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May 27, 2014

Mr. Kevin M. O'Neill
Deputy Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: Standards for Covered Clearing Agencies (File No. S7-03-14)

Dear Mr. O'Neil,

Vanguard[1] appreciates the opportunity to write in support of the letter submitted to the Security and Exchange Commission ("**SEC**" or "**Commission**") dated May 21, 2014 by the Investment Company Institute ("**ICI**") expressing concern with the Commission's proposal[2] to amend Rule 17Ad-22 and adopt Rule 17Ab2-2 under the Securities Exchange Act of 1934 ("**Exchange Act**") to establish standards for the operation and governance of registered clearing agencies that meet the definition of a "covered clearing agency."[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.

Under the Proposal, the SEC seeks to establish requirements for covered clearing agencies with respect to, *inter alia*, default management, margin segregation, position portability

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

[2] Standards for Covered Clearing Agencies, 79 FR 16865 (Mar. 26, 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-03-26/pdf/2014-05806.pdf ("**Proposal**").

[3] Covered clearing agencies include registered clearing agencies that (1) have been designated as systemically important by the Financial Stability Oversight Council ("FSOC") and for which the SEC is the supervisory agency; (2) provide central counterparty ("CCP") services for security-based ("SB") swaps or are involved in activities the SEC determines to have a more complex risk profile, where in either case the Commodity Futures Trading Commission ("**CFTC**") is not the supervisory agency for such clearing agency; or (3) are otherwise determined to be covered clearing agencies by the SEC pursuant to procedures under Proposed Rule 17Ab2-2.

and margin and position transparency. We have serious concerns particularly with respect to the Commission's proposed requirements related to margin segregation and portability as being significantly weaker than either those historically applicable to the over-the-counter uncleared derivatives ("**OTC swaps**") market or those that have been developed by the CFTC with respect to cleared Swaps.

Rather than seek to conform the SB swaps market to the existing rules applicable to the broker-dealer framework, we believe the SEC must look to the margining and segregation arrangements mandated by the CFTC and already being used in the marketplace, and establish a threshold level of protection for customer margin at least as strong as that applicable to margin for Swaps and OTC swaps.

Vanguard's position can be summarized as follows:

- **Margin practices for OTC swaps and CFTC rules related to margin for cleared Swaps provide significant protections,**
- **The Commission should adopt a mandatory threshold level of protection for SB swap margin that is consistent with that applicable to margin for Swaps, and**
- **The Commission should prohibit covered clearing agencies from using SB swap customer margin to aid in recovery in the event of financial stress.**

I. Margin practices for OTC swaps and CFTC rules related to margin for cleared Swaps provide significant protections.

Standard 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**"). In accordance with such contracts, OTC swaps used by Vanguard are fully margined on a ***bilateral*** basis with net exposures[4] calculated ***daily*** by both our dealer and ourselves, margin is exchanged on a ***same-day*** basis, and a ***two-day grace period*** for margin defaults (with all swap payments stopping during such grace period). Margin from both the dealer and the fund is ***held by the fund's custodian*** in accordance with a collateral control agreement. Under these arrangements ***there is either no or very limited fellow customer risk, fraud or malfeasance risk, investment risk or operational risk***.

These tight contractual arrangements, together with prudent risk management, meant that Vanguard funds (and the shareholders thereof), did not experience significant losses related to dealer defaults during the global financial crisis. It is our experience of the benefits of such tight

[4] Note that historically, trades which now meet the definition of either a Swap or a SB swap were collectively governed by the ISDA Master Agreement and ISDA Credit Support Annex so that upon a party's default, all such trades would be liquidated with a single net amount calculated as due from one party to the other with respect to all of the transactions. Through bifurcating such transactions between Swaps and SB swaps, this netting benefit is weakened and, as Swaps and SB swaps are margined separately, it is of serious concern that risks with respect to such margin could be in excess of that presented in the OTC swaps market and that such margin may be afforded different levels or protection depending on whether it is subject to CFTC or SEC rules.

controls applied to margin for OTC swaps that informs our support for tight controls to also be mandated to apply to margin for SB swaps.

Consistent with Vanguard's practices, registered funds that trade in uncleared Swaps and SB swaps enter into collateral control agreements between themselves, their dealer and their custodian for margin to be held in the segregated custodial account. These arrangements subject their margin to neither fraud risk of the FCM or broker dealer nor fellow-customer risk.[5]

In terms of cleared Swaps, we benefit from our due diligence in selecting and monitoring financially strong and well-managed Futures Commission Merchants ("**FCMs**"), the conservative provisions related to margin that we have negotiated with our FCMs, and the robust series of protections afforded by the CFTC both in terms of the CFTC's tight supervision of FCMs and the significantly enhanced protections mandated by CFTC rules for customer margin for cleared Swaps. ***The CFTC's rule set related to margin protections for cleared Swaps is especially important given the recent high-profile defaults involving FCMs where segregation was not maintained and customer assets were lost***. In our cleared Swaps agreements, our FCMs value our portfolios at least ***daily,*** with margin exchanged on a ***same-day basis***, with a ***one-day grace*** period for margin defaults ***only in the event of an administrative error***.

For cleared Swaps, the CFTC has required that all FCMs and clearing houses hold margin in a legally-segregated, operationally-commingled ("**LSOC**") manner whereby margin is fully protected from fellow-customer risk. Fellow-customer risk involves the margin of non-defaulting customers being accessed by the clearing house in the event of a fellow customer's default coupled with the FCM's default. In addition to the LSOC protection, the CFTC's margin rules also allow customers to instruct their FCMs to transfer excess margin to the clearing house ("**LSOC plus excess**") and thereby reduce the margin exposed to fraud and investment risk of the FCM.

The key to the success of the LSOC and LSOC plus excess approach is the significantly enhanced level of record keeping and reporting required by the CFTC which ensures full transparency between the FCM and clearing house as to each customer, its positions and its related margin. It is this enhanced recordkeeping that serves to dramatically improve the portability of customer positions as the FCM must require and record that its customers always maintain adequate margin for their positions (rather than rely on loans from the FCM or on the excess margin posted by other customers) and the bulk of such margin is actually held by the clearing house.

While the CFTC structured the cleared Swaps market largely consistent with the futures market, ***it recognized that the breadth and depth of the cleared Swaps market required enhanced margin protections compared to those afforded to margin for futures***. In addition to the LSOC and LSOC plus excess protections specifically mandated for cleared Swaps, the CFTC also upgraded the protections afforded to both futures and cleared Swaps by ***tightening the timing of required margin transfers between the FCMs and clearing houses, accelerating the***

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5 Under the Investment Company Act of 1940 ("**ICA**"), registered funds are required to custody their assets in accordance with Section 17 of the ICA. Nearly all registered funds use a U.S. bank custodian for the custody of domestic securities.

imposition of a capital charge on FCMs that fund their customers' margin obligations, and requiring significantly enhanced compliance and reporting obligations to better ensure FCMs are operating in a stable manner.

Given the enhanced protections provided to margin for cleared Swaps by the CFTC, we urge the Commission to take a fresh look and ensure that margin for cleared SB swaps is as least as well protected.

II. The Commission should adopt a mandatory threshold level of protection for SB swap margin that is consistent with that applicable to margin for Swaps.

Section 805(b) of the Dodd-Frank Act requires the SEC to regulate central clearing organizations in a manner so as to "(1) promote robust risk management, (2) promote safety and soundness, (3) reduce systemic risks, and (4) support the stability of the broader financial system." We do not agree with the Commission's proposed approach to address such risks by providing covered clearing agencies with broad discretion to adopt policies and procedures in these areas. While as a business matter, covered clearing agencies should be allowed to add enhanced protections, ***a threshold level of protection for customer margin must be mandated by the Commission consistent with that afforded Swaps and appropriate to the breadth and depth of the SB swaps market***.

In discussing the proposed delegation of discretion to covered clearing agencies with respect to SB swaps, the Commission highlights practices involving broker-dealers in the listed options markets in the context of promoting segregation and portability and the protection of customer positions and funds in those markets.[6] In the listed options market, margin is held by the clearing member in the customer's margin account and is generally not passed through to the options clearing agency (the clearing member transfers its own assets, generally in an amount less than that it receives from its customer).[7]

In terms of customer protection, Exchange Act Rule 15c3-3 allows broker-dealers (including SBSDs that are broker-dealers) to rehypothecate required and excess margin up to 140% of the customer's debit balance. Apart from the overall limit on the amount of rehypothecation, ***there is no limit on the type or characteristics of the investments of such margin equivalent to CFTC Rule 1.25***. Broker-dealers are also required to maintain physical possession and control of customer fully-paid and excess margin securities, and ***must maintain a special reserve account (calculated weekly) in an amount equal to its net obligation to its customers.***

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6 Proposal, *supra* note 2, at 16904.

7 The Commission has proposed Rule 18a-4 which proposes that Securities-based swap dealers ("**SBSDs**") will maintain customer assets in the same manner as broker-dealers with respect to listed options. *See* Capital, Margin, and Segregation Requirements for Security- Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214 (Nov. 23, 2012) ("SB Swaps Segregation Rules Proposing Release"), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-11-23/pdf/2012-26164.pdf. ("**Proposed Rule 18a-4**").

We agree with the Commission's view that under the approach to margin applicable to broker-dealers and listed options "***neither portability nor segregation could occur***"[8] given the lack of clearing agency transparency into the customers of its members, their positions or their margin. Such a model is also wholly inconsistent with the treatment for cleared Swaps where both clearing house-required initial and variation margin is held by the clearing house and, upon customer election, excess margin may also be transmitted to the clearing house for safekeeping.

The combination of broker-dealers holding customer assets, having relatively unfettered rehypothecation rights, and only charged with reserving the net amount owed to their customers (calculated weekly) provides little actual protection to customer assets. ***Broker-dealer held assets would be subject to a greater fraud risk, it is unlikely rehypothecated funds could be easily identified and recovered, and the reserving of a net amount owed effectively allows the margin surplus of some customers to mask margin deficits of other customers. The sum total of these issues serves to limit the likelihood that there will be adequate margin, or the needed transparency into the identity of each customer, its positions and the related margin, to enable the prompt porting of positions in the event of a broker-dealer's demise.***

Indeed, each of these problems was apparent in resolving customer issues upon the failure of Lehman Brothers. In the broker-dealer context, it was impossible to port customer positions and was also a serious challenge to identify and return pledged assets, to identify and recover rehypothecated assets and, generally, to meet customer claims against the special reserve account. On the basis of lessons learned from the global financial crisis, customers routinely seek to narrow broker-dealer rights in the negotiation of prime brokerage and other trading agreements including setting limits on the broker-dealer's rights to transfer assets to affiliates, to rehypothecate assets at all (or at least in an amount greater than 100% of debt), and to the eligible investments of the rehypothecated assets.

We do not believe these threshold customer protection issues should be left to the individual negotiation strength and strategy of each customer. Instead, the Commission should target these weaknesses and others in crafting an appropriate customer protection regime involving segregation and portability for the cleared SB swaps market.[9]

In developing the rule set for cleared SB swaps, the Commission should also be mindful of the recommendations of the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") entitled "Margin Requirements for Non-centrally Cleared Derivatives"[10] which includes strict limits on rehypothecation of margin for non-cleared swaps. The IOSCO recommendations include the right of customers to require full margin segregation without rehypothecation. If rehypothecation is allowed, it may only be performed for hedging purposes (effectively if a dealer owes margin on a mirror trade) and the party to which the margin is re-pledged must commit to no further rehypothecation and must provide full customer protection to such rehypothecated margin.

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8 Proposal, *supra* note 2, at 16905.

9 We also encourage the Commission to re-evaluate the Rules relating to broker-dealers and listed options generally and to consider changes in light of the experiences gained from the global financial crisis.

10 Basel Comm. on Banking Supervision and Bd. of the Int'l Org. of Sec. Comm'ns, *Margin requirements for non-centrally cleared derivatives* (Sept. 23, 2013), *at*: https://www.bis.org/publ/bcbs261.pdf.

Vanguard agrees with the ICI recommendation for a structure in which both initial and variation margin related to an SB swap must be passed to the covered clearing agency and held in an LSOC-like account and all excess margin must be held in either a segregated account at a custodian or, at minimum, at an LSOC-like account at the SBSD or at the covered clearing agency. Moreover, customers should have the right to require all of their margin to be held in segregated custody accounts under a tri-party account control arrangement.

In addition, we recommend that the SEC propose to amend Rule 15c3-3 and Proposed Rule 18a-4 to prohibit use by an SBSD that is a broker-dealer or by a stand-alone SBSD of customer assets held as covered clearing agency-required margin for SB swaps or excess margin elected to be held in segregation account or transferred to the covered clearing agency. This approach is designed to mitigate losses to SB swap customers upon an SBSD's default and bankruptcy and decrease the opportunities for misuse by the SBSD during times of stress. ***Most importantly, it will better ensure that positions and margin may be efficiently ported or, if positions are liquidated, margin may be returned to the appropriate customers upon an SBSD's failure.***

Just as the CFTC made changes to the futures model when applied to cleared Swaps, we strongly believe the SEC needs to reconsider the structure that has traditionally been applied to broker-dealers as being inappropriate for the SB swaps market. The SB swaps market has considerably greater depth and breadth than the broker-dealer market, there will be more customer assets (in the form of customer collateral) held by an SBSD dealer for SB swaps and, most importantly, the approach historically applied to the OTC swaps market and now in place for the cleared Swaps market has significantly tighter protections applicable to customer margin.

Rather than delegate policies and procedures related to customer protection issues to the covered clearing agencies, the Commission must mandate a threshold level of protection consistent with that applicable to cleared Swaps.

III. The Commission should prohibit covered clearing agencies from using SB swap customer margin to aid in recovery in the event of financial stress.

In the context of the Commission's proposal for covered clearing agencies to construct policies and procedures to address credit losses, liquidity shortfalls and other losses, we urge the Commission to prohibit the use of non-defaulting customer initial, variation and excess margin for such purposes.[11]

We are particularly concerned that margin of non-defaulting customers could be used by the covered clearing agency to meet losses sustained by other customers, by SBSDs, or by the covered clearing agency itself. In such a case, some or all of the margin of non-defaulting customers could be applied to meet other losses of the covered clearing agency and the value of

[11] Proposed Rule 17Ad-22(e)(3)(ii) would require a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure it establishes plans for the recovery and orderly wind-down of the covered agency necessitated by credit losses, liquidity shortfalls, losses from general business risk, or any other losses. The SEC does not propose any guidance regarding the content of such plans.

the margin to be returned to such customers would be reduced pro-rata by the amount needed to meet the loss. Effectively, losses would be allocated to participants who have not contributed to the loss.

In particular, we understand this approach is being contemplated in the context of covered clearing agencies viewed as being systemically important.

We cannot object strongly enough to such a concept as it would serve to impose on non-defaulting, well-managed, prudent and conservative participants losses attributed to defaulting participants, SBSDs and/or covered clearing agencies. Not only is such exposure not present in the OTC swaps market, where customer assets are fully protected in segregated custody accounts, but the participants have no means to fully assess and mitigate such risk, lacking complete transparency into the financial health and risk management practices of their fellow participants, SBSDs and/or covered clearing agencies.

To appropriate customer margin in such circumstances would bring into question the underlying fairness of the system, and ***we strongly urge the Commission to consider instead the development of enhanced recordkeeping and reporting, enhanced oversight and compliance, enhanced risk management and mitigation, increased contributions by SBSDs and increased contributions to, and management of, the covered clearing agency guaranty fund***. Surely the effect of the Dodd-Frank Act cannot be to move from a situation where a non-defaulting customer's assets are fully protected to a situation where they are viewed as the resource of last resort.

In sum, Vanguard joins with ICI in providing comments on the SEC's Proposal to enhance standards for covered clearing agencies. In particular, we recommend that the Commission mandate a minimum threshold of protection to be provided to customer margin at least as strong as the LSOC and LSOC plus excess rules mandated by the CFTC for cleared Swaps margin. Enhanced recordkeeping and reporting, supervision and compliance, and, if needed, capital contributions and guaranty fund investment is the best approach to ensure the stability of the system to meet the mandate of the Dodd-Frank Act. Access to non-defaulting participant's margin is completely inappropriate. While we have highlighted these points from the ICI letter for emphasis, we are fully supportive of the balance of the arguments made therein.

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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 Jane Wagner, Senior Counsel at (610) 669-3674.

Sincerely,

/s/ Tim Buckley

Managing Director
and Chief Investment Officer
Vanguard

/s/ John Hollyer

Principal and Head of Risk Management
and Strategy Analysis
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