges the Commission to redouble its efforts to achieve globally consistent margin rules, to assess substitute compliance based on overall consistency with the BCBS/IOSCO Framework and to take the initiative to clarify a single U.S. Person definition for all of its swap rules incorporating its further thinking as reflected in existing guidance and in the Proposal.

In closing, we thank the Commission for the opportunity to provide our comments 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 Frances Han, Senior Counsel at (610) 503-5804.

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: The Honorable Timothy G. Massad
The Honorable Sharon Y. Bowen
The Honorable J. Christopher Giancarlo

The Honorable Mary Jo White
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
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