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September 20, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-1090

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

Re: File Number S7-16-10 – Request for Comments: Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act (75 Fed. Reg. 51529)

Dear Ms. Murphy and Mr. Stawick,

Vanguard appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**") and the Securities and Exchange Commission (the "**SEC**" and, together with the CFTC, the "**Commissions**") with our comments regarding certain key definitions[1] in the derivatives title ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

Vanguard serves as adviser to approximately 24 million shareholder accounts for investors who entrust us with nearly $1.4 trillion in savings for their retirement, their children's education, or their other financial needs, such as home purchase. As a part of the prudent management of our more than 160 mutual funds and other portfolios, we enter into derivatives contracts to provide a number of benefits to our investors, including hedging portfolio risk, lowering transaction costs and achieving more favorable execution compared to traditional investments.

[1] The key terms for which comments on definitions are requested by the Commissions include: "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," and "major security-based swap participant." For the purposes of this letter, references to "**Swap**" shall address both "swap" and "security-based swap", "**Swap Dealer**" shall address both "swap dealer" and "security-based swap dealer" and "**Major Swap Participant**" shall address both "major swap participant" and "major security-based swap participant".

Throughout the legislative process and debate that preceded the enactment of the Dodd-Frank Act, Vanguard has been supportive of provisions to bring much-needed transparency and regulation to the derivatives markets. In our view, Title VII of the Dodd-Frank Act is a positive component of regulatory reform to restore the integrity of the markets and investor confidence.

We believe the over-arching goal of Title VII is to reduce the potential systemic risk presented by the derivatives markets, and the mandate for the Commissions in the rulemaking process is to effect risk reduction while preserving the benefits afforded by prudent activity in the derivatives market. In developing rules to further define key terms, Vanguard encourages the Commissions to consider the following principles:

- **Risk-Adjusted Regulation**: In assessing SEC and/or CFTC regulation and related rules, consideration should be given to a continuum with the market making activities of a Swap Dealer on one side and end-users already subject to registration and investment regulations (including derivatives) on the other side with Major Swap Participants presenting risks similar to Swap Dealers while not necessarily making markets in Swaps.

- **Look to Recourse to Assess Risk**: Tests to determine Swap Dealer and Major Swap Participant status should apply to the primary entity holding principal risk in Swaps and not to agents acting on behalf of such principals.

- **Major Swap Participant:**

    - An objective, quantitative test should apply based on exposure thresholds for average Swaps positions within an appropriate period with self-assessment and reporting of Major Swap Participant status.
    - The term "major swap category" / "major security-based swap category" should be based on product type given the different risk parameters presented by each product.
    - Cleared Swaps should not factor into the quantitative test in recognition of the protections afforded by central clearing and to encourage the clearing of an expanded range of products.
    - In assessing exposure, the Commissions should consider a risk-adjusted approach in recognition of the aspects of potential exposure presented by each major swap / security-based swap category.
    - Credit should be given to the value of high-quality, liquid collateral posted to the applicable Swap Dealer, as well as to high-quality, liquid assets segregated on the entity's books to satisfy Swaps exposures.
    - Registered investment companies should be exempt from registration with the Commissions as Major Swap Participants.

- **Swap**: As rule making and studies are conducted, Vanguard strongly believes that foreign exchange swaps and forward transactions should continue to be considered Swaps and that stable value products should continue not to be considered Swaps.

I. Risk-Adjusted Regulation: A risk-based approach to rulemaking should apply in determining whether an entity qualifies as a Swap Dealer or as a Major Swap Participant.

As the rulemaking process is mandated to address systemic risk, a graduated level of rules should apply based on the continuum of risk presented by different entity types and Swaps portfolios.

At one end of the risk continuum is a Swap Dealer which the Commissions should clarify to include entities which: (i) hold themselves out as a dealer, (ii) make a market in Swaps, and/or (iii) enter into Swaps on both sides of the market to profit from providing liquidity to clients (in all cases rather than merely trading for its own account). In relation to entities trading Swaps, the key differentiating factor for Swaps Dealers must be market-making activity in support of client trading. Regardless of the size of the positions actually maintained by Swap Dealers, given the scope of their activity and the potential risk arising from such activity, it is entirely appropriate for such entities to register with the SEC and/or CFTC and be subject to the most conservative level of rules related to Swaps activity.

At the other end of the risk continuum are highly regulated entities such as SEC-registered investment companies ("**RICs**"). RICs are presently subject to rigorous rules related to their investments (including derivatives) designed to provide transparency and to mitigate risk to investors. These rules also make it unlikely such usage could impact the U.S. banking system or financial markets. Given the existing SEC rules applicable to RICs' derivatives usage, further SEC and/or CFTC registration as either a Swap Dealer or a Major Swap Participant would be redundant and could potentially subject such entities to duplicative, conflicting and onerous regulations.

We believe a Major Swap Participant should fall relatively close to a Swap Dealer on the risk continuum. It is our view that Major Swap Participant status was conceived to capture a relatively limited number of entities not otherwise qualifying as a Swap Dealer but whose substantial Swaps positions pose a level of risk to the U.S financial system similar to that posed by a Swap Dealer. Obvious examples of problematic trading portfolios include those managed by Long Term Capital Management, Inc. ("**LTCM**") and AIG Financial Products ("**AIGFP**") where there was an significant accumulation of uncleared, concentrated, volatile, and undercollateralized positions for which the potential exposure was many multiples of such entity's ability to perform and resulted in the eventual bail-out by other financial institutions (in the case of LTCM) or by the U.S.

government (in the case of AIGFP) in an effort to mitigate the potential disruption to the U.S. financial system.

For the above reasons, we believe the enhanced level of rules applicable to Major Swap Participants should apply to entities where Swaps usage presents risk parameters closest to those presented by Swap Dealers.

II. Look to Recourse to Assess Risk: Swap Dealer / Major Swap Participant status should be determined with respect to trading entities (principals) and not with respect to asset managers (agents).

The overall goal of reducing systemic risk with respect to Swaps exposures requires a focus on the entities that hold positions generating such exposures. This approach was addressed in the Senate colloquy between Senators Kay Hagen and Blanche Lincoln where Senator Lincoln acknowledged that the Commissions should *"look at each entity on an individual basis when determining its status as a major swap participant."*

The definitions of each of Swap Dealer and Major Swap Participant could be viewed as applicable to entities that enter into Swaps as principal as well as to entities that act as agent on behalf of other principals. The phrases *"entering into swaps with counterparties as an ordinary course of its business"*[2] and *"maintains a substantial position in swaps"*[3] could be interpreted to include asset managers acting as agent in entering into transactions on behalf of their managed funds.

In terms of Swap Dealer, we believe the Commissions should clarify that the intent of the definition is to capture entities that make a market in Swaps in the ordinary course of business. While market-making is the distinguishing factor of a Swap Dealer, the focus in general should be on trades entered into as principal – whether on each side of the market to facilitate client trading or as a part of a proprietary trading strategy. As asset managers neither make markets in Swaps nor enter into transactions as principal, they should not qualify as Swap Dealers. Moreover, while funds enter into Swaps as principal, they do not make markets and therefore should also not qualify as Swap Dealers. For these reasons, it is important for the Commissions to clearly identify in the rules the entity types that are not Swap Dealers, including, specifically, asset managers and their funds.

In terms of Major Swap Participant, we believe the Commissions should similarly focus on trades entered into as principal rather than as agent on behalf of principals. In particular, in the case of an asset manager, while the overall positions it manages may be sizeable, recourse is to the assets of a particular fund to which such positions have been

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2 Dodd-Frank Act, Section 721(49)(iii).
3 Dodd-Frank Act, Section 721(32)(A)(i).

allocated. While similar positions may be held by different funds, each has its own distinct trading strategy and investors, and none is compelled to engage in or maintain a trading position in harmony with another fund or funds. An assessment of risk applies not to the aggregate position across funds but rather to whether each individual fund has the requisite level of resources needed to support the trading position.

In relation to fund structures, this approach should be consistently applied. While it is our position that RICs should be exempt from either Swap Dealer or Major Swap Participant status, a useful example of assessing risk based on recourse can be demonstrated with respect to transactions involving series registered investment companies (each a "**Series RIC**"). The governing documents provide for the separation of the assets and liabilities of one Series RIC from those of another Series RIC. In the event of profits or losses on an investment (including Swaps), the individual Series RIC (rather than its adviser, any other Series RIC or the legal entity to which the Series RIC belongs (e.g., Delaware statutory trust)) receives the profit or loss. Again, while RICSs should be exempt from consideration, if Major Swap Participant status was to be assessed, it would be based on exposures related to the individual Series RIC. In the case of a separately managed account ("**SMA**"), Major Swap Participant status should be based on the aggregate positions maintained by the owner of the SMA (even if advised by several different asset managers) as the owner of each SMA receives the profit or loss associated with such aggregate position.

For the above reasons, the Commissions should clarify that the definitions of Swap Dealer and Major Swap Participant clearly relate to the principal trading entity on an individual basis.

III. Major Swap Participant: Rules should establish objective standards for the determination of Major Swap Participant.

In developing the attributes of a quantitative test for Major Swap Participant status, both the terms of the Dodd-Frank Act and the related Senate colloquies provide guidance.

The definition of Major Swap Participant has three components with the first and third focusing on maintaining a "substantial position" in any major swap category. The first component carves out *"positions held for hedging or mitigating commercial risk"* as well as positions held by ERISA plans *"for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."* The third component includes no such carve-out but adds the requirement that such entity is *"highly leveraged relative to the amount of capital it holds"* and is otherwise not subject to Federal banking capital requirements. The second component of the definition targets substantial exposure that *"could have serious adverse effects on the financial stability of the United States banking system or financial markets."*

"Substantial Position" is defined as a threshold set by the Commissions that is *"prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States."* It is specifically provided that in setting the threshold, the Commissions shall consider an entity's *"relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quantity of collateral held against counterparty exposures."*

We consider the third component of the definition of Major Swap Participant as a backstop to the carve-outs relating to hedging contained in the first component of the definition. In other words, notwithstanding any hedging activity, if an entity is highly leveraged relative to the capital that it holds, it will qualify as a Major Swap Participant if it also maintains a substantial position in any major swap category. On that basis, the existence of leverage appears not to be intended as an add-on to the risk assessment relating to exposure. Instead, it serves to negate the carve-out with respect to Swaps traded for hedging or risk mitigation. For the purposes of this test, we believe the Commissions should consider a number of issues in assessing the meaning of "highly leveraged." It is possible that a relative test is appropriate whereby a higher leverage threshold will be reasonable for entities with a smaller capital base. For entities with a larger capital base, a lower leverage threshold may be appropriate given the potential for additional risk raised by a much larger trading portfolio. In addition, for the purpose of assessing Major Swap Participant status, the Commissions should confirm that the definition of leverage relates to debt financing and does not involve the potential leveraging effect produced in many types of derivatives (given the synthetic nature of the position). As noted above, it will also be useful for the Commissions to confirm that the intention in assessing leverage levels is not to produce an add-on to calculations of exposure, but rather to acknowledge that highly leveraged portfolios should not benefit from the carve-out for Swaps hedging risk.

Again, as a part of the colloquy between Senators Hagan and Lincoln, Senator Lincoln acknowledged the intent of the Commissions to *"focus on the risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and a lack of information about the aggregate size of positions."* In assessing factors comprising exposure, Senator Lincoln stated that: *"[b]ilateral collateralization and proper segregation substantially reduces the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently."*

Given the absence of any existing infrastructure to monitor and assess Major Swap Participant status, from a purely practical perspective, the Commissions should promulgate rules directing the self-monitoring and reporting of Major Swap Participant

status using a quantitative test based on average Swap positions over a defined period. By focusing on the average position over a defined period (e.g., each calendar quarter), limited peaks and troughs of position volume and value can be avoided and a truer picture of consistent Swaps usage and related risks can be determined. While the quantitative test should focus on the average position within a defined period, Major Swap Participant status should continue for an extended defined period (e.g., at least one calendar year) after an entity has qualified as a Major Swap Participant notwithstanding a subsequent falloff of position volume and/or value. Such an approach will provide greater certainty and consistency with respect to Major Swap Participant status and will help to ensure that compliance with the mandates of Title VII of the Dodd-Frank Act are fully implemented and achieve their intended purpose.

Taken together, we believe it is critical to develop a quantitative test to identify systemically important entities based on exposure. The parameters for such a test should include the following considerations:

- **Exclude cleared positions**: The Dodd-Frank Act requires "standardized-swaps" and "standardized security-based swaps" to be cleared. This recognizes the risk-mitigating benefits to be achieved through central clearing. To encourage both compliance with this requirement and the central clearing of an even broader range of products, cleared transactions should be excluded from the quantitative test.

- **Major Swap Categories**: The Dodd-Frank Act recognizes that an entity may be a Major Swap Participant with respect to one or more major swap categories but not with respect to others. Given that different product types have different risk parameters, it makes sense for the quantitative test to focus on different product types. On that basis, the CFTC should establish major swap categories including: interest rate swaps, foreign exchange swaps and forwards[4], broad-based equity

[4] The definitions of "foreign exchange forward" and "foreign exchange swap" at Sections 721(24) and (25) of the Dodd Frank Act raise what we believe to be the unintended inclusion of very short-dated transactions within the definition of Swap. While the Secretary of the Treasury may make a written determination that such foreign exchange instruments should be excluded from the definition of "Swap", it is our view that the proper distinction to be made in assessing Swap-status with respect to foreign exchange products lies in the maturity of the relevant trade-type. Foreign exchange transactions with a relatively short settlement cycle (T+6 or less) ("FX Spot") are typically entered into to hedge currency risk presented in the settlement of non-U.S. dollar-denominated security purchases and sales, dividend payments, and other similar transactions. The short-dated nature of such FX Spot transactions presents little speculative opportunity and is likely to raise significantly less risk than that of more longer-dated Swaps. Moreover, from a practical perspective, the collateralization of such FX Spot transactions is not market practice and would present significant challenges in terms of the frequency of valuations, collateral transfers, and collateral returns, with such challenges not commensurate with the risk arising from such product. Foreign exchange transactions with longer-dated maturities can present significant price volatility, are more easily used for speculative purposes, and are increasingly subject to collateralization in the market. The ramifications of the treatment of such longer-dated foreign exchange forwards and swaps as Swaps is

index swaps, broad-based credit default index swaps, agricultural swaps, energy swaps, and metals swaps and the SEC should establish categories for all other equity and credit default swaps (in each case consistent with the definitions of Swap and Security-based Swap).[5]

- **Risk Components**. In assessing the risk presented by an entity's Swaps, we believe that a risk-adjusted approach to calculating exposure is appropriate and is most consistent with:
    - the increasingly common approach applied by Swap Dealers with respect to Swaps – particularly with respect to Swaps involving hedge funds, and
    - the approach used by futures commission merchants and central clearers to determine margin levels for futures contracts and other cleared trades.

  Such an approach should go beyond the simple calculation of daily mark-to-market exposure related to a Swap and should include concepts related to potential exposure, including, but not limited to, volatility and concentration risk. While arguments can be raised that potential exposure is inherently subjective and, therefore, uncertain, we believe that consideration should be given to the approach used by futures commission merchants with respect to futures contracts and central clearers with respect to cleared derivatives to assess the possibility of identifying a consistent, objective standard to be used to determine Major Swap Participant status.

- **Mitigation Components**. Outstanding exposure relating to uncleared Swaps should exclude the following components:
    - **Collateral (Amount and Quality)**. The aggregate amount of cash and triple-A rated securities that an entity has transferred to its Swap Dealer (or custodian) under appropriate netting and collateral agreements (e.g., ISDA agreements) to secure its obligations in respect of its Swaps.
    - **Segregated Assets**. The amount of unencumbered cash and triple-A rated securities that an entity has segregated on its own books and records in support of its Swap obligations.

  These mitigation components are consistent both with the wording of the definition of substantial position and with the approach recognized by Senator Lincoln in the above referenced Senate colloquy.

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therefore fully consistent with the potential risks presented by such products. For these reasons we believe foreign exchange forwards and swaps (excluding FX Spot) should qualify as a major swap category.

5 We perceive several complicating factors in assessing Major Swap Participant status based on a single major swap category. For example, as multiple product types are typically traded under a single master agreement between two trading entities, rather than assessing exposure with respect to a single product type, a net exposure amount across all such products is determined with collateralization against such net exposure amount. In addition, we are unclear as to how the ramifications of Major Swap Participant status can be applied only to an entity's trading in qualifying major swap categories and not to trading in other major swap categories. It is for this reason that we have suggested both an exposure threshold for each major swap category as well as an exposure threshold across all categories.

- **Quantitative Test.** Once the risk components and mitigation components are determined (excluding cleared Swaps as noted above), we believe the Commissions should establish a quantitative test for Major Swap Participant status at a threshold of $500 million in uncollateralized exposure for any single major swap category (on the basis that the major swap participant categories are defined on a product-by-product basis as described above) or $1 billion in uncollateralized exposure in aggregate across all major swap categories.

IV. RICs should be exempt from the definition of Major Swap Participant.

As noted above, in relation to derivatives activity, RICs are at the opposite end of the risk continuum to Swap Dealers and Major Swap Participants given the existing SEC registration requirements and related extensive rules applicable to RICs and their investments.

In particular, RICs' derivatives usage is subject to stringent regulations, which effectively serve as a limitation on their ability to cause significant harm to U.S. financial markets. Section 18 of the Investment Company Act of 1940 and positions taken by the SEC staff impose restrictions on a RIC's ability to enter into transactions that have a leverage component (e.g., derivatives).[6] As a result of these rules, RICs may not enter into derivatives unless they cover their exposure. RICs typically cover their exposure by segregating liquid assets on their books, but may also maintain an offsetting position as permitted by SEC interpretative positions. These rules have the effect of limiting the use of transactions involving leverage (e.g., derivatives) by RICs and the segregated assets provide assurance that a RIC is able to meet its derivatives obligations.

Requiring RICs to also register as a Major Swap Participant would be largely redundant to rules already applicable to them and could raise potentially conflicting regulations. In addition to the existing SEC registration requirements for RICs, investment advisers of RICs must also register with the SEC under the Investment Advisers Act of 1940. RICs and their advisers are subject to significant recordkeeping requirements and must keep daily trading records of all transactions entered into, including derivatives. RICs are also subject to comprehensive disclosure requirements and must make specific public disclosures about their investment strategies, including transactions in derivatives. Further, they also must publicly report derivatives positions on a periodic basis. RICs and their investment advisers are subject to broad oversight by their board of directors/trustees and their chief compliance officer, and are subject to SEC inspection. They also must have written compliance programs to prevent violations of

6 See Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 18, 1979); Merrill Lynch Asset Management, L.P., SEC No-Action Letter, 1996 WL 429027 (July 2, 1996); and Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 48,525 (June 22, 1987).

Federal securities laws, and their directors/trustees, officers and employees are subject to codes of ethics.

As RICs are highly regulated and are subject to anti-leveraging rules, risk related to their derivatives usage is mitigated and is unlikely to have an impact on the stability of the U.S. banking system or financial markets. Our view is clearly echoed in the Senate colloquies between Senators Hagan and Lincoln, where Senator Lincoln states: *"[i]n addition, it may be appropriate for the CFTC and the SEC to consider the nature and current regulation of the entity when designating an entity a major swap participant or a major security-based swap participant. For instance, entities such as registered investment companies and employee benefit plans are already subject to extensive regulation relating to their usage of swaps under other titles of the U.S. Code. They typically post collateral, are not overly leveraged, and may not pose the same types of risks as unregulated major swap participants."*

For the above reasons, we strongly recommend that the Commissions clarify that RICs are exempt from consideration as either a Swap Dealer or Major Swap Participant.

V. Swap: The definition of Swap should include Foreign Exchange Swaps and Forwards and exclude Stable Value Products.

The Dodd-Frank Act confirms that foreign exchange swaps and forwards are Swaps unless the Treasury Department determines otherwise. Consistent with our previous comments on the subject, Vanguard's view is that foreign exchange swaps and forwards present many of the same concerns that are posed by other types of Swaps, including the possibility that large outstanding positions could create significant risk if adequate collateral has not been posted and/or the trading entity has not adequately covered its potential exposure on the position. As noted in Footnote 4 above, we believe it would be helpful for the Commissions to clarify that foreign exchange spot transactions (settling within one customary settlement cycle) do not constitute foreign exchange swaps or forwards. Apart from that clarification, we believe that foreign exchange swaps and forwards should be defined as Swaps and should be subject to the Dodd-Frank Act provisions applicable to Swaps.

In addition, with respect to stable value products, the Dodd-Frank Act calls for a study to be conducted to determine whether stable value products constitute Swaps and, if so, whether an exemption is appropriate. Regulators have 15 months to complete the study. Unless and until stable value products are determined to be Swaps, they do not constitute Swaps under the Act. Again, consistent with our previous comments, we strongly believe that such products are fully distinguishable from Swaps and therefore should not be regulated as Swaps.

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In closing, we thank the Commissions for the opportunity to comment in advance of their joint rulemaking on the further definition of key terms in the Dodd-Frank Act and appreciate the Commissions' consideration of Vanguard's views. We welcome future opportunities to provide additional comments on these topics, as well as on other rulemakings the Commissions will undertake in accordance with Title VII of the Dodd-Frank Act. If you have any questions, please do not hesitate to contact William Thum (610-503-9823 or William_Thum@Vanguard.com).

Sincerely,

Gus Sauter

cc: Securities and Exchange Commission
The Honorable Mary L. Shapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

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