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November 7, 2011

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

Via Electronic Submission

Re: File No. S7-33-11 – Use of Derivatives by Investment Companies under the Investment Company Act of 1940

Dear Ms. Murphy:

Vanguard[1] appreciates the opportunity to provide the Securities and Exchange Commission (the "**SEC**") with our comments on the SEC's concept release on the use of derivatives by management investment companies ("**funds**") registered under the Investment Company Act of 1940 (the "**1940 Act**").[2]

As a part of the prudent management of our mutual funds and other portfolios, we enter into derivatives contracts, including swaps,[3] futures, and foreign exchange forwards (collectively, "**derivatives**"), 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.

Throughout the legislative process and debate that preceded the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), Vanguard has been supportive of provisions that would bring much-needed regulation to the swaps markets including subjecting swaps to additional regulatory oversight and requiring the clearing of standardized swaps.

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[1] Vanguard offers more than 170 U.S. mutual funds with total assets of more than $1.5 trillion. We serve approximately 9 million shareholders.

[2] *See* Use of Derivatives by Investment Companies under the Investment Company Act, 76 FR 55237 (September 7, 2011) (the "**Concept Release**").

[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 of 1934) shall be referred to collectively as "**swaps**."

In our view, the framework of SEC regulatory guidance on derivatives usage by funds, including numerous SEC rules and no-action positions under the 1940 Act on the issuance of senior securities, has worked very well over the years to protect fund investors. However, in light of the increased use of derivatives by certain funds, the evolution of derivative products and the market disruptions of 2008, we believe that it is appropriate for the SEC to re-visit and modernize such rules, and we commend the SEC for seeking input on these important issues.

A key area for modernization relates to rules regarding the issuance of senior securities and related asset segregation as applied to derivative investments. The development of regulatory guidance tailored specifically to derivatives would allow fund complexes to adopt a clear and consistent approach for segregating assets in respect of derivatives. Given the broad diversity of derivative products, and the regular development of new products, we support a principles-based approach where the SEC would promulgate clear general guidelines dealing with asset segregation and related issues such as offsets. To assist funds in applying the general guidelines, we strongly recommend that they be accompanied by examples illustrating how the guidelines would apply to the most common types of derivatives. These principles-based guidelines could then be used by fund complexes to develop their own asset segregation policies based upon their unique investment programs and intended derivatives usage.

In addition, funds face a number of interpretative issues when applying certain provisions of the 1940 Act (e.g., Section 5(b), Section 12(d)(3)) to derivatives transactions. These provisions were adopted prior to the development of many derivative products and fund usage of such products. We recommend that the SEC issue interpretative guidance or rulemaking that would set forth the way derivatives should be treated by funds when testing diversification, concentration and investments in securities-related issuers under the 1940 Act.

The discussion below presents Vanguard's recommendations and additional comments on the Concept Release.

- **The moratorium on issuing SEC exemptive relief for ETFs using derivatives should be lifted.** We respectfully request that the SEC reinstate its review of applications of all exchange traded funds ("**ETFs**") that seek the flexibility to use derivatives in furtherance of their investment objectives, regardless of the level of anticipated derivatives use. The SEC analysis of fund use of derivatives could take a significant period of time to complete and the suspension deprives investors of lower-cost competitive and potentially innovative new ETFs.

- **The Dodd-Frank Act and related rules, when implemented, will significantly reduce risk for entities that participate in the swaps markets.** The new Dodd-Frank rules applicable to swaps (e.g., clearing, margining) are likely to significantly reduce risk in swaps markets and should mitigate SEC concerns around fund swap investments. Such protections will provide a strong foundation of risk mitigation and should figure prominently as the SEC contemplates a modernization of fund derivatives rules for the protection of fund investors.

- **The SEC should adopt a principles-based approach when assessing senior securities restrictions in the context of fund derivatives investments.** Derivatives have evolved and will continue to evolve, and approaches for asset segregation and offset should evolve and be adaptable as new and different derivatives emerge. Consequently, we support a principles-based approach under which the SEC would promulgate clear general guidelines dealing with

asset segregation and related issues such as offsets, accompanied by examples of how the guidelines might apply to the most common types of derivatives. Funds could utilize the guidelines and examples to develop their own asset segregation policies based upon their unique investment program and intended derivatives usage. For example, one guideline would focus on the principle that a fund must have assets available to meet all of its obligations based on a commercially reasonable assessment of the potential loss presented by its derivatives, either at the individual product level or, in appropriate circumstances, on a portfolio basis.

- **Interpretative guidance on diversification, concentration and securities-related issuer testing should be issued.** As the 1940 Act provisions relating to diversification, portfolio concentration and exposure to securities-related issuers raise a number of unresolved interpretative issues when applied to derivatives**,** we recommend that the SEC issue interpretative guidance or rulemaking, as described more fully below, for funds to clarify their compliance testing obligations.

- **The SEC should adopt a new rule governing fund counterparty risk.** Instead of addressing derivatives counterparty risk through interpretations of 1940 Act provisions not designed specifically to deal with such risk, we believe the SEC should consider adopting a new rule designed to address this risk.

Arguments in support of each of these comments are set forth below.

I. The moratorium on issuing SEC exemptive relief for ETFs using derivatives should be lifted.

In March 2010, the SEC staff imposed a moratorium on granting new exemptive relief for active ETFs that propose to use derivatives. When the SEC announced the moratorium, it stated that "new and pending exemptive requests from certain actively-managed and leveraged ETFs that *particularly rely on* swaps and other derivative instruments to achieve their investment objectives" would be suspended while it conducted a review of fund use of derivatives.[4] Notwithstanding the language of the March 2010 press release, it appears that the staff has suspended review of *all* active ETF applications except those from ETFs that agree not to invest at *all*, not even a de minimus amount, in futures, options or swaps.

In our view, the suspension creates an uneven playing field and provides a government-sanctioned competitive advantage to those ETF sponsors who were fortunate enough to receive their exemptive relief prior to institution of the freeze. Perhaps more important, from a public interest perspective the suspension deprives investors of lower-cost competitive products and potentially innovative new products.

Because the SEC analysis of fund use of derivatives could take a significant period of time to complete, we respectfully request that the SEC reinstate its review of applications of *all* ETFs that seek the flexibility to use derivatives in furtherance of their investment objectives, regardless of the level of anticipated derivatives use. The staff can use the review process to place appropriate limits

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[4] *See* SEC Press Release 2010-45, SEC Staff Evaluating the Use of Derivatives by Funds (Mar. 25, 2010).

on proposed ETFs whose derivatives use is deemed to pose undue risks to the investing public. This would allow ETFs that make limited use of plain vanilla derivatives to implement simple investment strategies (*e.g.*, using Treasury futures to cost-effectively adjust the duration of a bond ETF) to come to market.

II. The Dodd-Frank Act and related rules, when implemented, will significantly reduce risk for entities that participate in the swaps markets.

The enactment of the Dodd-Frank Act and the implementation of rules governing swaps and entities engaged in swaps transactions are intended to significantly reduce the risks presented by swaps trading. Under the Dodd-Frank Act, swap dealers and major swap participants ("**MSPs**") will be required to register with the Commodity Futures Trading Commission ("**CFTC**") and/or the SEC (collectively, the "**Commissions**"), which will give regulators direct regulatory oversight of swap activities of such entities.[5]

The Dodd-Frank Act also serves to establish a number of new safeguards to mitigate risks presented by swaps trading including swap transactions entered into by funds. In particular, the mandate for the central clearing of standardized swaps (as is presently required for futures) will effectively eliminate counterparty risk as both parties to a swap will face a clearinghouse that will clear, margin and guarantee settlement of swap trades.[6]

Outside of the inter-dealer market, most swaps trades are not currently centrally cleared. However, as most swaps entered into by funds are likely to fit within the "standardized swaps" definition, we expect the majority of such swaps to eventually be centrally cleared. Central clearing will add a strong foundation of protection to a fund's swap investing and represents a significant contribution by the Dodd-Frank Act toward market stability and fund protection. For swaps that are not cleared, rules currently in draft require swap dealers to call for initial and variation margin to mitigate the risk that swap counterparties (including funds) will not meet their payment obligations.[7] Because a portion of fund assets will be dedicated as swaps margin, such mandated margin postings also serve as a practical limit on a fund's swaps investments.

The Dodd-Frank Act further mitigates swaps risks by requiring swap dealers and MSPs to comply with capital requirements and to report swap and FX forward trades to a swap data repository

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[5] We have argued that funds should receive a full exemption from MSP status because their swaps investments are subject to extensive regulation. *See* Vanguard Comment Letter to the Commissions dated September 20, 2010, available at http://www.sec.gov/comments/s7-16-10/s71610-48.pdf and Vanguard Comment Letter to the Commissions dated February 22, 2011, available at http://www.sec.gov/comments/s7-39-10/s73910-56.pdf. As the Commissions have not issued final rules defining MSPs, it's possible that certain funds could be deemed MSPs depending on the level of their swaps trading. Based on proposed rules, we do not believe any of our funds would qualify as an MSP.

[6] We acknowledge that when entering into cleared swaps, funds may face a small, but theoretically possible, risk of loss referred to as fellow customer risk. We have argued that the CFTC adopt an approach for cleared swap collateral protection – the Legal Segregation with Commingling approach – that would eliminate fellow customer risk. For a discussion of fellow customer risk see Vanguard Comment Letter to the CFTC dated January 18, 2011, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27182&SearchText= and Vanguard Comment Letter to the CFTC dated August 8, 2011, available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48060&SearchText=.

[7] To reduce their counterparty risk, we expect funds will continue to require margin from their counterparties.

("**SDR**") in real time. Capital requirements are likely to limit overall swaps activity. SDR reporting will allow the Commissions to engage in surveillance of swaps markets and thereby better understand and assess the related risks.

Taken together, the new Dodd-Frank rules and regulations are likely to significantly reduce risk in swaps markets and should mitigate many regulatory concerns around fund swap investments. Such protections will provide a strong foundation of risk mitigation and should figure prominently as the SEC contemplates a modernization of fund derivatives rules for the protection of fund investors.

III. The SEC should adopt a principles-based approach when assessing senior securities restrictions in the context of fund derivatives investments.

Because derivative products continue to evolve in significant ways, and because different funds may use derivatives differently, the regulatory regime must be flexible. We recommend that the SEC adopt a principles-based approach when applying senior security restrictions to fund derivatives investments.

A. Background and purpose of senior security limitations.

The Concept Release states that the 1940 Act's restrictions and staff positions on the issuances of senior securities under Section 18 are intended to address concerns about: "(i) potential abuse of the purchasers of senior securities; (ii) excessive borrowing and the issuance of excessive amounts of senior securities by funds which increased unduly the speculative character of their junior securities; and (iii) funds operating without adequate assets and reserves."[8]

In a seminal 1979 release ("**Release 10666**"), the SEC identified several types of securities trading practices that raise "senior securities" issues.[9] In that Release, the SEC determined that it would not treat a fund employing those trading practices as having issued a senior security, provided that the fund either "covers" its obligations by maintaining a "segregated account" with assets sufficient to satisfy 100% of the fund's obligations or enters into an offsetting transaction to nullify such obligations.[10] More recently, with respect to certain derivatives products (e.g., interest rate

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[8] *See* Concept Release at 55242.

[9] *See* Investment Company Act Release No. 10666 (April 18, 1979). The three practices identified in Release 10666 were reverse repurchase agreements, firm commitment agreements, and standby commitment agreements. The SEC made clear that Release 10666 has far wider applicability than simply those three practices: "[b]ecause such types of securities trading practices are subject to innumerable variations, this release is intended to address generally the possible economic effects and legal implications of all comparable trading practices which may affect the capital structure of investment companies in a manner analogous to the securities trading practices specifically discussed herein."

[10] "A segregated account freezes certain assets of the investment company and renders such assets unavailable for sale or other disposition. If an investment company continues to engage in the described securities trading practices and properly segregates assets, the segregated account will function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock. Additionally, such accounts will assure the availability of adequate funds to meet the obligations arising from such activities." *Id*.

swaps; cash settled futures and forwards), the SEC appears to permit a fund to cover its net obligations rather than 100% of its fund's gross obligations.[11]

In Release 10666, the SEC permitted segregated accounts for the purpose of covering obligations to include "only liquid assets, such as cash, U.S. government securities or other appropriate high grade debt obligations." In 1996, the SEC staff issued a no-action letter to Merrill Lynch that permitted segregated assets to include not only the specific instruments enumerated by the SEC in Release 10666, but also any asset that is liquid and marked to market daily, including equity securities and non-investment grade debt.[12] This position greatly increased the amount funds could invest in derivatives because most of a fund's portfolio securities could be used to cover its derivatives positions.

B. For the purpose of assessing a fund's derivatives coverage or offset levels, leverage should be limited to "indebtedness leverage".

Of primary concern with respect to a fund's derivatives investments is the potential for heightened risk achieved through leveraging of fund assets. The SEC has addressed concerns regarding a fund's use of leverage to obtain market returns in excess of its asset base through interpretations of the senior security provisions in Section 18 of the 1940 Act, including Release 10666.[13]

The Concept Release appropriately distinguishes between "indebtedness leverage" – i.e., leverage created by transactions (including investments in derivatives) that create obligations or potential indebtedness on the part of a fund to a third party – and "economic leverage" – i.e., leverage created by transactions that "do not impose a payment obligation on the fund above its initial investment."[14] It is our understanding that the current regulatory regime applicable to fund derivative investments applies only to investments that involve indebtedness leverage; investments that involve economic leverage but do not impose a payment obligation on the fund above its initial investment are not considered senior securities and thus require neither cover (segregated account) nor offset. We agree with this approach because we believe it is consistent with the plain language of Section 18. A contrary approach focusing on "economic leverage" would suggest that Section 18 authorizes the

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[11] *See* The Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) ("**2010 ABA Derivatives Report**") at footnotes 22 and 25 and accompanying text.

[12] Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) (the "**Merrill Letter**").

[13] "The legislative history of the Act indicates that Congress intended Section 18, inter alia, to limit increases in the speculative character of junior securities issued by investment companies. Leveraging of an investment company's portfolio through the issuance of senior securities and through borrowing magnifies the potential for gain or loss on monies invested and, therefore, results in an increase in the speculative character of the investment company's outstanding securities." *See* Release 10666. Release 10666 concludes that "trading practices involving the use by investment companies of [certain instruments] for speculative purposes or to accomplish leveraging fall within the legislative purposes of Section 18." The Release notes that "[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return." *Id.* at footnote 5 (*citing* Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3rd Sess. At 240 (1940)).

[14] See Concept Release at 55240, notes 31-32 and accompanying text. Examples of transactions that involve only economic leverage include the purchase of a put or call option, commodity-linked note, or shares of a leveraged closed-end fund or business development company.

SEC to substantively regulate a fund's volatility, a position that has no support and has implications far beyond the issue of fund use of derivatives.

C. Asset Segregation: The need for a principles-based approach with examples.

We support a principles-based approach under which the SEC would promulgate clear general guidelines dealing with asset segregation and related issues such as offsets, accompanied by examples of how the guidelines might apply to the most common types of derivatives. Funds could utilize the guidelines and examples to develop their own asset segregation policies and procedures (the "Procedures") based upon their unique investment programs and intended derivatives usage.

A principles-based approach is appropriate for a number of reasons. First, derivatives have evolved and will continue to evolve, and approaches for asset segregation and offset should evolve and be adaptable as new and different derivatives emerge. Second, the risk posed by any particular derivative instrument is based not only on the nature of the instrument but also how the instrument is used and how it fits into a fund's overall portfolio. A "command and control" regulatory approach lacks the necessary flexibility.

1. Updated SEC asset segregation guidance.

As a first step, the SEC should update and expand its existing asset segregation guidance so that it addresses derivatives for which an official SEC position has not previously been issued. New, refreshed guidance should be issued in an interpretative position or rule, to focus on the foundational principle that a fund must have assets available to meet all of its obligations based on a commercially reasonable assessment of the potential loss presented by its derivatives, either at the individual product level, or, in appropriate circumstances, on a portfolio basis.[15]

To clarify the principle, the SEC should outline the approach to segregation and offsets applicable to the most common types of derivatives in use today (e.g., futures, forwards, interest rate swaps, credit default swaps, total return swaps). Rather than targeting either a derivative's notional amount or its market value, we advocate an approach that focuses on a fund's potential future exposure from owning the derivative.

In our view, a fund's potential future exposure is the market value of the derivative (calculated daily) plus an additional amount that takes into account the derivative's potential intra-day price changes based on its volatility during reasonably foreseeable market conditions. In the cleared derivatives context (e.g., futures), this amount is known as initial or up-front margin, while in the non-cleared markets, this amount is sometimes referred to as independent amount. Such margin in excess of a derivative's market value serves as a reserve for the fund and also protects the clearinghouse or counterparty against a fall in the value of the derivative between the time a fund last posts margin and the earliest time the clearinghouse or counterparty can terminate the derivative and liquidate the margin to satisfy the exposure.

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[15] Typically, funds segregate amounts based either on the notional amount of the contract or the market value of the contract. Segregating based on these amounts has inherent weaknesses. For example, using a notional amount test for certain transactions can result in the segregation of excess assets based upon the fund's potential future exposure. In contrast, using a market value test for certain transactions can result in the under-segregation of assets.

With respect to cleared derivatives, we believe that the segregation requirement could be satisfied by the fund's posting of assets as margin to cover both market value (variation margin) plus volatility (initial margin) to protect the clearinghouse from the fund's failure to meet its obligations under the derivative. In our view, the required clearinghouse margin amounts would, in most circumstances, be the absolute minimum asset segregation amount for Section 18 compliance. Because the Dodd-Frank Act will also require counterparties to post initial and variation margin in respect of uncleared swaps, the variation and initial margin that a fund would be required to post to a swaps dealer or MSP to secure its swaps obligations would, in most circumstances, be the absolute minimum asset segregation amount for Section 18 compliance.

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We expect that such segregation principles and examples set forth by the SEC would illustrate that segregation amounts would be substantially higher for certain derivatives which present greater levels of volatility and/or lesser levels of liquidity, than the segregation amounts for less volatile and more liquid derivatives, which might be very close to the instrument's market value. Of course, funds would be free to segregate assets in an amount greater than the minimum segregation requirements specified in the examples. Funds would also be permitted to segregate less than the amounts set forth in the examples based on a derivatives' positioning in the fund's overall portfolio – for example, when the fund holds a substantially offsetting position.

The SEC's updated asset segregation guidance should affirm the position taken by the staff in the Merrill Letter that segregated assets may include those that are liquid and marked to market daily, including equity securities and non-investment grade debt.[16] Finally, the guidance should include a series of offset examples that would demonstrate the types of offsets that would be permissible including, both instrument and portfolio level offsets.[17] Given the relative limited guidance available on what constitutes valid offset as applied to certain derivatives, regulatory assistance on this issue would be particularly helpful to the industry.

2. The principles-based approach.

We believe a principles-based approach involves funds developing their own Procedures based on the principles and the compendium of examples of both segregation and offsets provided by the SEC. A fund's Procedures (and material changes thereto) will be approved by its board of directors, and the fund's chief compliance officer will be responsible for overseeing compliance with the Procedures as part of his or her Rule 38a-1 duties.

A fund's Procedures will cover each type of derivative the fund is permitted to own, and the corresponding method(s) to be used for segregation or offset against its potential future obligations. The Procedures will discuss the type and amount of liquid assets that can be used for segregation purposes. Funds that are infrequent users of derivatives would likely have simple procedures, while those funds that use derivatives as part of their primary investment strategy would have more detailed procedures.

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[16] If the SEC decides to pull back from the Merrill Letter, it should not eliminate equity securities and non-investment grade debt as potential assets that can be used for segregation purposes provided they are liquid, but should instead require haircuts on such securities.

[17] For example, if the fund had long exposure to an issuer through a credit default swap, the example would demonstrate that a permissible offset would be ownership of bonds of that issuer.

The approach to segregation and offsets would vary depending on the specific trade types, anticipated liquidity, underlying instruments and terms.[18] A fund's Procedures would take into account the volatility of the liquid securities that are being segregated, and, if appropriate, apply haircuts to certain types of segregated securities.

3. Disclosure.

In line with current disclosure requirements, we believe that funds that utilize derivatives as a primary strategy should make clear and complete disclosure about their derivatives use including how they are used in the portfolio and the attendant risks of such use. The principles-based approach should also mandate that a fund's Procedures be described in its statement of additional information.

IV. Interpretative guidance on diversification, concentration and securities-related issuer testing should be issued.

Applying 1940 Act provisions relating to diversification, portfolio concentration and exposure to securities-related issuers to a fund's derivatives transactions raises a number of interpretative questions given that the applicable provisions were adopted prior to widespread fund derivatives use, and derivatives trading involves a more complex set of variables than general securities trading, including multiple parties (e.g., a clearinghouse and counterparty) and underliers (e.g., reference asset or index).

We recommend that the SEC issue interpretative guidance and/or rulemaking on these issues for funds that use derivatives. When crafting guidance, we believe that it is imperative for the SEC to consider the original policy reasons for adopting the applicable 1940 Act provisions.

A. Diversification interpretative guidance.

1. Purpose of diversification requirements.

The SEC has stated that "[t]he purpose of the diversification requirements [of Section 5(b) of the 1940 Act] is to prevent a fund that holds itself out as diversified from being too closely tied to the success of one or a few issuers or controlling portfolio companies."[19]

2. Apply diversification testing to the reference entity.

We believe that funds should treat the reference entity underlying the derivative (rather than the counterparty) as the issuer for diversification testing. This approach is appropriate because a fund intends to obtain economic exposure to the reference entity just as if it held a direct investment in such entity. Including a fund's indirect economic exposure to an issuer through a derivative with its direct investments in an issuer furthers the underlying diversification policy because it ensures that a diversified fund's performance is not tied too closely to the performance of a few issuers.

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[18] We recognize that the SEC may have concerns about allowing funds to develop their own asset segregation approach based upon SEC examples. To allay those concerns, the SEC may wish to consider adopting an overall leverage limit that funds would be required to comply with, notwithstanding that they have segregated liquid assets to back their obligations.

[19] *See* Concept Release at 55250.

For example, if a fund enters into a total return swap providing long exposure to a single underlying reference entity, then the fund should view the reference entity (and not the counterparty) as the issuer because the fund's performance is tied directly to the performance of the reference entity. Here, the fund should value the reference entity position based upon its economic exposure[20] to such issuer rather than the current market value of the swap.[21] For certain derivatives, we believe that the context may require a valuation of the derivative based on market value (e.g., purchased call).

Presently, fund complexes may also include their exposure to a counterparty in diversification testing. One reason for this approach is that the SEC has suggested, in certain contexts, that "the person to whom an investor looks for payment on an instrument will be deemed to be the issuer of the instrument."[22] While it is true that a fund looks to a clearinghouse or counterparty for payment on a derivative, and funds may have some credit exposure to their derivatives counterparties, funds do not intend to seek this type of exposure in furtherance of their investment objectives. Moreover, the fund's performance would not be tied to the performance of a clearinghouse or counterparty except in the rare circumstances where the solvency of that party was in doubt. Therefore, funds should not be required to look at exposure to a clearinghouse or counterparty for purposes of diversification testing.

That said, we believe that counterparty exposure should be addressed outside of diversification testing. Similar to certain international investment regimes (e.g., Irish UCITs), we believe a new rule under the 1940 Act should be adopted that is designed for the express purpose of regulating a fund's counterparty risk. We discuss this idea in more detail below in Section V.

We agree with the 2010 ABA Derivatives Report that Treasury futures should not be considered in diversification testing because U.S. government securities (instruments referenced by Treasury futures) are expressly excluded from Section 5(b)(1) diversification testing. Moreover, we believe the SEC should confirm that exposure to commodity-linked futures and swaps, FX forwards, futures and swaps as well as interest rate futures and swaps should not be considered in diversification testing as these instruments do not reference securities, and themselves may not be securities captured by Section 5(b)(1).

We also agree with the 2010 ABA Derivatives Report that broad-based stock index futures should not be included in diversification testing as they provide diverse exposure to a stock index and such futures are not defined as "securities" under the 1940 Act and therefore not covered by Section 5(b)(1).[23] Conversely, because narrow-based stock index futures are "securities" under the 1940 Act

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[20] In this example, economic exposure would be based on market value of the underlying reference entity. If on T, a fund has long exposure to 100 shares of IBM via a total return swap, and on T+1 IBM is trading at $25 per share, then for diversification testing, the fund's exposure to IBM would be valued $2,500. We recommend that the SEC's guidance in this area provide for off-sets where appropriate (e.g., if a fund sold short 50 shares of IBM, when testing for diversification, a fund would be able to reduce its economic exposure to IBM).

[21] Although Section 5(b)(1) of the 1940 Act incorporates a definition of value from Section 2(a)(41) of the 1940 Act, which defines "value" using a market value or fair value of the derivative instrument, we believe that for certain derivatives (e.g., a total return swap on a single security; sale of a credit default swap on a bond) the "context otherwise requires" an economic exposure value be placed on the derivative reference entity position for Section 5(b)(1) testing. We note that Section 2(a) of the 1940 Act permits utilization of a different definition of value "if the context otherwise requires."

[22] *See* 2010 ABA Derivatives Report at 25.

[23] If the SEC decides to include stock index futures on broad indexes in diversification testing, then we believe funds should only be required to deconstruct the future into its underlying components with respect to

and could materially increase a fund's exposure to a few issuers, we believe that the most appropriate treatment of such instruments for diversification testing is to deconstruct the index future into its component parts.

B. Industry concentration interpretative guidance.

1. Purpose of concentration disclosure.

Disclosure of whether a fund is concentrated in an industry (i.e., invests more than 25% of its assets in an industry or group of industries) "reflects the view that such a policy is likely to be central to a fund's ability to achieve its investment objective, and that a fund that concentrates its investments will be subject to greater risks than funds that do not follow the policy."[24]

2. Apply concentration testing to the reference entity.

The policy reasons requiring portfolio concentration disclosures are largely the same as those for diversification (e.g., to put shareholders on notice if a fund intends to focus its investments in particular issuers or industries). For this reason, we believe that concentration testing of derivatives should largely follow the approach set forth above for diversification testing.

C. Securities-related issuer interpretative guidance.

1. Purpose of securities-related issuer limitations.

For a number of reasons, Section 12(d)(3) of the 1940 Act places limitations on the ability of a fund to purchase or otherwise acquire any security issued by, or any other interest in, the business of a broker, dealer, underwriter, or investment adviser (each, a "**securities-related issuer**"). The Concept Release provides two explanations for the Section 12(d)(3) limits:[25]

> First, it limits a fund's exposure to the entrepreneurial risks of securities-related issuers, including the fund's potential inability to extricate itself from an illiquid investment in a securities-related issuer [(the "**Entrepreneurial Risk Policy**")]. Second, it is one of several [1940] Act provisions which, taken together, prohibit fund sponsors, which include broker-dealers, underwriters, and investment advisers, from taking advantage of the funds that they sponsor. Specifically, the prohibition has the effect of limiting the possibility of abusive reciprocal practices between funds and securities-related issuers [(the "**Reciprocal Practices Policy**")].

In general, the issues addressed by the Entrepreneurial Risk Policy are no longer a concern for funds because an investment in a securities-related issuer normally occurs via purchasing publicly

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any component security that adds to a fund's issuer position an amount that is at least 1% of the fund's overall assets. This will reduce the compliance burden for funds.

[24] *See* Concept Release at 55254; Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23064 (Mar. 1998); and 2010 ABA Derivatives Report at 29.

[25] *See* Concept Release at 55252.

traded securities rather than through becoming a general partner of the issuer's partnership.[26] Reciprocal practices include (1) "the possibility that an investment company might purchase securities or other interests in a broker-dealer to reward that broker-dealer for selling fund shares, rather than solely on investment merit," and (2) "an investment company might direct brokerage to a broker-dealer in which the company has invested to enhance the broker-dealer's profitability or to assist it during financial difficulty, even though that broker-dealer may not offer the best price and execution."[27]

2. Section 12(d)(3) limitations should be reassessed in the context of derivatives trading.

a. Counterparty to a derivative investment.

It is appropriate for the SEC to modify the framework for analyzing securities-related issuer holdings as applied to derivatives counterparty exposures under Section 12(d)(3) and Rule 12d3-1. We think a new rule designed to address such exposures should be established under Section 12(d)(3). The new rule would target derivatives counterparty exposures and, similar to Rule 12d3-1, permit such exposures up to certain levels. This concept is discussed more fully in Section V.

Determining the extent to which Section 12(d)(3) and Rule 12d3-1 applies with respect to derivatives entered into between a fund and its counterparty presents a number of interpretative challenges for funds. Because a derivative could be characterized as either a "security" or "other interest" issued by a securities-related issuer counterparty, based on a plain reading of Section 12(d)(3), such transaction would seem to fall within the general prohibition of Section 12(d)(3).[28] The SEC has stated that a derivative "is likely to be categorized as a debt security"[29] and subject to the 10% limit in Rule 12d3-1. However, it has also stated that if a "derivative is not a security issued by the counterparty, but the transaction may be deemed to be the fund's acquisition of "an interest in" a securities-related issuer (the counterparty), then Rule 12d3-1 would not be available because it only exempts acquisitions of securities, and the transaction would be prohibited under the Investment Company Act."[30] The inability to use Rule 12d3-1 in respect of derivatives transactions would prove problematic for funds.

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[26] *See* Concept Release at note 147 citing Exemption for Acquisition by Registered Investment Companies of Securities Issued by Persons Engaged Directly or Indirectly in Securities Related Businesses, Investment Company Act Release No. 13725 (Jan. 17, 1984) [49 FR 2912 (Jan. 24, 1984)] ("1984 Proposing Release") at n. 7 and accompanying text (discussing that "[i]n 1940, securities related businesses, for the most part, were organized as private partnerships. By investing in such businesses, investment companies would expose their shareholders to potential losses which were not present in other types of investments; if the business failed, the investment company as a general partner would be held accountable for the partnership's liabilities; if the business floundered, the investment company would be locked into its investment").

[27] See Concept Release at note 149 and 1984 Proposing Release at n. 9.

[28] The SEC has taken the position that entering into a repurchase agreement with a securities related issuer "may be considered to be *the acquisition of an interest* in the counterparty" *see* Release at 55252 at n. 155 and, Treatment of Repurchase Agreements and Refunded Securities as an Acquisition of the Underlying Securities, Investment Company Act Release No. 25058 (July 5, 2001) at n. 5 and accompanying text [66 FR 36156 at note 5 (July 11, 2001)].

[29] *See* Concept Release at note 156.

[30] *See* Concept Release at 55253.

Including uncleared derivatives in the Rule 12d3-1(b) analysis requires funds to face the practical difficulty of valuing the derivatives position for the purposes of the Rule. It is unclear if such derivative's notional value or market value, if either, would be relevant for purposes of calculating a fund's position in a counterparty when testing under Rule 12d3-1(b). The use of collateralization raises additional complexities. Applying Section 12(d)(3) and Rule 12d3-1 to uncleared derivatives counterparty exposures is tantamount to trying to fit a square peg into a round hole. Given the issues and complexities described above, we believe that the best outcome – one that best mitigates investor protection concerns – is for a new rule to be issued that addresses uncleared derivative counterparty risk.

With respect to cleared derivatives, it appears that a clearinghouse should not be deemed to be a securities-related issuer[31] and on that basis we believe that the SEC should affirm that Section 12(d)(3) has no application as applied to the counterparty.

b. Exposure to other securities-related issuers through derivatives.

Based on a plain reading, Section 12(d)(3) does not appear to apply to a reference entity of a derivative transaction. The reference entity is not the issuer of the derivative rather it's merely referenced by the derivative. A derivative presents no direct connection between a fund and the reference entity of the derivative. The reference entity neither knows of the relevant derivative nor can it benefit in any material way from derivatives in which it is the reference entity. Although a fund *may* be able look through to the reference entity underlying a repurchase agreement for purposes of Section 12(d)(3), we are unaware of any precedent that a fund would be required to do so.[32]

Given that the Reciprocal Practices Policy targets, among other things, the potential benefits afforded to a broker-dealer by securities trading, and derivatives present no potential material benefit, and that Section 12(d)(3) on its face does not appear to require application to reference entities, we believe that the SEC should confirm that the reference entity of a derivative is irrelevant in the context of Section 12(d)(3). We hold this view notwithstanding that the Concept Release suggests that a fund may direct brokerage or other business to a broker-dealer if the fund had a long synthetic position referencing such broker-dealer.[33] While we think that such activity could theoretically occur, we believe the possible impact of such directed business to be far too attenuated to justify application of Section 12(d)(3) to a derivative's reference entity.

V. The SEC should adopt a new rule governing fund counterparty risk.

A critical consideration for funds entering into derivatives is managing their counterparty risk. While certain international regulators have recognized the importance of regulating counterparty risk, such risk is not directly addressed in the 1940 Act. We believe that many fund complexes address this risk through their own internal policies and procedures. That said, we think that the SEC

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[31] *See* Concept Release at 55253 and Institutional Equity Fund, SEC Staff No-Action Letter (Feb. 27, 1984).

[32] See Rule 5b-3 of the 1940 Act permitting funds that are parties to repurchase agreements to look though to the underlying securities if certain conditions are met (e.g., the transaction is fully collateralized) for purposes of Sections 5 and Sections 12(d)(3).

[33] *See* Concept Release at 55253.

should consider rulemaking under Section 12(d)(3) designed to address derivatives counterparty risk, which would be specifically tailored to derivative investments.

Any proposed rulemaking should acknowledge that clearing derivatives through a clearinghouse will effectively eliminate counterparty risk and rules should encourage clearing to the greatest extent possible. While the Dodd-Frank Act will require clearing of standardized swaps, not all instruments will be required to be cleared. For example, the Treasury Department has proposed to exclude FX forwards from the definition of swap, and thus the clearing requirement. SEC rulemaking could be drafted in a way that would incentivize funds to have their derivatives cleared even if not required by the Dodd-Frank Act.

For non-cleared swaps, a rule could be designed to limit the amount of uncollateralized swap exposure a fund may have to a counterparty (e.g., not more than X% of a fund's total assets). The counterparty risk rules should give full credit for collateralization posted to a fund to reduce its exposure to the counterparty. If the SEC adopts such an approach, we believe that exposure to the counterparty should be measured after all derivatives transactions with a counterparty are netted to the fullest extent possible.[34]

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In closing, we thank the SEC for the opportunity to comment on the Concept Release and appreciate the SEC's consideration of Vanguard's views. If you have any questions about Vanguard's comments or would like additional information, please contact Barry Mendelson, Principal, at (610) 503-2398, William Thum, Principal, at (610) 503-9823, or Michael Drayo, Associate 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: Securities and Exchange Commission
The Honorable Mary L. Shapiro
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Troy A. Paredes
The Honorable Elisse B. Walter

[34] Here, OTC derivatives entered into via an ISDA agreement could be netted with all other exposures (e.g., futures) for which the parties have agreed can be netted under a master netting agreement.