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March 28, 2016

Submitted electronically

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: *Use of Derivatives by Registered Investment Companies and Business
Development Companies – File No. S7-24-15*

Dear Mr. Fields:

Vanguard¹ appreciates the opportunity to provide comments to the Securities and Exchange Commission (the “**SEC**”) on its recent proposed rule (the “**Proposed Rule**”) regarding the use of derivatives by registered investment companies and other pooled investment vehicles (the “**Regulated Funds**”). Vanguard supports the stated goals of the Proposed Rule to address the investor protection purposes and concerns underlying Section 18 of the Investment Company Act of 1940 (the “**1940 Act**”) and to provide an updated and more comprehensive approach to the regulation of Regulated Funds’ use of derivatives.²

As a part of the prudent management of our Regulated Funds and other portfolios, Vanguard funds enter into derivatives contracts, including swaps and futures, to achieve a number of benefits for our investors, including hedging portfolio risk, lowering transaction costs, managing cash, and achieving more favorable execution compared with traditional investments.

It is important to note that Vanguard has been fully supportive of the mandate of the derivatives title 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**”) (collectively, “**swaps**”), and exchange-trading of the most liquid swaps (collectively, “**Derivatives Reforms**”). In crafting an updated approach to the regulation of Regulated Funds’ use of derivatives, the SEC should gain significant comfort that the Derivatives Reforms, together with similar initiatives across the globe, have created a fundamentally safer, more transparent, and more stable regime for the benefit of the markets and investors, and which serves as a strong foundation in support of the SEC’s goals for Regulated Funds.

¹ Vanguard is an SEC-registered investment adviser that offers more than 190 funds with aggregate assets of approximately \$3.1 trillion.

² *Use of Derivatives by Registered Investment Companies and Business Development Companies*, 80 Fed. Reg. 80883 (Dec. 28, 2015) (the “**Proposing Release**”).

We are heartened that the Proposed Rule adopts many of the recommendations in Vanguard's letter to the SEC dated November 7, 2011,³ in response to the SEC's concept release on the use of derivatives by Regulated Funds (the "**Concept Release**").⁴ We also appreciate that with respect to every aspect of the Proposing Release, while the SEC expressed its current thinking, it also invited the market to provide input in response to detailed questions requesting feedback on the proposals, alternative suggestions for consideration, and arguments and data in support of such alternatives.

In this letter we have taken that invitation for collaboration *very seriously* as Vanguard shares the SEC's commitment to maintaining the reputation of Regulated Funds as the premier choice for investors in meeting their investment objectives in a well-regulated, protective environment. For much of the Proposed Rule, we have relatively minor suggestions for improvement as we believe the SEC has chosen the right goal as well as the right approach in targeting that goal. Those suggestions follow at the end of this letter. For some aspects of the Proposed Rule, while we agree with the SEC's overall intent, we believe the targets to achieve that intent can be better defined, and the approaches outlined can be better crafted to have the optimal success in achieving those targets while also avoiding unintended harmful consequences.

Especially with respect to overall limits on derivatives usage, we embrace the SEC's efforts to move beyond a more "disclosure oriented" approach to establish a dispositive "line in the sand" in clear differentiation between Regulated Funds' usage and that of the unregulated funds' market. However, we caution the SEC that in several areas, its self-described use of a "*blunt measurement*" approach⁵ to limit Regulated Funds' usage of derivatives presents significant negative consequences that cannot be justified on a cost/benefit analysis when the SEC has the opportunity to deploy a more risk-sensitive approach that better addresses the perceived problems while avoiding implications that would be harmful to the markets, harmful to investors and harmful to the SEC's overall goals.

It is our aim in this letter to outline steps to help the SEC better navigate that path based on our deep understanding of the markets, of the benefits of the Derivatives Reforms, of the benefits of derivatives usage to investors, of the appropriate risks to target, and of the best means to target those risks while avoiding harmful impacts. Our recommendations, together with a summary of our key points, are highlighted below.

I. EXECUTIVE SUMMARY

- **Derivatives Usage is Fundamental to Prudent Portfolio Management.** Derivatives are essential tools that enable portfolio managers to effectively and efficiently mitigate risk and achieve investment objectives. In seeking a simple solution to address risks presented by the use of certain derivatives, the SEC has overlooked the many beneficial effects of common portfolio management techniques. Through providing a detailed

³ Vanguard Comment Letter, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940* at 3 (November 7, 2011) (File No. S7-33-11), available at <https://www.sec.gov/comments/s7-33-11/s73311-38.pdf> (the "**2011 Vanguard Letter**").

⁴ *Use of Derivatives by Investment Companies under the Investment Company Act*, 76 Fed. Reg. 55237 (September 7, 2011).

⁵ Proposing Release at 80903, 80909.

explanation of both the products and their positive uses, we intend to clarify the many benefits to Registered Funds' investors which would be sacrificed if the SEC does not better clarify its targeted risk and better tailor its approach to more effectively address such risk.

- **The Objectives of Asset Segregation Can Be Achieved with Expanded Qualifying Coverage Assets, Recognition of Offsets, and Broader Netting.** We are pleased the Proposed Rule demonstrates considerable effort to rationalize existing asset segregation rules. We believe only modest changes are advisable to better reflect market practices while maintaining the intended protective effect, including: expanding the range of qualifying coverage assets, more fully recognizing offsetting transactions, and extending the application of netting benefits to certain financial commitment transactions.
 - **Expand Qualifying Coverage Assets for Derivatives Transactions.** We believe the SEC's goal of ensuring there are adequate segregated assets to meet derivatives obligations can be met in an approach patterned on that presently mandated for eligible collateral for over-the-counter swaps. In allowing a broader range of assets to be eligible for segregation, subject to value haircuts reflective of each assets' relative volatility, more assets will actually be held in protective segregation while also allowing Regulated Funds to stay fully invested, to avoid cash drag, and to limit tracking error.
 - **Recognize Offsetting Transactions as Qualifying Coverage Assets.** While the Proposed Rule recognizes as a direct offset the particular asset subject to delivery under a derivatives contract, Vanguard believes the SEC can recognize a range of additional offsets and thereby achieve its goals while also avoiding unintended penalties on effective risk reduction techniques and the need to levy asset segregation requirements on offsetting, risk-reducing trades.
 - **Extend Netting to Financial Commitment Transactions.** We are pleased the Proposed Rule recognizes the benefits of netting agreements for the purpose of calculating the asset segregation amount for derivatives transactions. The SEC can safely extend such recognition to netting agreements governing additional transaction types including those used for certain financial commitment transactions.
- **The Proposed Derivatives Notional Amount Limits Should be Amended to Better Address the Actual Risk of Derivatives Usage While Avoiding Unintended Harmful Consequences.** The SEC's intent in establishing threshold limits on Registered Funds' derivatives usage is not unreasonable. However, if limits beyond those achieved through asset segregation and offset are viewed to have merit, Vanguard has specific recommendations intended to better address SEC objectives while at the same time preserving the many beneficial aspects of derivatives usage. If such limits are to be mandated, our proposed changes should be included as the present Proposed Rule includes aspects that cannot be justified by a cost/benefit analysis when the SEC has the opportunity to better address its concerns in a manner that avoids significant negative impacts on the market, on investors and, indeed, on the SEC's larger goals for Regulated Funds.

- **Asset Segregation and Offset Rules Adequately Limit Leverage.** Especially given the widespread use of derivatives by Regulated Funds as a part of prudent portfolio management, and the potential for serious negative unintended consequences in posing more conservative limits, Vanguard believes asset segregation is the most appropriate approach to ensure the adequacy of assets to meet obligations owed to third parties, and to mitigate the potential leveraging effect of derivatives.
- **General Notional Amount-Based Limits on Derivatives Usage Are Ineffective in Limiting Risk and Serve to Compromise Prudent Derivatives Usage.** The SEC's Proposed Rule does not effectively limit the risk of leverage, and instead serves to constrain the ability of portfolio managers to use prudent, efficient and long-standing portfolio management tools.
- **If Limits on Derivatives Usage Must Apply, They Should Aim for Conformity with Existing Standards That Target Risk While Avoiding Harmful Effects.** Vanguard believes that the SEC should reconsider the merit of the approach applied to Undertakings for Collective Investments in Transferable Securities ("UCITS") in establishing clear risk limits without the harmful effects, with the added benefit of already being deployed by the market and being recognized by other regulators as a prudent approach to managing derivatives' risk.
- **If the SEC is Uncomfortable with Existing Global Standards, Vanguard Strongly Recommends Improvements to the SEC Model to Better Target Risk and Avoid Unintended Harm.** If the SEC is committed to applying an overall limit on derivatives, we recommend that the SEC adopt a hybrid approach, incorporating key aspects of both the SEC's Proposed Rule and the UCITS rules. To better target the risk of leverage, we recommend the adoption of a simple, objective approach that applies relative risk weightings to derivatives notional amounts, as well as an absolute limit on the value-at-risk ("VaR") of portfolios that include derivatives.
- **Vanguard Supports the Requirement for a Derivatives Risk Management Program.** We are very supportive of the SEC's call for a robust derivatives risk management program. We believe it is appropriate for the board to receive a derivatives risk program assessment from the derivatives risk manager on an annual basis.
- **The SEC's Proposed Derivatives Disclosure, Reporting, and Recordkeeping Regime is Compelling with Modest Changes.** Vanguard supports the disclosure, reporting, and recordkeeping requirements of the Proposed Rule with the following modifications:
 - **Regulated Funds Should Not Be Required to Report Data Derived From Subjective Analysis.** We believe that the SEC should calculate risk metrics (*i.e.*, gamma and vega) from Form N-PORT data, which would empower the SEC to draw "apples-to-apples" comparisons among Regulated Funds and better monitor for industry trends.
 - **Regulated Funds Should Disclose the Approach Used to Measure Derivatives Usage.** We support disclosure on Form N-CEN and in a Regulated Fund's offering documents of a Regulated Fund's approach to measure derivatives usage. This will

give the SEC and the public an additional tool to understand a Regulated Fund's level of derivatives usage, while imposing a minimal additional burden on Regulated Funds.

- **Recordkeeping Requirements Should Be Based on End-of-Day Positions.** To reduce administrative burden and cost, we recommend that Regulated Funds be required to maintain records confirming compliance with their applicable portfolio limitation as determined by the Regulated Fund at least once per day, rather than immediately after execution of each trade.

A more detailed discussion of each of these points follows.

II. DERIVATIVES USAGE IS FUNDAMENTAL TO PRUDENT PORTFOLIO MANAGEMENT

Regulated Funds have long used derivatives in prudent portfolio management. The reason for such usage is abundantly clear: derivatives have served as a fundamental tool used by market participants to mitigate perceived risks presented by other assets and to invest in assets synthetically in a cost-effective, risk-mitigating manner. Derivatives have long been used to hedge against commodity price movements, interest rate fluctuations, foreign currency shifts, and other market risks and have thereby provided significant benefits to investors. The SEC has long required that such usage, including any attendant risks and mitigants, be disclosed to Regulated Fund investors to afford the opportunity for investment decisions to be made on a fully-informed basis. It is these many benefits to the market, to investors, and to the SEC's larger goals of risk-mitigated investing that must be preserved as the SEC contemplates the potential for limits on derivatives usage by Regulated Funds.

A. Derivatives Regulatory Reform Provides Significant Risk Mitigation to Create a More Stable and Resilient Global Derivatives Market

While, historically, the global and heavily-regulated futures and options markets have offered a relatively narrow range of standardized contracts with significant liquidity for both investing and hedging, the early 1980's saw the rise of over-the-counter derivatives that effectively created a synthetic means in which to invest and hedge risks across a significantly broader scope of assets. In the absence of active regulatory involvement, market participants and trade associations created both the market architecture and legal and contractual infrastructure that shepherded the growth of highly liquid derivatives products, which could be sourced on a consistent basis from banks and dealers around the globe. As much as favorable pricing and enhanced liquidity contributed to the growth of derivatives, the market standard contracts provided a common set of protections for derivatives, including exposure netting and collateralization.

To be clear, we recognize the role of derivatives in the context of the global financial crisis. Particularly through the use of then-opaque credit default swaps, securitized sub-prime mortgage risk was transferred to a risk aggregator without the benefit of regulatory oversight and guardrails, including proper risk management, position reporting, central clearing, and collateral management. However, it must be understood that the factors that contributed to the crisis did not arise in the context of Regulated Funds' use of derivatives. The well-established 1940 Act

protections, including Section 18 asset segregation and offset requirements and the mandate to hold fund assets serving as collateral for over-the-counter derivatives at the Regulated Fund's custodian, coupled with the consistent application of netting and collateralization, mitigated the possibility of the crisis seriously impacting Regulated Funds' derivatives positions.

Before the crisis, regulators had little insight into derivatives' risk concentrations, collateral was inconsistently applied, and few standardized trades were either traded on an exchange or centrally cleared and risk-managed. *Since the crisis, however, regulators have systematically addressed sources of risk and have achieved a holistic, transparent, and stable framework within which derivatives are used.* In the United States, significant volumes of formerly opaque over-the-counter derivatives are now transparently traded on an exchange, are centrally cleared and risk managed, and, following a relatively short phase-in period, will be margined consistently to mitigate both current market risk and potential market volatility.

Today, given all of the Dodd-Frank Act's reforms, it is likely that most swaps entered into by Regulated Funds will be executed on an exchange and centrally cleared. While exchange trading provides full transparency to the regulator, mandated central clearing means that the clearinghouse has a window into sizeable market positions that provide robust trade data to enhance the effectiveness of the clearinghouses' centralized risk management tools including, especially, the requirement for initial margin to mitigate volatility risk.

The SEC can take considerable comfort that the critical mass of global Derivatives Reforms has established a much more transparent, stable and resilient derivatives market than was the case when the SEC issued its Concept Release. Indeed, the collective impact of the Derivatives Reforms must serve as an effective foundation for derivatives risk management on which the SEC should assess the merit of a more highly prescriptive, generalized, and conservative approach as compared with one which better targets specific risks while preserving important investor benefits.

B. Derivatives Are a Critical Portfolio Management Tool for Hedging Risk, Managing Cash, and Synthetically Investing in a Risk-Mitigating Manner

Vanguard Regulated Funds use derivatives, 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 with traditional investments. Indeed, the lion's share of derivatives use across the industry falls into two main buckets: risk mitigation and cash management. Vanguard firmly believes these uses must not be compromised as the SEC contemplates the merit of overall derivatives limits.

i. Derivatives Provide Important Hedging Benefits

Risk mitigation takes a variety of forms. At the most basic and, indeed, the most extensive level, foreign exchange spot and forward trades are executed to hedge foreign currency risk both with respect to settling buys and sells of foreign securities and in converting foreign currency proceeds into U.S. dollars to meet shareholder needs. To the extent that a Regulated Fund invests in foreign securities, hedging may require foreign exchange spot and forward trade notional amounts equal in size to the Regulated Fund's entire net assets.

Foreign exchange risk management in particular may benefit from dynamic hedging approaches where an ongoing series of spots and forwards are executed over time to fine-tune the overall position. Sometimes overall positions need to be reversed, and sometimes a portion of the position may need to be upsized or downsized. The dynamic hedging decision-making is performed by the portfolio manager based on an overall assessment of the underlying exposure, the effect of the outstanding positions, and the impact of potential new positions on both the underlying portfolio and the outstanding positions. Other issues may also factor into the decision making, such as the preference to spread out the maturities of large notional amount positions or the desire to address projected future cash flows.

In short, the complexities of dynamic portfolio management necessitate highly tailored choices involving a multitude of variables, including the choice of hedging products to deploy, as well as their size, timing, direction, and other variables with the overall result often reflecting a combination of these multi-dimensional objectives. At any one time there may be a relatively large aggregate notional amount position if one were to add up the multi-layering of open buys and sells and upsize and downsize position adjustments. Of course, the overall risk associated with such trades may be relatively small especially given their risk-reducing effect, and Regulated Funds have historically addressed this risk via asset segregation and/or offset, as well as through exposure netting and collateralization.

Another example of hedging includes using interest rate swaps to adjust the duration risk in fixed income portfolios. The overall interest rate exposure of a portfolio is determined and then an interest rate swap is executed to mitigate some portion of the duration risk. The swap's notional amount may be quite large, and for the swap to have the intended risk-reducing effect it may require a notional amount equal to a significant portion, if not all, of the size of the overall portfolio.

Dynamic risk management also may be appropriate with respect to managing duration risk. A series of swaps may be executed to fine-tune the overall exposure over time and may result in a relatively large aggregate notional amount position if one were to add up the multi-layered swaps. As with foreign exchange hedging, dynamic duration hedging also may involve a variety of factors that produce sizeable aggregate notional amounts with an overall risk-reducing effect. Such risk is mitigated through the application of asset segregation, offset, netting, and collateralization.

These two products dominate the derivatives usage of fixed income Regulated Funds and also mean that while overall effect on the Regulated Fund is risk reducing, the notional amounts of the trading can be large including, in some cases, notional amounts equal to or in excess of the Regulated Fund's net assets. If a Regulated Fund's access to these key risk management tools was limited, its performance could be more volatile and investor returns less stable. It would be a mistake for the SEC to impose overall limits in derivatives usage not sensitive to the beneficial use of these tools by portfolio managers, especially as investors have long selected funds for investment with full disclosure that these products could be used for such purposes.

ii. Derivatives Provide Effective Cash Management Tools to Efficiently Invest Subscriptions and to Synthetically Invest to Maintain Cash for Redemptions

Portfolio managers need a flexible set of efficient tools for cash management, and derivatives often provide a cost-effective solution. A Regulated Fund's cash management needs arise in the case of both cash inflows and outflows. When a Regulated Fund receives new subscriptions, it is preferable to immediately invest the cash to best ensure that the expected return is available for Regulated Fund shareholders. That being said, portfolio managers may need time to identify appropriate investments and to achieve preferred pricing. In the period during which securities investments are being made, portfolio managers may invest synthetically using either the futures or the swaps market. Futures and options and some credit default swaps are executed on an exchange and total return swaps may be executed over-the-counter, in each case to obtain immediate cost-effective exposure to the underlying assets. Liquidity in the synthetic derivatives markets can be greater than in the securities markets and synthetic investing through derivatives provides the portfolio manager with the time needed to source and obtain the desired assets at the preferred price.

Prudent portfolio management likewise requires that managers make provisions to address potential redemptions to achieve the anticipated liquidity needs of Regulated Fund investors. To maintain a reserve of cash to fund potential redemptions, while at the same time ensuring that the Regulated Fund is fully invested to provide investors with expected returns, are critical objectives for which derivatives often provide the most efficient, cost-effective solution. Futures, options, credit default swaps, and total return swaps are often used for this exact purpose. Regulated Funds can stay fully invested on a synthetic basis, while simultaneously reserving a pool of cash to meet redemptions. Rather than maintain direct investments in specific assets, Regulated Funds with fixed income portfolios execute credit default swaps on an index of diversified issuers. Credit default swaps on such indexes often have greater liquidity than do the bonds of the underlying issuers. In selling credit protection, Regulated Funds gain synthetic exposure to the bond market and thereby preserve cash reserves to meet redemption needs. Likewise, in equity portfolios, Regulated Funds can execute highly liquid equity index futures contracts in which the Regulated Fund receives any appreciation in the value of an asset or assets and the Regulated Fund pays any depreciation—without the need to purchase the underlying asset. In gaining exposure to the asset in such a manner, Regulated Funds can stay fully invested in the intended assets, while also maintaining a cash reserve to provide liquidity in the event of investor redemptions.

Effective cash management often requires the use of derivatives and this usage must not be compromised through the impact of overall usage limits that inadvertently serve to constrain such benefits to the market, to investors and to overall SEC objectives.

iii. Derivatives Provide Cost-Effective Synthetic Investing to Mitigate Volatility and Other Risks More Effectively Than Through Securities Investing

Synthetic investing through the use of derivatives also enables portfolio managers to meet investor objectives using approaches that mitigate the volatility and other risks that might arise through more traditional securities investments. It is important to note that while investing directly in securities always presents risks, the investment return presented by certain investment portfolios can also be targeted using synthetic investment tools. Such synthetic products often

offer greater liquidity and can be managed in a more efficient and cost-effective manner than could be achieved using traditional securities markets.

Examples of such synthetic investment strategies include using commodity futures when it is impractical to take delivery of physical commodities. In addition, total return swaps are used to gain synthetic exposure to assets in emerging markets where there are barriers to enter the local securities markets. With respect to futures generally, a long/short strategy used by an alternative strategies fund could result in notional amounts of 200% of net assets, notwithstanding that the purpose of the positions is to reduce overall beta volatility and focus instead on a form of risk premium or alpha spread. A relatively low risk, long/short total return swap strategy including a \$100 long position on one asset and a \$100 short position on a related asset raises the question as to whether the notional amount for the purpose of the SEC's proposed limits should be \$0, \$100, or \$200. Of course, focusing on what should be the notional amount ignores the actual risk presented by the transaction. It is only the risk to fund investors that is relevant and risk bears no direct relationship with the derivative's notional amount.

Particularly in the managed-futures and alternative strategies space, the incentive to use derivatives products is not always to obtain leveraged returns (*e.g.*, enhanced returns through the use of derivatives to gain exposure to assets in excess of the Regulated Fund's net assets), but instead to achieve investor goals while at the same time mitigating position volatility, liquidity and other risks. Derivatives enable portfolio managers to execute investor-driven strategies in the most cost-effective manner, while also mitigating a variety of risks to a degree often not possible through investing in securities alone. While in such portfolios there may be a significant usage of derivatives, it may be the case that such synthetic investing methods are intended to produce similar returns offered by more traditional securities' investments with much more flexibility in managing a series of risks.

Again, in targeting aggregate notional amounts, the SEC is likely limiting efficient, risk-mitigating investment strategies while at the same time missing its goal of effectively limiting risk to investors. If such limits are to be mandated, they must better target actual risk and in so doing avoid negative impacts to the market, to investors and to the SEC's broader goals.

III. THE OBJECTIVES OF ASSET SEGREGATION CAN BE ACHIEVED WITH EXPANDED QUALIFYING COVERAGE ASSETS, RECOGNITION OF OFFSETS, AND BROADER NETTING

A. Expand Qualifying Coverage Assets for Derivatives Transactions to Mirror Eligible Collateral for Over-the-Counter Swaps

The SEC explained that its proposed approach to asset segregation is "designed to provide a *flexible framework* that would allow funds to apply the requirements of the Proposed Rule to particular derivatives transactions used by funds at this time as well as those that may be developed in the future."⁶ We agree that the Proposed Rule's approach for determining the segregation amount with respect to derivatives transactions does provide a certain degree of the intended flexibility.

⁶ Proposing Release at 80926 (emphasis added).

Indeed, in our 2011 Vanguard Letter, we advocated a principles-based approach and noted: “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.”⁷ We are pleased the SEC agreed that using the mark-to-market value of a Regulated Fund’s derivatives transactions plus a “cushion” determined in accordance with board-approved policies and procedures is a superior approach to using the full notional value, which can result in a Regulated Fund holding more liquid assets than may be necessary to address the investor protection concerns underlying Section 18.

We further support that the segregation amount may be determined on a net basis for derivatives transactions that are covered by a netting agreement and reduced by any assets posted as margin. However, limiting the assets required to satisfy any “shortfall” in the segregation amount to only cash and cash equivalents could significantly reduce investor returns, while not measurably advancing the Section 18 policy of ensuring that a Regulated Fund has sufficient assets to meet its obligations.

Regulated Funds should not be required to liquidate holdings to generate eligible assets (or to keep an increased amount of cash and cash equivalents) for segregation, but rather should be allowed to use a broad range of liquid fund assets, subject to appropriate haircuts. This will benefit Regulated Funds in meaningful ways by allowing them to stay fully invested, avoiding cash drag on returns for investors, and decreasing tracking error. Holding cash and cash equivalents to satisfy asset segregation requirements may be in conflict with the Regulated Fund’s investment objectives as stated in its disclosure documents and serve to discourage asset managers from using derivatives to efficiently hedge risk. Moreover, it represents a significant departure from market practice under current SEC guidance, which permits segregated assets to consist of U.S. government securities and other high-grade debt obligations,⁸ as well as any asset that is liquid and marked to market daily, including equity securities and non-investment-grade debt.⁹

It is counterintuitive that a Regulated Fund is credited for *any assets* posted as margin but may not use those same assets to satisfy the asset segregation requirement if they are in the Regulated Fund and segregated on the books. Indeed, the Proposed Rule would allow a Regulated Fund to reduce its mark-to-market coverage and risk-based coverage amounts for a derivatives transaction by the value of any assets posted as variation and initial margin, respectively, an aspect of the Proposed Rule with which we completely agree. To not recognize posted margin for purposes of determining the asset segregation amount would be to undermine key regulatory initiatives that significantly reduce risk in the derivatives markets (including reporting, clearing, exchange-trading, and margining requirements as discussed in more detail in Section II.A). The final collateral rules for over-the-counter swaps (“**Swap Margin Rules**”)¹⁰

⁷ 2011 Vanguard Letter at 7.

⁸ *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (April 18, 1979).

⁹ *Merrill Lynch Asset Management, L.P.*, SEC No-Action Letter (July 2, 1996).

¹⁰ *Margin and Capital Requirements for Covered Swap Entities: Final Rule*, 80 Fed. Reg. 74,839 (Nov. 30, 2015) and *Interim Final Rule*, 80 Fed. Reg. 74,915 (Nov. 30, 2015) (“**Prudential Regulators’ Final Margin Rule**”); *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 6, 2016) (“**CFTC Final Margin Rule**”). We note that the SEC has

requiring swap dealers to call for margin were drafted to mitigate the risk that swap counterparties (including Regulated Funds) will not meet their payment obligations, representing one of the same goals the SEC seeks to meet with its asset segregation approach. The Swap Margin Rules permit a broad range of liquid assets to be posted as margin, including, among other things, cash, high-quality government and central bank securities, high-quality corporate bonds, equities in major stock market indices, and gold. For those assets that are not extremely liquid or that are otherwise more volatile in price or value, haircuts are applied to ensure that sufficient assets are available to meet the Regulated Fund's potential obligations under the derivatives transactions.

The SEC noted its concern that “other types of assets, such as equity securities or other debt securities . . . could decline in value at the same time the fund's potential obligations under the derivatives transactions increase, thus increasing the possibility that such assets could be insufficient to cover the fund's obligations.”¹¹ However, haircuts such as those applied under the Swap Margin Rules are designed precisely to address these volatility and liquidity concerns. The eligible assets and corresponding haircuts were determined by the prudential regulators and the CFTC after a careful analysis of the likelihood that the assets would remain liquid and retain their value (after haircutting) under extreme market conditions.¹² Moreover, central clearinghouses, upon which systemic risk mitigation is based, have likewise long recognized a broad range of assets as eligible collateral, using historically observed volatility and liquidity assumptions to inform the applicable haircuts. Finally, the risk-based coverage amount under the Proposed Rule—which we support—provides an additional “cushion” during an economic downturn to ensure that Regulated Funds are able to meet their obligations.

We also support that the haircutted assets posted as margin under the Swap Margin Rules are appropriately recognized for purposes of determining a Regulated Fund's asset segregation amount, a recognition that may result in the mark-to-market and risk-based coverage amounts equaling zero, in which case the Regulated Fund would not have to segregate additional cash and cash equivalents on its books.¹³ However, in instances where the full amount is not posted as margin—such as for transactions in products for which initial margin is not required—Regulated Funds would be required to segregate cash and cash equivalents rather than the same assets it would be eligible to post as margin, yielding an illogical and inconsistent result that penalizes investors.

proposed different margin rules for security-based swaps, but we believe that both those rules and the asset segregation approach should track the existing Swap Margin Rules.

¹¹ Proposing Release at 80932.

¹² *E.g.*, the Commodity Futures Trading Commission (the “CFTC”) initially proposed that eligible assets for variation margin should be limited to cash. *CFTC Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 79 Fed. Reg. 59898 (Oct. 3, 2014). However, the CFTC subsequently agreed with commenters (including Vanguard) that cash-only variation margin would be inconsistent with the current, robust market practice and would drain the liquidity of financial end-users by forcing them to hold more cash. CFTC Final Margin Rule at 668. Thus, the list of eligible collateral was expanded to highly liquid assets, aligning with international standards. *Id.*

¹³ *E.g.*, if a Regulated Fund that has entered into an over-the-counter swap and has delivered collateral equal to its mark-to-market loss on the swap, the Regulated Fund generally would not also be required to segregate qualifying coverage assets with respect to the swap's mark-to-market coverage amount, because the collateral delivered would equal the amount payable by the Regulated Fund, based on market conditions, if the Regulated Fund were to exit the transaction at that time. Proposing Release at 80927–28.

For example, many Regulated Funds invest in foreign securities in order to gain exposure to foreign markets for their investors and implement a currency hedging strategy. Investors may explicitly look for these currency-hedged Regulated Funds because they provide international exposure while reducing non-US currency volatility, which results in less volatile and more consistent returns. These Regulated Funds are required to convert holdings in foreign securities denominated in foreign currencies back into US dollars, and they use foreign exchange forwards to do so. Such currency forwards are problematic under the proposed asset segregation requirements because they are not subject to mandatory clearing and therefore do not require posting of initial margin.¹⁴ Accordingly, the Regulated Funds are unable to avail themselves of the Proposed Rule's initial margin credit for their currency forwards and would instead be required to segregate cash and cash equivalents on the books for the full risk-based coverage amount.¹⁵ As a result—and in light of the fact that the Proposed Rule only recognizes limited offsets—the portfolio manager may need to sell assets to generate cash for segregation, which penalizes the investor by preventing the Regulated Fund from remaining fully invested in the investors' selected strategy, creating cash drag on the investors' returns, and increasing tracking error.

A Regulated Fund may similarly experience “shortfall” and have to segregate cash and cash equivalents on the books with the same negative impacts noted above when the calculated variation margin falls below the bilaterally negotiated “minimum transfer amount” under its master netting agreement. In such circumstances, no variation margin would be posted and the Regulated Fund would instead be required to segregate assets on its books to satisfy the mark-to-market coverage amount in the form of cash and cash equivalents only (notwithstanding the limited exception for deliverable assets). By virtue of segregating the mark-to-market coverage amount on the books, the Regulated Fund would be limited to a completely different set of eligible assets than it would be had it posted variation margin, notwithstanding that the mark-to-market coverage amount and variation margin are “conceptually similar” with both seeking to address the asset sufficiency concern.¹⁶ Such an outcome may encourage some Regulated Funds to lower their negotiated minimum transfer amounts such that they have more flexibility in the type of assets available to them to satisfy the asset segregation requirement, which in turn could lead to a much more operationally burdensome, inefficient, and frequent exchange of de minimus amounts of variation margin.

In sum, we believe that qualifying coverage assets should mirror eligible collateral with haircuts under the Swap Margin Rules to benefit investors, to ensure parity of treatment between posted margin and coverage assets segregated on the books, and to align with current market convention and general liquidity assumptions, while still satisfying the policies underlying Section 18. Eligible collateral for uncleared swaps and the corresponding risk-based haircuts have been well vetted and approved by both prudential regulators and the CFTC. We believe that the SEC should look to these existing regulations promulgated by other regulators and seek to ensure consistency in the spirit of the Dodd Frank Act's overall support for global regulatory

¹⁴ Deliverable currency forwards will likewise not be subject to the initial margin requirements of the Swap Margin Rules.

¹⁵ Our initial calculations of the risk-based coverage amounts on these positions under the Proposed Rule range between 125 and 550 basis points.

¹⁶ Proposing Release at 80932.

harmony. We also note that the SEC has already endorsed this approach to the extent that it appropriately recognizes and credits any assets posted as margin in determining the asset segregation amount. Our recommendation is that any “shortfall” not accounted for by posted margin be permitted to be in the form of the same assets that would have been permitted had it been posted.

B. Recognize Offsetting Transactions as Qualifying Coverage Assets for Derivatives Transactions

We support that the Proposed Rule permits that the particular asset that a Regulated Fund may deliver to satisfy its obligations under a derivatives transaction would be a qualifying coverage asset and further that the asset segregation amount may be determined on a net basis for derivatives transactions that are covered by a netting agreement. However, a qualifying coverage asset for a derivatives transaction generally would not include a derivative that provides an offsetting exposure. We do not believe that this is appropriate because it does not recognize that derivatives instruments that are fully offset by other positions are not subject to the same payment risk as uncovered positions.

Just as many commenters to the Concept Release advocated, we support retaining the flexibility offered by the current offsetting transaction approach. By the SEC’s own acknowledgement, risk may be reduced or closed out through execution of an offsetting transaction (whether with the same counterparty *or* another having the same close out effect). For example, the SEC recognized that a Regulated Fund may “*close out* of [a] position through execution of an offsetting transaction,” *i.e.*, eliminate its risk of having to meet its full payment obligation.¹⁷ However, if such offsetting transaction is entered into with a different counterparty than the first under a different netting agreement, the Regulated Fund would have to cover *both* transactions notwithstanding that the latter essentially “closed out” the former. Further, in a transaction where a currency forward hedges a foreign security’s currency risk—a transaction that should be encouraged—the foreign security would not be recognized as an appropriate offset under the Proposed Rule. By not recognizing such offsets, the SEC is effectively penalizing efforts at risk reduction, and the result would be to impose asset segregation requirements on many multiples of offsetting, risk-reducing trades. Accordingly, we recommend that qualifying coverage assets include offsetting transactions.

C. Extend Netting to Financial Commitment Transactions

Under the Proposed Rule, if a Regulated Fund has entered into a netting agreement that permits the Regulated Fund to net its payment obligations with respect to multiple derivatives transactions, the asset segregation amount for all derivatives transactions covered by the netting agreement may be calculated on a net basis. The SEC explained that this aspect of the rule was designed to “more accurately reflect... the fund’s current net amounts payable.”¹⁸ The same holds true for netting agreements that govern financial commitment transactions.

For example, certain forward-settling transactions in mortgage-backed and other asset-backed securities such as those commonly referred to as “to-be-announced” (“**TBAs**”) would fall

¹⁷ Proposing Release at 80927 (emphasis added).

¹⁸ *Id.*

within the Proposed Rule's definition of "financial commitment transactions." TBA transactions are often documented under Master Securities Forward Transaction Agreements ("MSFTAs"), which provide the framework for margining and netting of obligations similar to derivative netting agreements. However, by virtue of being categorized as financial commitment transactions under the Proposed Rule, the TBAs could not be netted for purposes of determining the asset segregation amount notwithstanding that they are governed by a derivatives-like master netting agreement that provides for the net settlement of all transactions.

Accordingly, we strongly recommend that financial commitment transactions that are covered by a master netting agreement be permitted to be calculated on a net basis. This would ensure parity of treatment across products that are governed by a master netting agreement, whether they are derivatives or financial commitment transactions, and more accurately reflect how such products are traded and risk managed. Further, for the same considerations discussed in Section III.B, qualifying coverage assets with respect to financial commitment transactions should include offsetting cover transactions.

D. Other Clarifications to Asset Segregation Proposal

i. Exclude Securities Lending from Financial Commitment Transactions

The Brinson Funds No Action Letter expressed the view that the obligation of Regulated Funds to return collateral upon termination of a securities loan may involve the issuance of a senior security.¹⁹ In line with that view, the SEC took the position that the 300% asset coverage requirement for bank borrowings contained in Section 18(f) should also apply to a Regulated Fund's loan of its portfolio securities.

SEC guidelines expressly limit the lending of securities to one-third of a Regulated Fund's total asset value. In addition, the guidance requires that Regulated Funds accept only highly liquid collateral from borrowers, and if a Regulated Fund accepts cash collateral, it should be invested conservatively in instruments that produce reasonable interest for the loan but that also have maximum liquidity to pay back the borrower if and when the loan is terminated. Limiting the lending of securities to one-third of a Regulated Funds total asset value practically constrains the amount of collateral that a Regulated Fund can receive and its corresponding obligation to return the collateral to the borrower. Moreover, the highly liquid collateral received and the Regulated Funds' remaining assets address the concerns that the Regulated Fund would be unable to meet its obligations to return the collateral.

Therefore, we believe that the current SEC guidance on securities lending effectively addresses the Section 18 asset sufficiency concerns, and it is not necessary for the SEC to address securities lending in the Proposed Rule.

ii. Exclude Certain Other Transactions from Financial Commitment Transaction Definition

We believe that the definition of financial commitment transaction needs to be fine-tuned so that it appropriately excludes certain commitments that do not implicate the policy concerns

¹⁹ *The Brinson Funds*, SEC No-Action Letter (Nov. 25, 1997).

underlying Section 18, particularly Regulated Funds (a) issuance of excessive amounts of senior securities, which increase unduly the speculative character of their junior securities, and (b) operating without adequate assets and reserves.

An example of a commitment that we believe does not implicate such policy concerns would involve a Regulated Fund's obligation to make a capital contribution (not for investment purposes) to its wholly owned subsidiary.²⁰ Under the Proposed Rule, this unique contribution could be read to be a financial commitment transaction subject to the rules' requirements. We do not believe that the drafters of the Proposing Release intended this result, particularly because such a structure does not implicate the policy concerns behind Section 18 noted above. In addition, the potential commitment is not a transaction that a Regulated Fund makes for investment purposes in furtherance of its investment objective. On that basis and for the sake of certainty, we ask that the definition of financial commitment transaction be appropriately modified to make clear that the capital commitment noted above is not a financial commitment transaction under the Proposed Rule.

IV. THE PROPOSED DERIVATIVES NOTIONAL AMOUNT LIMITS SHOULD BE AMENDED TO BETTER ADDRESS THE ACTUAL RISK OF DERIVATIVES USAGE WHILE AVOIDING UNINTENDED HARMFUL CONSEQUENCES

Vanguard agrees it is completely appropriate for the SEC to assess the risks associated with derivatives usage by Regulated Funds and to consider the merit of appropriate mitigants to potentially apply to such risks. That being said, Vanguard is convinced the proposed derivatives usage thresholds will have limited impact on relevant risks while at the same time will have significant adverse consequences in compromising the ability of portfolio managers to achieve investor goals in a risk mitigating, cost-effective manner. As noted previously, the notional amount of a derivative has little, if any, correlation with either its risk profile or with its leveraging effect. With that in mind, Vanguard has specific recommendations to help the SEC achieve its goals.

Indeed, Vanguard fears the Proposed Rule could actually serve to concentrate and spur some Regulated Funds to exploit the use of risk-increasing derivatives within the 150% notional amount limit because portfolio managers would potentially seek to maximize the impact of their efforts within the lower notional amount limit, which does not include any risk limitation. In so doing, managers could be incentivized to manage notional amount usage in conformity with the rule as opposed to using derivatives to achieve traditional investor-benefitting objectives. Moreover, in rejecting the existing global approaches designed to target such risks, the SEC has discounted the benefit of applying tried and true approaches that could be efficiently implemented for Regulated Funds in global harmony with the existing limits mandated for their regulated overseas counterparts.

²⁰ Vanguard is a wholly-owned subsidiary of the Vanguard funds and operates under a Funds' Service Agreement (the "FSA"). Pursuant to the FSA and exemptive relief, each Vanguard fund may be called upon to invest up to 0.40% of its net assets in Vanguard. *In the Matter of The Vanguard Group, Inc.*, Investment Company Act Release No. 19184 (Dec. 29, 1992). Currently, each Vanguard fund has contributed approximately 0.01% of its assets to Vanguard.

A. Asset segregation and Offset Rules Adequately Limit Leverage

In our 2011 Vanguard Letter, we advocated for a rationalization of asset segregation rules to target a derivative's market value plus volatility, for an expansion of exposure netting, and for a credit for posted margin. We also suggested that, in exchange for asset segregation rationalization, the SEC consider an overall limit on derivatives that increase a Regulated Fund's leverage.

In treating all types and uses of derivatives alike, the SEC risks compromising prudent portfolio risk management techniques it has long recognized and from which shareholders and the overall market have benefitted for years. Indeed, while in our 2011 Vanguard Letter we suggested that the SEC could consider the merit of an overall "*leverage*" limit, notwithstanding full compliance with the asset segregation and offset rules,²¹ we never advocated for such a limit to apply either generally to all derivatives for all purposes or specifically with respect to any product that provides such an effective means to manage both market risk and cash positions. To do so would impose significant costs in removing powerful and effective risk management tools that have demonstrably benefitted Regulated Fund shareholders. Such costs cannot be justified, particularly when there are alternative approaches that better target the intended risk while minimizing the likely adverse effects.

i. Derivatives Notional Amounts Are Not an Indicator of Leverage

As to the issue of how to identify the problem of leverage, we appreciate that the white paper produced by the SEC's Division of Economic and Risk Analysis²² attempted to quantify derivatives usage by Regulated Funds. Our concern with the analysis in the DERA White Paper is that first, the sample of Regulated Funds surveyed was quite small (10% of all Regulated Funds); second, all derivatives are counted equally without any assessment of either the relative risk of the specific product or of the actual impact on risk when coupled with an asset or in the context of the overall portfolio; and third, that the measure used in the calculations was the notional amount of the particular derivative, which in most cases substantially overstates the actual risk, bears little or no relationship to the impact on risk, and is a highly inconsistent indicator of what might be considered "leverage." Indeed, the DERA White Paper itself states:

"[T]here are drawbacks to using notional amounts. First, because of differences in expected volatilities of the underlying assets, notional amounts of derivatives across different underlying asset generally do not represent the same unit of risk. For example, the level of risk associated with a \$100 million notional of a S&P500 index futures is not equivalent to the level of risk of a \$100 million notional of interest rate swaps, currency forwards or commodity futures."²³

The DERA White Paper also noted the significant challenges presented with respect to the lack of consistency in the reporting of notional amounts, the problem of double counting

²¹ Vanguard Letter at 9 n. 18.

²² Daniel Deli, Paul Hanouna, Christof W. Stahel, Yue Tang & William Yost, *Use of Derivatives by Registered Investment Companies* (2015) ("**DERA White Paper**"), available at <http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf>.

²³ DERA White Paper at 10.

offsetting derivatives, the difficulty in converting foreign currency notional amounts, etc. Given the challenges in producing the DERA White Paper, and of the self-assessed observation as to the lack of a consistent correlation between notional amounts of different derivatives products and risk, we urge the SEC to consider the DERA White Paper as an initial analysis that has demonstrated the need to provide a much more granular and extensive survey, and for the next iteration to focus very clearly on the issues of risk and leverage presented by derivatives.

In Vanguard's view, the SEC has taken the observations from the DERA White Paper, which acknowledged both the difficulty in assessing the aggregate derivatives usage within the Regulated Fund industry, and the absence of a clear correlation between notional amounts and risk, and recharacterized the data as evidence of high levels of market "*exposure*" obtained through derivatives by some Regulated Funds. While the DERA White Paper noted that a limited number of Regulated Funds may possess aggregate notional amounts of up to 950% of the Regulated Fund's net assets, the SEC refers to such use as indicative of the additional market "*exposure*" such Regulated Funds have achieved through the use of derivatives. In justifying its "*blunt measurement*" approach, the SEC has replaced the words "*notional amounts*" with the word "*exposure*," and thereby has effectively discounted the extensive use of derivatives by portfolio managers as a risk management tool.²⁴ Vanguard firmly believes it is wholly inappropriate to so discount such benefits.

In Vanguard's view, there is significant danger in adopting such a shorthand analysis of derivatives risks especially to justify an overall limit on usage at the expense of constraining the beneficial aspects afforded to Regulated Fund investors. The findings of the DERA White Paper may be used to justify a more in-depth analysis of derivatives usage and risks, but it is inappropriate for the SEC to base such conservative proposed limits on such a preliminary, small-scale, and inconclusive survey and analysis.

ii. Asset Segregation and Offsets Adequately Address Obligations Owed to Third Parties and Also Serve to Limit Leverage

On the topic of leverage, the DERA White Paper noted that for Section 18 purposes, the focus was on limits related to "a fund's ability to obtain leverage, or incur obligations to persons other than the fund's common shareholders, through the issuance of senior securities as defined in that section."²⁵ Thus, the targeted definition of leverage relates to both the Section 18 focus on obligations to third parties, as well as the concept of leverage involving transactions having the effect of obtaining exposure to assets in excess of the Regulated Fund's net assets. Vanguard believes that the appropriate approach to both limiting such transactions and ensuring that the Regulated Fund has adequate assets to meet its obligations is through the asset segregation and offset framework.

Provided that the Proposed Rule's asset segregation and offset requirements are met (amended as recommended in Section III of this letter), Regulated Funds' obligations to third parties can be satisfied and the volume of such obligations (including any potential leveraging effect) is effectively limited by the amount of assets available for asset segregation purposes. We note in particular that the SEC has adopted into the Proposed Rule the recommendations included

²⁴ Proposing Release at 80924.

²⁵ DERA White Paper at 4.

in our 2011 Vanguard Letter that asset segregation requirements include both the derivative transaction's market value, as well as an additional amount to reflect the challenge of closing out a transaction in a stressed market.

Given the inclusion of these two components, we have confidence that the Proposed Rule's asset segregation and offset requirements are well calibrated to mitigate the risk of both the Regulated Fund's performance and concerns related to leverage.

B. General Notional Amount-Based Limits on Derivatives Usage Are Ineffective in Limiting Risk and Serve to Compromise Prudent Derivatives Usage

The SEC's Proposed Rule adds overall limits on derivatives that do not differentiate between hedging, cash management, and leverage, and bring into question the ability of portfolio managers to hedge risks and manage cash through the prudent use of derivatives.

In Vanguard's view, this result is the clearest justification for the SEC to reconsider its Proposed Rule. As noted above, the DERA White Paper specifically notes that derivatives notional amounts do not necessarily correlate with concepts of risk, leverage, or speculation. Throughout the Proposed Rule, the SEC repeatedly acknowledges that the proposed limit is, at best, a "*blunt measurement*" targeting the professed concerns. While the DERA White Paper suggests that many, if not most, Regulated Funds may actually hold aggregate derivatives notional amounts smaller than the SEC's proposed thresholds, smaller notional amounts do not necessarily indicate a smaller level of risk, speculation, or leverage, in the same way that larger notional amounts do not necessarily indicate a larger level of risk, speculation, or leverage.

We strongly urge the SEC to avoid proceeding with an approach that has so many adverse unintended implications and that will so negatively impact the many beneficial uses of derivatives to the detriment of investors, and instead clearly identify the appropriate object of concern and craft an approach that addresses such concern in a surgical manner.

i. In Limiting Market Leverage Obtained Through Derivatives, the Appropriate Target Should Be On the Risk of Loss Occasioned By Such Leverage

If the SEC believes it appropriate to introduce limits, over and above those achieved through asset segregation and offset, specifically targeting the potential risks arising from the use of derivatives to achieve leverage, the natural question is what risks are presented, and what would be a reasonable, appropriate, and cost-effective manner to address such concerns?

In the Proposed Rule, the SEC plainly rejects a definitional approach based on a derivative's purpose on the basis that such an approach would be challenging both to assess and to enforce given its perceived subjective nature. While we are not convinced that such concerns are valid, if one were to assume such a definitional approach was impossible, the question remains—how to identify the risks and how best to address them?

In focusing on leverage, Vanguard views the appropriate concern should involve the extent to which a particular investment strategy (and its related products and practices) serves to increase overall risk levels beyond the tolerance level established and communicated to investors

and, potentially, beyond some overall tolerance level targeted by the SEC with respect to Regulated Funds.

ii. Assessing VaR Provides a Reasonable Assessment of the Risk of Loss Presented by a Portfolio's Positions, Including its Leveraging Positions

Regulated Fund complexes have for years managed portfolio risk against internal risk tolerance limits based on, among other things, limits related to VaR demonstrated by the overall portfolio by evaluating the potential loss to the Regulated Fund in the event of stressful market circumstances lasting over some time horizon. VaR assessments are routinely performed on portfolios comprised of cash and securities, as well as on portfolios also including derivatives. Not only is a Regulated Fund's absolute VaR closely monitored by both portfolio and risk managers, but it is also typically compared with the VaR of the Regulated Fund's target benchmark. For example, a Regulated Fund targeting performance with that of the S&P 500 Index would compare its VaR with that of the Index itself, with the expectation that the Regulated Fund's absolute VaR would be close to, if not less than, the VaR of the benchmark index.

While it is true that Regulated Fund complexes use a variety of approaches to calculate VaR, and that both the selection of the approach and the performance of the test can involve some level of subjective judgment, Vanguard believes it is unreasonable for the SEC to conclude that the existing level of subjectivity is impossible to overcome and therefore precludes the use of a VaR approach to gauge a Regulated Fund's absolute level of risk.

A VaR-like approach to risk measurement has been recognized by a range of U.S. regulators, including the SEC, the CFTC, and the U.S. bank prudential regulators, including the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Farm Credit Administration, and the Office of the Comptroller of the Currency with respect to a number of critical derivatives risk measurements including both the major Swap and SB Swap participant definitions,²⁶ as well as the framework for initial margin requirements for specific swaps.²⁷ Central clearinghouses have long used VaR-modelling frameworks to risk manage futures and centrally cleared Swaps with such risk-modelling being overseen by the CFTC as a fundamental component of clearinghouse risk management.

Given the extensive use of VaR modelling in the market and the fact that its methodology to assess risk has been otherwise embraced by regulators for other purposes, we strongly recommend that the SEC reconsider its reservations as to the merit of measuring and limiting risk with respect to Regulated Funds' usage of derivatives.

²⁶ *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and Eligible Contract Participant*, 77 Fed. Reg. 30596 (May 23, 2012), available at <https://www.gpo.gov/fdsys/pkg/FR-2012-05-23/pdf/2012-10562.pdf> (the "**MSP Risk Assessments**").

²⁷ Prudential Regulators' Final Margin Rule; CFTC Final Margin Rule.

iii. The SEC Should Adopt Standard Parameters for Calculating VaR Rather Than Reject the Concept Due to Perceived Variability and Subjectivity

Rather than rejecting outright the concept of using VaR as a valid risk measurement, and thereby adopting a risk-agnostic measure focusing on notional amounts, Vanguard calls on the SEC to consider introducing a mandated format for a VaR calculation for the purpose of this rulemaking with defined guardrails to limit the subjectivity and variability in its calculation. For example, the SEC could mandate certain parameters, such as the confidence interval, coverage period, and the number of years in the historical observation period, and thereby establish an “apples-to-apples” approach across Regulated Fund complexes, which could be calculated in determining the Regulated Fund’s compliance with an overall threshold for portfolio risk.

By establishing a standardized approach to VaR and using it as the basis for an overall limit on the risk to be exhibited by a Regulated Fund, the SEC would be targeting a true risk parameter instead of using an ineffective proxy for risk in the form of threshold on aggregate derivatives notional amounts. Especially because the use of such a weak proxy provides no true risk benefits or mitigants and seriously compromises tried, true, and legitimate portfolio management techniques, the SEC should reassess its view of the merits of absolute VaR as the best means to assess and limit the overall risk of portfolios that include derivatives.

iv. The SEC’s Relative VaR Test is Flawed and Should Be Abandoned as Ineffective in Limiting Risk

Similarly, Vanguard has serious concerns with the SEC’s proposed relative VaR approach, in terms of both its design and its limited effectiveness in regulating the risk associated with portfolios involving derivatives products. Despite the SEC’s expressed perception as to the subjectivity of VaR calculations generally, the proposal effectively compares the outcomes of two applications of the same VaR test performed in the same manner. Such an approach is problematic because at the lower threshold of derivatives usage it ignores derivatives’ risk levels altogether, while at the higher threshold, it effectively limits all usage solely to the purpose of risk reduction.

The proposed relative VaR approach is also confusing to interpret and to apply as it appears to compare the VaR of the overall portfolio including derivatives with the VaR of the same portfolio without derivatives. This point is especially concerning because, by comparing the portfolio’s overall VaR with that of a much smaller portfolio holding only securities, it would be difficult for the comprehensive portfolio to have the smaller VaR and thereby pass the test. The SEC itself has acknowledged that certain Regulated Funds, which invest synthetically through derivatives and hold only cash and cash equivalents, will be unable to pass the test because the portfolio with derivatives will never be able to have a lower VaR than the cash portfolio.²⁸ Even if such synthetic investing effectively mitigates certain risks that would arise if the portfolio manager had invested in securities, it would be banned under the Proposed Rule. In Vanguard’s view, that the SEC acknowledges that the rule does not work with respect to certain risk-mitigating investment strategies discredits the proposal.

²⁸ Proposing Release at 80924 n. 314.

The overall structure of the SEC's proposed relative VaR test is questionable when one considers that it appears to accept virtually unlimited risk for derivatives with aggregate notional amounts up to 150% of the Regulated Fund's net assets, but if usage crosses over to 151%, derivatives overall must be risk-reducing. As mentioned previously, the likely unintended result of this approach could be that some portfolio managers will utilize derivatives to maximize the risk / return up to the proposed 150% regulatory limit and give less attention to the hedging and cash management needs otherwise recommended by prudent portfolio management.

An additional issue with the SEC's relative VaR test is that it assumes that the non-derivatives portfolio would be the same if the Regulated Fund were prohibited from using derivatives. For example, a global equity fund investing in both developed and emerging markets' securities may gain emerging markets exposure through total return swaps. The non-derivative portfolio would certainly have a lower VaR than the full portfolio including derivatives because the non-derivative portfolio would only hold developed markets securities. However, if the Regulated Fund did not use total return swaps to gain emerging markets exposure, it would have to purchase emerging markets securities which would serve to increase its non-derivatives VaR. Effectively encouraging the portfolio manager to purchase higher-risk emerging markets securities rather than gaining such exposure through the use of lower-risk derivatives cannot be the SEC's objective—which must instead be to limit overall portfolio risk—and serves to illustrate the deficiencies of a relative VaR test.

For the above reasons, Vanguard strongly recommends that the SEC reconsider its aversion to an absolute VaR threshold and also forego its proposed relative VaR approach as both an ineffective limit on actual risk and a serious constraint on the discretion of portfolio managers to hedge, manage cash, and execute risk-mitigating synthetic strategies.

C. If Limits on Derivatives Usage Must Apply, They Should Aim for Conformity with Existing Standards That Target Risk While Avoiding Harmful Effects

While the SEC considered and rejected the derivatives limits provided in the UCITS rules,²⁹ we believe both their focus on risk and their selection of tools to target such risk have considerable merit. We encourage the SEC to reconsider developing a regime that is reflective of such choices, not only because they are more effective choices than a focus on notional amounts, but also that in so doing the SEC's approach would be more consistent with risk limiting rules already effectively deployed by the market and recognized by other regulators as a prudent approach to limit derivatives usage while avoiding unintended harm.

If the SEC feels compelled to implement an overall limit on derivatives usage by Regulated Funds in addition to mandating asset segregation and offset requirements, Vanguard recommends that the SEC reevaluate its doubts with respect to aspects of the UCITS limits, especially as they recognize that a derivative's risk relates to the purpose for which it is deployed and that hedging and netting should be excluded from the limits. Vanguard recommends an approach that targets actual risk and creates clear risk limits while accommodating different risk

²⁹ Committee of European Securities Regulators, *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* (July 28, 2010), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/10_108.pdf.

limiting methodologies depending on the type and level of derivatives usage as disclosed to investors.

In the Proposed Rule, the SEC considers and rejects every aspect of the UCITS methodology as overly complicated, open to subjective abuse, and impossible to supervise. To the extent that elements of these concerns may have some validity, Vanguard calls on the SEC reconsider their core structure and adopt changes that address their flaws.

i. An Approach That Includes an Exclusion for Hedging and Provides Broad Netting Rights Avoids Sacrificing the Benefits While Better Targeting Actual Risk

First, the SEC should reconsider the merit of risk-sensitive controls for limited derivatives users that do not penalize beneficial uses of derivatives and better reflect netting. The SEC's first-level limit of 150% of Regulated Fund net assets was intended to accommodate such practices but, as noted above, it is an inadequate counterbalance given the sophistication of netting practices and well-developed use of dynamic hedging strategies that layer multiple trades, and ever increasing notional amounts, to fine tune risk positions.

A more granular approach, which carefully identifies and limits true sources of derivatives risk in portfolio management, necessitates some definitional carve-outs especially with the most common risk mitigation and netting strategies. Such an approach would serve as a much more effective limit on risk while avoiding the harmful effects of the current broad-brush proposal. Vanguard is seriously troubled by the SEC's reluctance to carve prudent portfolio management practices out of the limit, while at the same time effectively allowing unlimited risk at smaller levels of derivatives usage, and calls on the SEC to reconsider its views of a more nuanced approach, which provides a more appropriate outcome.

ii. A More Granular, Risk-Sensitive Approach Has Already Been Implemented by Global Asset Managers and Could Be Easily Adapted for Regulated Funds

While such granular calculations may appear dauntingly complex, the SEC should take comfort in the fact that many Regulated Fund complexes have long adopted operational systems to evaluate portfolios in compliance with regulatory carve-outs for prudent risk management techniques. Rather than having to create new systems out of whole cloth, fund complexes need only extend existing methodologies to Regulated Funds (with refinements, as appropriate, to address SEC concerns). While exclusions for hedging, and the broader acceptance of netting, may present the SEC with concerns over subjective interpretations, the solution to such concerns could be the assignment of such interpretations to the SEC's proposed risk manager.

iii. Absolute Limits Are Preferable to the SEC's Relative VaR Test Because They Better Target Risk

In the Proposing Release, the SEC expressed concerns regarding both the possible lack of an unleveraged benchmark for the "relative VaR" test and the unreliability of VaR calculations generally for the "absolute VaR" test. In our experience, many Regulated Funds identify and disclose their target benchmark in their disclosure documents provided to investors. If there are concerns regarding the selection of benchmarks, the SEC could, again, delegate responsibility for benchmark selection to the SEC-proposed risk manager.

As to issues with the absolute VaR test, and to VaR calculations in general, the SEC also expressed concerns about the variety of approaches used to calculate VaR. As noted previously, the solution would be to adopt a standard VaR calculation framework within which calculations for these purposes would be performed, again, by the SEC-proposed risk manager. In our view, a more prescriptive VaR test should give the SEC considerable comfort that the calculations would be performed in a consistent, objective manner. If there are perceived shortcomings in that approach, the SEC should propose modifications. By taking such an approach, the SEC can better achieve its objectives without the significant harm which will arise from aspects of its present proposal.

iv. The Appropriate Focus in Assessing Leverage Should Be on the Risk of Loss Produced by the Portfolio Including Derivatives

In the Proposed Rule, the SEC expressed its concern that models which target “risk” serve to ignore “leverage.”³⁰ This seems to be an inappropriate argument as the SEC’s derivatives limits themselves do not directly address using derivatives to gain leveraged exposure. Rather than target a derivative’s notional amount, *the relevant concern with respect to leverage in any portfolio must be to the risk of loss such leverage could cause to investors.*

Vanguard calls on the SEC to reevaluate its views on alternative approaches to derivatives limits that more closely targets the actual risk of loss presented by derivatives while avoiding the harmful effects of more generalized limits.

D. If the SEC is Uncomfortable with Existing Global Standards, Vanguard Strongly Recommends Improvements to the SEC Model to Better Target Risk and to Avoid Unintended Harm

If the SEC is committed to apply a limit on derivatives usage by Regulated Funds over and above that supplied through asset segregation and offset, we recommend that the SEC adopt a hybrid approach incorporating key aspects of both the SEC’s Proposed Rule and existing alternatives that better target risk and avoid harm. For limits to be more closely calibrated to aspects of derivatives’ potential to raise leverage, we advocate for the adoption of a simple, objective approach that includes an initial threshold based on aggregate discounted notional amounts for Regulated Funds that have a limited, basic use of derivatives and a higher threshold based on aggregate discounted notional amounts subject to an absolute limit on the VaR of the overall portfolio.

This can be achieved through the use of two approaches, namely by the application of risk conversion factors to the notional amounts of derivatives products consistent with existing regulatory conversion standards that have assessed the relative risks presented by the products, and by the application of an overall risk limit for investment portfolios that include derivatives products.

³⁰ Proposing Release at 80977.

i. The SEC Should Apply Risk Conversion Factors to Derivatives Notional Amounts

As noted above, Vanguard urges the SEC to focus on the risk of loss presented by the overall investment portfolio (including derivatives), as the most appropriate means to address leverage concerns. While individually assessing the risk potential of each derivative's impact on a specific portfolio should be the goal, Vanguard recommends a reasonable, objective approach that acknowledges the relative levels of risk generally presented across categories of derivatives.

In evaluating risk at a very basic level, one can easily see that different forms of derivatives present very different opportunities for risk. For example, parties to an interest rate swap merely exchange the net difference between their applicable payment obligations and are not required to pay each other the notional amount of the swap. Likewise, as noted in the DERA White Paper, the risk associated with a futures contract on a U.S Treasury security is significantly less than that associated with a similarly sized futures contract on the more volatile S&P 500 Index. The seller of a credit default swap may be obligated to pay an amount equal to a smaller or larger portion of the derivative's notional amount based on the value of the reference asset in default compared with its par value. Derivatives involving more volatile underliers, such as certain commodities, present a greater likelihood of payment obligations approaching the trade's notional amount.

Differences in the risk profile of derivatives products is also affected by the residual maturity of the specific transaction. While a short-dated interest rate swap may present a nominal level of risk, the volatility of the position and its attendant risk naturally increases as the maturity of the trade is extended.

In proposing a notional amount-based test, the SEC is effectively treating the risk presented by all products on all underliers at all maturities as exactly equal. Such treatment serves to both penalize significant users of derivatives that present relatively little risk and possibly fails to adequately control significant users of derivatives that present relatively greater risk. Fixed income funds that use interest rate swaps to mitigate duration risk, global equity funds that use foreign exchange forwards to mitigate currency risk, and alternative strategy funds that invest synthetically to mitigate liquidity risk are all treated the same despite the relative risk presented by the specific derivative product type with a specific maturity and used for a specific purpose.

A significant improvement to the Proposed Rule can be achieved through the application of standard risk conversion factors to the notional amounts. Through the application of such factors, relative, objective risk assessments can be made based on product, underlier, and residual maturity to establish more nuanced guardrails that will avoid some of the most harmful aspects of the Proposed Rule.

Low-risk products used to manage portfolio risk will not be subject to limits to the same degree as will higher risk products that may have more of a leveraging effect and thereby introduce a greater risk of loss to the Regulated Funds. Such an approach serves to more effectively achieve SEC objectives while avoiding harm to the market and to investors.

ii. The SEC’s Major SB Swap Participant Derivatives Notional Amount Conversion Factors is the Best Existing Approach to Apply in Assessing Limits for Regulated Funds

For this purpose, we strongly recommend that the SEC implement the risk conversion factors based on those it has previously applied to derivatives for the purpose of determining major SB Swap (“MSBSP”) status.³¹ Such conversion factors have merit for a number of reasons. First, the approach utilizes an assessment of the relative risk of specific derivatives types and maturities that has already been approved by the SEC for another purpose. Second, the approach is already known by Regulated Funds and incorporated into their compliance procedures. Third, it assesses relative risk on a highly granular level based on both product type and residual maturity and has specific factors for each of Swaps and for SB Swaps. Finally, it avoids the downside risk that general limits would constrain prudent, effective and long-standing portfolio management techniques.

To apply the MSBSP risk conversion factors to derivatives for these purposes, Vanguard recommends that the factors be multiplied so that the highest MSBSP factor becomes a 100% conversion factor for the purpose of the Regulated Funds’ derivatives usage limit. The reason for this is that while the MSBSP factors demonstrate the SEC’s perception of the relative risk presented by different derivatives products and residual maturities, they are lower for the purposes of assessing MSBSP status. Vanguard is comfortable with raising the conversion factors for the purpose of assessing notional amounts for derivatives use limitations for Regulated Funds. This would require the application of a multiplier of 6^{2/3} to each MSBSP factor and would result in the following conversion factors for these purposes:

**PROPOSED NOTIONAL AMOUNT CONVERSION CHART
 BASED ON MAJOR SECURITY-BASED SWAPS PARTICIPANT
 NOTIONAL AMOUNT CONVERSION FACTORS**

Asset Class / Residual Maturity	MSBSP Notional Amount Conversion Factors	Proposed Regulated Fund Notional Amount Conversion Factors
<i>Security-Based Swaps</i>		
Credit / Debt: 1 year or less	10%	66.7%
Credit / Debt: 1-5 years	10%	66.7%
Credit / Debt: 5+ years	10%	66.7%
Equity / Other SBS: 1 year or less	6%	40%
Equity / Other SBS: 1-5 years	8%	53.3%
Equity / Other SBS: 5+ years	10%	66.7%
<i>Swaps</i>		
Interest Rate: 1 year or less	0%	0%
Interest Rate: 1-5 years	0.5%	3.3%
Interest Rate: 5+ years	1.5%	10%

³¹ MSP Risk Assessments.

Asset Class / Residual Maturity	MSBSP Notional Amount Conversion Factors	Proposed Regulated Fund Notional Amount Conversion Factors
Foreign Exchange: 1 year or less	1%	6.7%
Foreign Exchange: 1-5 years	5%	33.3%
Foreign Exchange: 5 + years	7.5%	50%
Gold: 1 year or less	1%	6.7%
Gold: 1-5 years	5%	33.3%
Gold: 5 + years	7.5%	50%
Precious Metals (ex. Gold): 1 year or less	7%	46.7%
Precious Metals (ex. Gold): 1-5 years	7%	46.7%
Precious Metals (ex. Gold): 5 + years	8%	53.3%
Other Commodities: 1 year or less	10%	66.7%
Other Commodities: 1-5 years	12%	80%
Other Commodities: 5 + years	15%	100%

In mandating a standardized notional amount conversion factor, Regulated Funds would be applying an objective measurement consistent with other regulatory standards, which would be easy to administer. Note that while other conversion approaches exist, such as that used to assess gross initial margin for swaps, Vanguard prefers the MSBSP conversion factors as there is more granularity with respect to differences on the basis of residual maturity for all product types.³² That being said, the approach used for assessing initial margin is also acceptable as it demonstrates existing factors approved by U.S. regulators based on the perceived relative risk across different derivatives of different maturities.

iii. Having Applied Conversion Factors to Derivatives Notional Amounts, the SEC Should Apply an Overall Risk Limitation with Respect to Larger Derivatives Users

Once the above noted conversion factors are applied to derivatives notional amounts, Vanguard is comfortable following the two-tiered thresholds specified in the Proposed Rule of 150% and 300% of a Regulated Fund's net assets. Relatively smaller users of derivatives could execute trades with aggregate discounted notional amounts up to 150% of such Regulated Fund's net assets without the need to perform other tests. However, if the aggregate discounted notional amounts exceed 150% of a Regulated Fund's net assets (up to a maximum of 300% of net assets), to establish a limit focused specifically on the risk of loss attributable to any leveraging effect of such derivatives, Vanguard recommends that the SEC require Regulated Funds to also perform a risk assessment using VaR methodology to ensure the absolute risk of the overall portfolio does not exceed 20% of net assets.

We have several reasons for strongly advocating for the application of an overall absolute VaR limit. First, the VaR risk methodology is a well-respected risk management tool, in wide use across the industry, and should be utilized by the SEC to best target risk especially if the SEC mandates a standardized approach to be applied by every Regulated Fund in calculating VaR.

³² Prudential Regulators' Final Margin Rule; CFTC Final Margin Rule.

Second, only through the use of an absolute VaR threshold can the SEC apply a true limit on the risk of loss for Regulated Funds. Third, the 20% absolute VaR limit is consistent with the UCITS approach and is already applied by fund complexes with UCITS funds.

Vanguard has significant reservations with respect to the concept of the relative VaR test outlined in the Proposed Rules. At its core, the SEC's relative VaR test is both too permissive at lower levels of derivatives usage in that unlimited levels of risk can arise while also being too restrictive at higher levels in that the overall impact of derivatives usage must be to reduce risk for the portfolio excluding derivatives. As noted previously, we are concerned this approach could serve to encourage some Regulated Funds to increase the use of risk-increasing derivatives significantly while overall usage would be kept under the lower threshold and thereby avoid the application of the relative-VaR test. Vanguard believes such a result which does not effectively limit actual risk while also constraining prudent, efficient and long-standing portfolio management techniques is inconsistent with the SEC objectives for Regulated Funds.

Setting the absolute risk of loss at 20% of a Regulated Fund's net assets is a much more effective limit on the potential leveraging effect of derivatives. Vanguard also believes such an approach to be reasonable as both a supplement to the complementary asset segregation and offset rules and in recognition of the many benefits of global Derivatives Reforms in creating a more transparent, protective and resilient derivatives' market.

For these reasons, Vanguard urges the SEC to consider an approach whereby Regulated Funds could use derivatives up to an aggregate discounted notional amount of 150% of a Regulated Fund's net assets, and could exceed the 150% limit (up to 300% of net assets) provided the absolute VaR of the overall portfolio does not exceed 20% of net assets. Such an approach is a much better means of targeting SEC concerns while avoiding harm to the market and to investors.

E. Other Clarifications with Respect to the Derivatives Usage Limit Proposal

i. Exclude Direct Hedging Transactions from Portfolio Limits

While specifically excluding all hedging practices from the limits may be impractical, we recommend that the SEC identify specific forms of hedging to exclude from any limits as there can be no leveraging effect. Such a hedging exclusion should include the following circumstances:

- (a) A currency derivative involving the currency in which a security held by the fund is denominated in a notional amount not exceeding the value of the security;
- (b) An interest rate swap involving the interest rate payable by a security held by the fund in a notional amount not exceeding the value of the security;
- (c) A written call option on securities in the fund's portfolio; and
- (d) A purchased single-name credit default swap involving a security and/or its issuer held by the fund in a notional amount not exceeding the value of the security.

ii. Exclude Financial Commitment Transactions from Portfolio Limits

Given the Proposed Rule requires financial commitment transactions to require asset segregation at the full amount of the financial commitment obligations, any potential leveraging use is effectively limited. For this reason, it would be inappropriate to include such fully-covered obligations in the calculations to assess specific derivatives limits.

iii. Permit Netting Across Different Instruments for Portfolio Limits

Netting allowances can be expanded beyond the one-for-one netting permitted in the Proposed Rule without sacrificing the SEC's objectives. Regulated Funds may find it more efficient and less costly to eliminate the economic exposure of their positions through the use of different instruments, or different notional amounts – especially in the context of dynamic hedging as described above. Offsetting positions in different instruments may be used to eliminate market risk and thereby Regulated Funds should be allowed to net such positions in the context of applying the derivatives usage thresholds. Netting should also be available for rolling spot and forward currency transactions used to hedge portfolio currency risk.

iv. Clarify Calculation of Notional Amounts for Cross-Currency Forwards

In determining the relevant notional amount assessment for the usage limits with respect to cross-currency forwards, the SEC should clarify the relevant amount is that applicable to the notional value of the U.S. dollar (or base currency) leg. The SEC should also clarify the preferred approach with respect to forwards where neither currency is denominated in U.S. dollars.

v. Require VaR to be Reported as a Percentage of Assets

To avoid unintended confusion, we ask the SEC to require that the calculation of VaR to be represented as a percentage of assets rather than as a U.S. dollar amount.

vi. Permit Regulated Funds to Compute Portfolio Limit Tests Once Each Business Day

Rather than require Regulated Funds to conduct the testing, including any VaR calculations, immediately prior to entering into each senior securities transaction³³, Vanguard recommends the SEC confirm such calculations need only be performed once each business day. We likewise recommend the application of a reasonable grace period for the Regulated Fund to remedy a temporary breach of applicable limits of up to five (5) business days.

vii. Permit Regulated Funds that Exceed the Portfolio Limits to Acquire Additional Derivatives Which Reduce Notional Amounts

During the grace period for the Regulated Fund to remedy a temporary breach of the mandated limits, we recommend the SEC allow the Regulated Fund to enter into additional derivatives transactions which would reduce the Regulated Fund's overall risk even if the notional amount of such derivatives exceeds the mandated notional amount limits.

³³ See Proposed Rule 18f-4(a)(1).

viii. Permit Regulated Funds to Satisfy Either Limit Threshold At Any Time

Rather than require board approval of any change to the selection of the derivatives use threshold to be applied by the Regulated Fund, we propose such selection should be possible to be made in the discretion of the portfolio manager as permitted by the Regulated Fund's risk management program.

V. VANGUARD SUPPORTS THE REQUIREMENT FOR A DERIVATIVES RISK MANAGEMENT PROGRAM

As a practical matter, we believe that derivatives risk management programs are in place at most Regulated Fund companies that use derivatives in more than limited amounts (or that use complex derivatives) given the complexity of the instruments and the variety of risks that they can pose. It is simply not possible to manage a Regulated Fund that utilizes significant amounts of derivatives effectively without a substantial derivatives risk management program, although we believe programs vary widely throughout the industry.

We strongly support the SEC's objective to enhance the effectiveness of existing derivatives risk management programs, and we share the SEC's belief that such programs will provide additional shareholder protections. We agree that the Regulated Fund board should receive reporting from the designated risk manager. As proposed, the derivatives risk manager must prepare, and the board must review, a written report describing the adequacy of the Regulated Fund's program and the effectiveness of its implementation. This appears to be a comprehensive assessment of the overall derivatives risk management program. We believe there is value in this type of report because it will aid the board in its oversight function.

We believe, however, that this board report should only be required to be prepared on an annual rather than quarterly basis. We are concerned that the derivative risk manager will be required to spend an inordinate amount of time preparing quarterly deep dive board reports. In our view, the risk manager's time could be better spent handling the day-to-day administration of the risk management program.

In addition, boards receive voluminous amounts of required and non-required materials, which they need to review and analyze. We question the merit of requiring the board to review a comprehensive assessment of the derivatives risk management program each quarter. Given the boards' other responsibilities, this is a suboptimal use of their time, particularly in light of the proposed asset segregation and other requirements.

In sum, we believe our proposed annual reporting approach better aligns with how boards and derivatives risk managers should be spending their time and efforts without undermining the overall objective of the derivatives risk management program.³⁴ Of course, Regulated Funds and their boards may choose to adopt more frequent board reporting. We agree with the SEC that any significant compliance event should be brought to the board's attention on a prompt basis.

³⁴ We note that our proposed board reporting frequency is consistent with the SEC's existing compliance program reporting rules (*i.e.*, 1940 Act Rule 38a-1).

VI. THE SEC'S PROPOSED DERIVATIVES DISCLOSURE, REPORTING AND RECORDKEEPING REGIME IS COMPELLING WITH MODEST CHANGES

A. Regulated Funds Should Not Be Required to Report Data Derived from Subjective Analysis

The SEC has proposed that those Regulated Funds required to implement a written derivatives risk management program also be required to disclose, on Form N-PORT, the gamma and vega for options and warrants, including options on a derivative, such as swaptions.³⁵ Consistent with our prior comments on the Form N-PORT rule proposal,³⁶ we recommend that the SEC omit risk metrics (*i.e.*, gamma and vega) from Form N-PORT reporting. Instead, we recommend that the SEC use the raw data reported on Form N-PORT to perform its own calculation of risk metrics.

As noted in the Proposing Release, ascertaining the inputs required to calculate Regulated Fund gamma and vega involves a level of subjectivity.³⁷ This is because Regulated Funds may use different pricing sources, analytics, and other information to make risk metrics calculations. Input variability makes it more difficult to accurately compare a Regulated Fund's risk profile with the risk profile of a non-affiliated Regulated Fund. Stated differently, if each Regulated Fund performs its own risk calculations, the results may not enable the SEC to draw "apples-to-apples" Regulated Fund comparisons. If, however, Regulated Funds provide the SEC with the raw data via Form N-PORT and the SEC, in turn, performs its own risk metric calculations, the result should allow for improved comparability. We believe this approach will better enable the SEC to monitor for trends and analyze the impact of various market conditions on Regulated Funds, including how a Regulated Fund's risk profile will change as volatility and securities prices change.

To the extent that the SEC requires public reporting of gamma and vega, we believe such reporting should only apply to those Regulated Funds required to adopt a derivatives risk management program. Regulated Funds required to adopt such a program utilize derivatives in more than limited amounts. These Regulated Funds may already have the infrastructure in place to make the calculations in a cost-effective manner. This alternative approach strikes the right balance between imposing additional requirements on all Regulated Funds (even those that use derivatives in limited amounts) versus Regulated Funds that use derivatives in meaningful amounts.

B. Regulated Funds Should Disclose the Approach Used to Measure Derivatives Usage

As noted above, Proposed Rule 18f-4 requires Regulated Funds that engage in senior securities transactions to comply with one of two alternative portfolio limitations. We support the requirement that a Regulated Fund identify the portfolio limitation (as modified by our recommendations) which it relied on during the reporting period on Form N-CEN. This disclosure will provide useful backward looking information to the SEC and the public. We also

³⁵ Item C.11.c.viii of proposed Form N-PORT.

³⁶ Vanguard Comment Letter, *Investment Company Reporting Modernization and Amendments to Form ADV and Investment Advisers Act Rules* at 3 (Aug. 11, 2015) (File No. S7-08-15), available at <http://www.sec.gov/comments/s7-09-15/s70915-28.pdf>.

³⁷ Proposing Release at 80952.

support offering document disclosure of the portfolio limitation approach a Regulated Fund intends to use. This will give the SEC and public an additional tool to understand, at the time of Regulated Fund purchase, the level of senior securities usage the Regulated Fund intends to utilize while imposing a minimal additional burden on Regulated Funds.

C. Recordkeeping Requirements Should Be Based on End-of-Day Positions

In general, we support the recordkeeping requirements proposed by the SEC. We recommend, however, that Regulated Funds be required to maintain records confirming compliance with their applicable portfolio limitation as determined by the Regulated Fund at least once per day rather than immediately after execution of each senior securities trade.

As proposed, a Regulated Fund would be required to maintain a record, after each and every senior security trade, that reflects the Regulated Fund's aggregate exposure, the value of the Regulated Fund's net assets and, if applicable, the Regulated Fund's VaR calculations. We believe the maintenance of such records will be administratively burdensome, costly, and may be difficult to achieve from an operational perspective. We believe the SEC can sufficiently confirm compliance with portfolio limitation requirements if Regulated Funds were required to maintain an end-of-day record. We believe that this is a reasonable approach that will effectively ensure a record of compliance without causing an unnecessary recordkeeping burden for Regulated Funds.

VII. CONCLUSION

Vanguard supports the overall objectives of the Proposed Rule and is pleased to provide recommended improvements based on our deep understanding of the benefits of derivatives usage to investors, of the appropriate risks to target, and of the best means to target those risks. It is our belief that through implementing our proposed changes, the SEC can better achieve its objectives in limiting the risks associated with Regulated Funds' usage of derivatives while at the same time avoiding implications that would be harmful to the markets, harmful to investors and harmful to the SEC's overall goals.

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We appreciate the opportunity to comment on the SEC's Proposed Rule. If you have any questions about Vanguard's comments or would like any additional information, please contact William C. Thum, Principal, at (██████████), or Tara Buckley, Senior Counsel, at ██████████.

Sincerely,

/s/ Mortimer J Buckley
Managing Director
and Chief Investment Officer
Vanguard

/s/ John Hollyer
Principal and Head of Risk Management
and Strategy Analysis
Vanguard

cc: The Honorable Mary Jo White, Chair
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
David Grim, Director, Division of Investment Management