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Via Electronic Submission

April 23, 2020

Vanessa A. Countryman
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; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles (File No. S7-24-15)

Dear Ms. Countryman:

The Vanguard Group, Inc. (Vanguard)[1] welcomes the Securities and Exchange Commission's (Commission) re-proposal of rule 18f-4 under the Investment Company Act of 1940 (1940 Act), regarding the use of derivatives by registered investment companies.[2] Vanguard supports the Commission's objectives of addressing through rulemaking the investor protection purposes and concerns of Section 18 of the 1940 Act and providing an updated and more comprehensive regulatory approach to funds' use of derivatives. We appreciate the Commission's effort in reflecting industry comments in preparing the Proposal and support the Commission's expeditious adoption of the Proposal with minor modifications.

Proposed rule 18f-4 would impose new and significant obligations on the derivatives activities of regulated funds, including some of Vanguard's mutual funds and exchange-traded funds. Specifically, the Proposal would require regulated funds that engage in more than a limited amount of derivatives to adopt and implement a written derivatives risk management program and adhere to new leverage restrictions. The boards of regulated funds which exceed the threshold would be required to approve the designation of a new "derivatives risk manager," who would oversee the derivatives risk management

[1] Vanguard is one of the world's leading investment management companies, offering a diverse selection of low-cost investment products—including mutual funds and exchange-traded funds—advice and related services. As of March 31, 2020, we managed approximately $5.3 trillion in assets globally on behalf of more than 30 million investors. Our core purpose is to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success.

[2] *Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles*, 85 Fed. Reg. 4446 (January 24, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-01-24/pdf/2020-00040.pdf (Proposal).

program and provide written reports to the board on the program's implementation and functioning.

We generally believe these new requirements would impose appropriate constraints on the leveraging effect of funds' use of derivatives while also permitting funds to continue using derivatives as part of prudent portfolio management practices. The use of derivatives in fund portfolios benefits investors in numerous ways and helps them meet their most important financial goals. For example, derivatives play a fundamental role in funds' risk management and investing strategies by providing cost efficient and liquid means of hedging against foreign currency shifts, interest rate fluctuations, commodity price movements, and other market risks. Derivatives are also important cash management tools for portfolio managers and can provide cost-efficient access to certain investment products or markets. The Proposal would preserve these important benefits.

The Proposal's risk-based approach to regulating funds' derivatives activities is a prudent means of protecting investors, consistent with Section 18 of the 1940 Act. The Proposal also provides a more comprehensive approach to regulating funds' use of derivatives than the asset segregation framework prevailing under no-action letters and other guidance documents. We appreciate the many refinements that the Commission has made to the Proposal in response to comments from Vanguard and others.[3] For instance, by allowing the derivatives risk manager to construct the program and review its effectiveness and test results with the board, we believe the Proposal appropriately recognizes the critical oversight role of the fund board without hindering operational effectiveness. Overall, this program will allow the continued responsible use of derivatives by regulated funds and safeguard investor assets.

While we strongly support the Proposal and believe it is well tailored towards accomplishing the SEC's stated goals, we do have a few recommendations to enhance the Proposal as summarized below:

1. The two proposed exceptions for qualification as a limited derivatives user should be combined so that a fund is allowed to exclude currency derivatives used for hedging as defined in the Proposal before it calculates whether the notional amount of its derivatives usage beyond currency hedging exceeds ten percent of its net assets.

2. The Commission should permit a fund to qualify for the limited derivatives user exception even if its policies and procedures permit it to temporarily exceed the ten percent limit, provided such exceedance is remedied within seven calendar days.

[3] *See* Letter from Mortimer J. Buckley, Managing Director and Chief Investment Officer, Vanguard, and John Hollyer, Principal and Head of Risk Management and Strategy Analysis, Vanguard, to Brent J. Fields, Secretary, Commission, dated March 28, 2016, *available at* https://www.sec.gov/comments/s7-24-15/s72415-162.pdf.

3. The Commission should provide guidance for the currency hedging exception specifying that the definition of "negligible amount" of divergence between the hedge and the value of the hedged assets is at least plus or minus five percent.

4. The Commission should adopt a sixty-day implementation period to permit funds that can no longer rely on the limited derivatives user exception(s) to comply with proposed rule 18f-4's risk management regime requirements.

5. The Commission should amend Form N-PORT and rule 22e-4 to eliminate references to assets segregation.

6. The Commission should permit funds to elect to apply either the relative or absolute VaR test rather than defaulting funds to the relative VaR test.

7. The Commission should align the VaR-based limits of proposed rule 18f-4 with the limits in the European UCITS Guidelines.

8. The Commission should clarify that "Derivative Transactions" do not include municipal notes and when-issued Treasury securities and/or permit money market funds to rely on proposed rule 18f-4.

I. The Proposed Exceptions for Limited Derivatives Users Should Be Combined and Key Terms Should Be Clarified

We share the Commission's view that "[r]equiring funds that use derivatives only in a limited way to adopt a derivatives risk management program" that meets all specifications of proposed rule 18f-4 could result in fund shareholders "incur[ring] costs and bear[ing] compliance burdens that may be disproportionate to the resulting benefits." To address this concern, the Proposal provides two alternative exceptions to the requirement that funds implement a derivatives risk management program: (1) an exposure-based exception for any fund that limits its aggregate derivatives notional amount to ten percent or less of its net assets; and (2) a currency hedging exception for any fund that limits its use of derivatives transactions to currency derivatives for hedging purposes.[4]

We agree that excepting funds that are limited users of derivatives from the requirement to implement a derivatives risk management program would reduce unnecessary costs for fund shareholders while allowing limited derivatives use to hedge risks. We also generally agree with the parameters of the exceptions that the Commission proposed. However, as described in more detail below, we urge the Commission to combine the proposed limited derivatives user exceptions so that a fund that limits its aggregate derivatives notional amount to ten percent or less of its net assets, excluding any currency hedges, would qualify for the limited user exception. We also recommend that the

[4] Proposal at 4484.

Commission clarify three aspects of the limited derivatives user exceptions to provide greater certainty to the marketplace.

A. The Commission Should Offer A Single Exception That Excludes Currency Hedging Derivatives from the Calculation

We agree that the Commission should except funds that use derivatives in a limited manner from the risk management program requirement in proposed rule 18f-4. We also generally support the proposal to condition availability of the exceptions on the extent of derivatives use—calculated by notional amount—and the nature of that use—currency hedging. Based on our analysis of the funds we manage and our experience using derivatives in some of those funds, we generally believe that the proposed notional amount and currency hedging exceptions are pragmatic and workable.

We suggest, however, that the Commission combine these two conditions into a single exception, rather than separating them into alternative exceptions. Specifically, we recommend that a fund should qualify for the limited derivatives user exception if its aggregate derivatives notional amount (excluding currency derivatives used for hedging as defined in the proposed rule) does not exceed ten percent of its net assets.

As Congress, the Commission, and other regulators have recognized, currency derivatives are fundamentally different from other types of derivatives[5], so much so that the Proposal asserts that "using currency derivatives solely to hedge currency risk does not raise the policy concerns underlying Section 18" of the 1940 Act.[6] We agree with this view and believe that the use of these risk-mitigating instruments should not cause a fund to become subject to the derivatives risk management program requirements of proposed rule 18f-4 if that fund otherwise limits its aggregate derivatives notional amount to no more than ten percent of its net assets.

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[5] For example, in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Congress amended the Commodity Exchange Act to provide a comprehensive regulatory regime for swaps. Section 721 of the Dodd-Frank Act amends section 1a of the Commodity Exchange Act, which defines the term "swap" to include foreign exchange swaps and foreign exchange forwards, among other transactions. In a different provision of section 1a, Congress authorized the Secretary of the Treasury to make a written determination that foreign exchange swaps and foreign exchange forwards, or both should not be regulated as swaps under the Commodity Exchange Act. The Treasury Secretary exercised this authority in November 2012 and, in making the determination, found that these currency derivatives contracts have salient differences—including risk profiles—from other types of derivatives contracts. *See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act*, 77 Fed. Reg. 69694, 69695 (November 20, 2012), *available at* https://www.govinfo.gov/content/pkg/FR-2012-11-20/pdf/2012-28319.pdf ("Unlike most other swaps, foreign exchange swaps and forwards have fixed payment obligations, are settled by the exchange of actual currency, and are predominantly short-term instruments…For the vast majority of foreign exchange swap or forward contracts, the risk profile is centered on settlement risk). *See also id.* at 69696 ("Foreign exchange swaps and forwards are particular types of transactions that are *qualitatively different from other classes of derivatives* covered under the definition of "swap" in the [Commodity Exchange Act]. The distinctive structural characteristics of foreign exchange swaps and forwards…merit different regulatory treatment…") (emphasis supplied).

[6] Proposal at 4488.

By way of example, one of Vanguard's largest global fixed income funds is designed to provide broad exposure to non-U.S. investment-grade bonds. This fund employs currency derivatives for hedging purposes while also investing approximately one percent of its NAV through the use of futures contracts. The fund uses futures contacts to equitize cash holdings which are used to cover the operational costs of managing the portfolio. Through the use of futures contracts, while the fund retains cash, it is able to more closely track its reference index and to deliver the expected returns to its investors. Under the Proposal, this fund, which employs derivatives nearly exclusively to hedge currency risk for investors, would be forced to employ a full derivatives risk management program as it also uses futures positions in an aggregate amount equal to approximately one percent of its net assets. The funds' shareholders would be forced to incur all of the costs of establishing a full risk management program, despite the negligible derivatives risk present in the portfolio. We do not believe this result is consistent with the investor protection purposes underlying Section 18 of the 1940 Act, which chiefly focus on ensuring that funds do not employ excessive leverage or hold inadequate assets and reserves.[7]

The Commission's analysis of the proposed limited derivatives user exceptions supports our position that a single exception would be appropriate. The Commission has preliminarily determined that funds that limit their aggregate derivatives notional amount to ten percent or less of their portfolio are limited derivatives users. We agree. A fund that limits its aggregate derivatives notional amount to ten percent or less of its total portfolio should not be considered excessively leveraged for purposes of Section 18 of the 1940 Act and should be excepted from the derivatives risk management requirement of proposed rule 18f-4. We also concur with the Commission's analysis that "currency hedges are not intended to leverage the fund's portfolio, and conversely could mitigate potential losses."[8] Essentially, this analysis finds that adding currency hedges to a portfolio with a limited amount of other derivatives use would not increase the leverage of the portfolio and could, in fact, reduce its risk.

Based on our experience with our funds, we do not agree with the Commission's concern that combining exceptions "may raise risks that…should be managed through a derivatives management program and subject to the proposed VaR-based limited on fund leverage risk." The purpose of using foreign exchange derivatives for currency hedging is to reduce the unintended currency risk in the unhedged portfolio, making the hedged portfolio less impacted by swings in the currency markets. The existence of the currency-hedging derivatives in the portfolio will have little impact on the risk contribution of the other non-currency-hedging derivatives to the risk of the hedged portfolio. Currency hedging is a means of mitigating portfolio risks and would not introduce additional risk.

Put simply, we see no reason for a fund with little potential to use derivatives for leverage (*i.e.*, one that limits its aggregate derivatives notional amount to less than ten percent of its portfolio) to lose access to the limited derivatives user exception merely because it

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[7] *See id.* at 4450.

[8] *Id.*

also takes steps to *reduce* the currency risk of its portfolio.[9] Such funds and their shareholders should not be forced to assume the costs associated with developing, implementing, and maintaining a derivatives risk management program. Such costs are unnecessary as the Commission has determined that limiting the aggregate derivatives notional amount to ten percent of net assets appropriately limits the risks and potential adverse impacts of these funds' derivatives.[10]

B. The Commission Should Clarify the Application of the Limited Derivatives User Exceptions

We believe that the Commission would improve the workability of the proposed exceptions for limited derivatives users by clarifying three key aspects of their terms. Specifically, we recommend that the Commission address exceedances and remediation in the context of the exception for funds that limit their aggregate derivatives notional amount to ten percent or less of their net assets. We further suggest that the Commission provide guidance on the meaning of "negligible amount" to clarify the acceptable exceedance for purposes of the exception for currency hedging. Finally, we recommend that the Commission allow funds that can no longer rely on the limited derivatives user exception sixty calendar days to implement their derivatives risk management program and come into compliance with the VaR-based limits on fund leverage risk.

1. The Commission Should Provide a Seven-Day Cure Period for Funds that Rely on the Ten Percent Limited Derivatives User Test

The Commission requests comment on whether the exception for funds that limit their aggregate derivatives notional amount to ten percent or less of their net assets should address exceedances and remediation. We believe it should and suggest that the Commission adopt a cure period that would permit a fund to use the exception provided that the fund's policies and procedures permit it to cure a temporary exceedance within seven calendar days.

A seven calendar day cure period would closely align the proposed exception with the test that a fund must use to determine if a position (including a derivatives position) is illiquid under rule 22e-4(a)(8) of the 1940 Act. Funds may enter into derivatives with varied liquidity profiles. Often, funds will negotiate these contracts to include early termination provisions that ensure a fund can liquidate a derivatives position and receive proceeds within seven calendar days. These provisions serve an important liquidity risk management purpose that protects investors. Providing a seven calendar day cure period for an exceedance of the ten percent limited derivatives user threshold would enable funds to rely on proven, cost-effective liquidity-enhancing mechanisms to reduce their derivatives exposure. This would benefit fund investors by reducing costs and mitigating

[9] The fund would take these steps consistent with disclosure in its prospectus and the expectations of its shareholders.

[10] *See* Proposal at 4484.

the potential for a fund to need to liquidate a derivatives contract on disadvantageous terms or risk losing the limited derivatives user exception.

2. The Commission Should Define "Negligible Amount" For Purposes of the Currency Hedging Exception

The Proposal requires that the notional amounts of currency derivatives cannot exceed the value of hedged assets denominated in a specific currency by more than a "negligible amount". The Commission requests comment on whether it should provide guidance on what a "negligible amount" would be in this context. We request the Commission provide guidance specifying that the definition of "negligible amount" means at least plus or minus five percent of the value of the hedged assets.

We base our recommendation on an analysis of the operational costs associated with effective hedging. Specifically, we analyzed our foreign exchange hedging methodology in early 2019 and found that when allowing a plus or minus five percent daily tolerance when tracking the S&P 500 over a given period, the annual transaction cost dropped from twelve bps to three bps. In other words, adjusting a hedge to account for daily price fluctuations in an underlying asset costs approximately four times as much as adjusting the hedge only when its value exceeds a specified tolerance threshold. We believe, therefore, that permitting a currency hedge to exceed the value of the underlying instrument would enable funds to provide more cost effective hedging benefits to investors.

In addition, the notional value of currency hedges held by index funds might sometimes exceed the value of hedged assets due to operation of index rules. For example, the methodology of certain fixed income indexes establishes the size of a hedge with reference to the market value of portfolio holdings as of each rebalancing period (typically the first day of a calendar month). Although the value of the holdings change during the month, index rules call for the hedge to remain at its first-day size until the next rebalancing.

To illustrate how this works in practice, assume that a theoretical index fund holds foreign bonds with a market value of $100,000,000 on March 1. The rules of the index stipulate that foreign bond exposures should be hedged and that all hedges should be implemented based on the market value of the bonds as of the first of each month. Under these rules, the fund's portfolio manager would establish a $100,000,000 notional currency hedge on March 1. If the bonds decrease in value during March so that they are worth only $96,000,000 on March 31, the notional value of the hedge would exceed the market value of the bonds by $4,000,000 (approximately 4 percent). As the example demonstrates, index rules and price moves within a portfolio can cause the notional value of a hedge to exceed the value of the hedged assets denominated in foreign currency.

We urge the Commission not to interpret "negligible amount" so strictly that index funds could face the untenable choice of: (1) losing the ability to rely on the limited derivatives user exceptions; or (2) reducing hedging to maintain the exception and, in doing so,

accepting tracking error and significant costs. We analyzed three years of data for one of our index mutual funds that holds a significant amount of foreign bonds and determined that defining "negligible amount" as at least plus or minus five percent of the hedged assets would provide an adequate tolerance to ensure that index methodology-related hedging exceedances would not cause the fund to lose access to the limited derivatives user exception.

3. The Commission Should Adopt a Sixty Calendar Day Implementation Period to Permit Funds that Can No Longer Rely on the Limited Derivatives User Exceptions to Comply with Proposed Rule 18f-4

When considering the specific time period for actions associated with implementing a derivatives risk management program and compliance with the VaR-based limits on fund leverage risk, we feel that the implementation time frame should be sixty calendar days. This would give the manager time to complete operational set up for the new program as well as allow for the board to select a derivatives risk manager and other logistics required by the new program.[11]

One of the most time-consuming requirements of the program concerns the requirement that the fund board approve the designation of the fund's derivatives risk manager. We support the board's role in establishing and maintaining a derivatives risk management program for funds. We believe, however, that the board's oversight role would require the board to meet to approve the designation of the derivatives risk management program and to take other steps required to establish the program. A sixty calendar day implementation time period would provide adequate time to identify a derivatives risk manager and organize his or her appointment.

Moreover, depending on the time of year a fund may need to adopt a derivatives risk management program, additional time-consuming steps might need to be taken. For example, there are certain disclosure obligations that would require amendments to a fund's prospectus if the program were adopted near year-end. Funds also would need to update their N-PORT and N-CEN forms and set up operational and technological programs to comply with the stress testing standards or any other risk-management measures that a derivatives risk manager may employ. In sum, there will be multiple items to consider for each fund that implements a new program, and the Commission should provide funds with at least sixty calendar days to complete implementation.

[11] The Commission may wish to consider whether the time period for adopting a derivatives risk management program should be different for institutions which already have a derivatives risk management program in place and institutions that will have to start a new program from scratch. Regardless, due to the logistical hurdles necessary to set up a new program for any fund we believe we will need 60 calendar days to implement a program even if we have an existing program for other funds.

4. The Commission Should Amend Form N-PORT and Rule 22e-4 to Eliminate References to Asset Segregation.

We agree with the Commission's assessment that the proposed requirements for a derivatives risk management program, including VaR and stress testing, would appropriately address the asset sufficiency concerns underlying Section 18 with respect to derivatives use. We do not believe asset segregation requirements are necessary on top of the comprehensive measures included in the derivatives risk management program. Accordingly, we believe the Commission should revise Form N-PORT and rule 22e-4 to eliminate references to asset segregation with respect to derivatives use.

Form N-PORT requires a fund to disclose the percentages of its highly liquid investments that is has segregated to cover or pledge to satisfy margin requirements in connection with illiquid, less liquid, and/or moderately liquid derivatives transactions. However, the proposed rule would eliminate the Commission and staff guidance requiring funds to segregate liquid assets for these transactions.

The Commission did not propose corresponding amendments to either rule 22e-4 or Form N-PORT to remove the references to the assets a fund segregates to cover its derivatives transactions. We therefore recommend that the Commission amend rule 22e-4, Form N-PORT, and any related guidance provided thereunder to eliminate references to assets segregated to cover its derivatives transactions in order to ensure consistency with the proposal.

II. The Commission Should Adopt Modified VaR Tests that Align More Closely with the VaR-Based Leverage Limitations for European UCITS Funds

The Proposal generally would require funds that do not qualify for the limited derivatives user exemptions to comply with a VaR-based limit on their derivatives exposures. The applicable limit would be based on a relative VaR test that compares the fund's VaR to the VaR of a "designated reference index" chosen by the fund's derivatives risk manager. If the derivatives risk manager is unable to identify an appropriate designated reference index, the Proposal would require the fund to comply with an absolute VaR test.[12]

We support the proposed use of VaR to measure the exposure created by a funds' derivatives positions. Fund managers have for years managed portfolio risk against internal risk tolerance limits using VaR-based metrics, among other tools. Fund managers also typically compare a fund's VaR with the VaR of the fund's target benchmark. In other words, the proposed relative and absolute VaR tests build on established derivatives risk management practices that asset managers employ today, consistent with Section 18 of the 1940 Act.

Other regulators also employ VaR-based tests to constrain the derivatives exposures of the regulated funds under their jurisdiction. For example, European guidelines for UCITS

[12] *See* Proposal at 4469.

funds permit a fund to use either an absolute or a relative VaR approach to calculate and limit UCITS fund leverage.[13] The absolute VaR approach limits the maximum VaR that a UCITS fund can have relative to its net assets, and as a general matter, the absolute VaR is limited to twenty percent of the UCITS fund's net assets. Under the relative VaR approach, the VaR of the portfolio cannot be greater than twice the VaR of an unleveraged reference portfolio.[14] The guidelines, which were adopted nearly ten years ago,[15] have a demonstrated track record of appropriately limiting leverage and protecting investors.

The VaR-based methodology permitted under the European UCITS fund guidelines has worked well, and we recommend that the Commission align the relative and absolute VaR tests in proposed rule 18f-4 more closely with the European standard. The Commission has recognized, in various contexts, the many benefits associated with minimizing differences among regulatory regimes.[16] According to the Commission, harmonization ensures a level playing field among market participants and protects against market fragmentation and the negative consequences of inconsistent or duplicative rules.[17] The same rationale applies to derivatives limitations for regulated funds.

We encourage the Commission to make two modifications to the VaR-based tests of proposed rule 18f-4 to promote greater consistency with the European UCITS fund guidelines. First, rather than defaulting funds to the relative VaR test, the Commission should permit all funds to comply with either the relative or absolute VaR test. Second, the limits of the proposed VaR tests should be aligned with the limits applicable to UCITS funds.

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[13] *See Use of Derivatives by Registered Investment Companies and Business Development Companies* (2015 Proposal), 80 Fed. Reg. 80883, 80977 (December 28, 2015), *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-28/pdf/2015-31704.pdf (describing the European Union's approach to regulating leverage in UCITS funds).

[14] *See id.*

[15] *See* European Securities and Markets Authority (formerly Committee of European Securities Regulators), *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*, CESR/ 10–788 (July 28, 2010), *available at* https://www.esma.europa.eu/sites/default/files/library/2015/11/10_788.pdf.

[16] For example, the Commission aligned final rules related to capital requirements for security-based swap dealers with rules promulgated by other domestic regulators and recommendations made by IOSCO/BCBS. *See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers,* 84 Fed. Reg. 43872 (August 22, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-08-22/pdf/2019-13609.pdf. The Commission also applied the concept of substituted compliance in its application of Dodd-Frank Act derivatives regulation, which recognizes the comparability of foreign regulatory regimes in achieving investor protection objectives similar to the Exchange Act. *See Cross-Border Application of Certain Security-Based Swap Requirements*, 85 Fed. Reg. 6270 (February 4, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-02-04/pdf/2019-27760.pdf (Cross-Border Rule).

[17] *See* Cross-Border Rule at 6272.

A. The Proposal Should Permit Funds to Comply with Either the Relative or Absolute VaR Test

The Proposal determines that both the relative and absolute VaR tests would appropriately constrain leverage in regulated funds.[18] According to the Proposal, the two tests are intended to "provide approximately comparable treatment" to each other,[19] and the Division of Economic and Risk Analysis (DERA) provided a comparability analysis supporting this finding. Despite this comparability analysis, the Proposal would require funds to use the relative VaR test if their derivatives risk manager can identify a designated reference index.

We respectfully urge the Commission to reconsider this approach. In our view, DERA's comparability analysis demonstrates that the existence (or not) of a designated reference index is irrelevant to the amount of leverage a fund can assume through derivatives. DERA's analysis and the Commission's findings also seem at odds with the Commission's assertion that permitting funds to choose between the relative and absolute VaR tests "may be inconsistent with investors' expectations where a designated reference index is available."[20] The Commission provides no data or analysis supporting this contention and does not address why investors would expect a fund to use one test over another if the results are comparable.

We also encourage the Commission to consider the increased risks and costs that regulated funds would face if the Commission imposes the relative VaR test as a default even though it is comparable to the absolute VaR test. By favoring the relative VaR test, the Proposal raises the possibility that the SEC or its staff could disagree with the derivatives' risk manager's choice of a designated reference index or determination that no such index exists.[20] This could subject a fund and its manager to reputational and other risks and impose unnecessary costs on fund shareholders. The Commission could address these concerns by permitting funds to use either the relative or absolute VaR tests regardless of whether a fund has a "designated reference index" and requiring the derivatives risk manager to document which test she or he chooses and the reasons for making the choice.

B. The Commission Should Align the VaR-Based Limits of Proposed Rule 18f-4 with the Limits in the European UCITS Guidelines

We also recommend that the Commission align the limits of the relative and absolute VaR tests with those in the European UCITS guidelines. The European UCITS

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[18] *See* Proposal at 4471 (stating that the relative VaR test "resembles the way that section 18 [of the 1940 Act] limits a fund's leverage risk) and 4475 (noting that the absolute VaR test would "often approximate the level of risk that investors may understand, and frequently choose to undertake, through investments in funds").

[19] *See* Proposal at 4475 (finding that the absolute VaR test is intended to "provide approximately comparable treatment" to the relative VaR test).

[20] *See* Proposal at 4471.

framework has been in place for years and asset managers have implemented processes to comply with these tests. Funds and their shareholders would benefit greatly from the efficiencies that could be realized by leveraging these processes any applying them in the U.S. context.

III. The Commission Should Clarify That "Derivative Transactions" Do Not Include Municipal Notes and When-Issued U.S. Treasury Securities and/or Permit Money Market Funds to Rely on Proposed Rule 18f-4.

The Proposal would place limitations on the ability of money market funds to satisfy their investment mandate while maintaining a stable net asset value per share or minimizing principal volatility. These limitations arise from the uncertainty that would accompany the proposed repeal of Release 10666[21] and the proposed exclusion of money market funds from proposed rule 18f-4.

Although money market funds do not enter into derivatives, money market funds, like other open-end mutual funds, have long relied on Release 10666 to purchase securities that could be characterized as "firm commitment agreements," provided these securities are permitted under rule 2a-7 under the 1940 Act. "Firm commitment agreements" are included in the definition of "derivatives transactions" under proposed rule 18f-4[22] and are generally defined as a "buy order for delayed delivery in which an investment company agrees to purchase a [security] at a future date, stated price, and fixed yield."[23] Firm commitment agreements may include forward-settling securities with non-standard or delayed settlement cycles,[24] when-issued securities,[25] or any other "evidence of indebtedness" described in Release 10666 which would be otherwise unavailable to an open-end mutual fund by virtue of the prohibition against issuing senior securities under Section 18 of the 1940 Act.[26]

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[21] *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 Fed. Reg. 25128 (Apr. 27, 1979)] (Release 10666).

[22] While the definition does not explicitly include "firm commitment agreements," the proposal explains that the phrase "any similar instrument" includes these types of agreements. *See* Proposal at 4456 (explaining that a "firm commitment agreement has the same economic characteristics as a forward contract").

[23] *See* Release 10666 at 25130 (internal footnotes omitted).

[24] *See id.* at 25130 & n.10-11 (distinguishing a "delayed delivery" addressed under Release 10666 to an ordinary purchase of securities where the selling party and its agent require only "a delay of a few days between the purchase of the security, and clearance and settlement" for the purpose of preparing customary closing deliverables and other pre-settlement matters.)

[25] *See* Proposal at 4455 (suggesting that "when-issued" securities are "derivatives transactions" without regard to their actual trading characteristics or potential for leverage). *See infra* Section III.B.

[26] *See id.* at 4450-51 ("The Commission concluded [in Release 10666] that . . . firm commitment agreements . . . fall within the "functional meaning of the term 'evidence of indebtedness' for purposes of Section 18 of the [1940 Act]." . . . while section 18 would generally prohibit open-end funds' use of . . . firm commitment agreements . . . the Commission nonetheless permitted funds to use these and similar arrangements subject to the constraints that Release 10666 describes.")

If the Commission repeals Release 10666 as contemplated in the Proposal without introducing new authority under which open-end mutual funds can purchase these types of securities, portfolio managers may decline to purchase these securities due to concerns of unintentionally violating Section 18 of the 1940 Act. Proposed rule 18f-4 addresses this concern with respect to most open-end mutual funds, but not with respect to money market funds, which are excluded from the proposed rule.[27]

The purchase by money market funds of (1) municipal notes with delayed or non-standard settlement cycles, and (2) when-issued U.S. Treasury securities, is permitted under rule 2a-7 and is not inconsistent with maintaining a stable net asset value per share or minimizing principal volatility. However, the Proposal may nevertheless have a chilling effect where money market funds decline to invest in these securities due to concerns of unintentionally violating Section 18 of the 1940 Act. Money market funds rely heavily on these investments, and an ambiguous regulatory framework which has the potential to prohibit such investments can harm investors and markets without conferring additional protections to money market fund shareholders.

We respectfully request that the Commission avoid this result, which we believe is unintentional, by (1) providing guidance that the definition of "derivatives transaction" does not encompass municipal notes with delayed or non-standard settlement cycles or transactions in when-issued U.S. Treasury securities; and/or (2) revising proposed rule 18f-4 to clarify that money market funds may continue to invest in "derivatives transactions" that are permissible under rule 2a-7. Money market funds should not, however, be required to comply with the other conditions under the proposed rule 18f-4, as money market fund shareholders are already sufficiently protected under the stringent risk-limiting conditions of rule 2a-7.

A. Municipal Notes With Delayed or Non-Standard Settlement Cycles Should Not Be Considered "Derivatives Transactions"

Municipal bonds play a critical role in the capital markets by providing state and local governments with low-cost financing for infrastructure, education, and other public development projects. Municipal notes[28] are a significant source of rule 2a-7-eligible investments for tax-exempt money market funds, which collectively owned in excess of $130 billion as of 2019.[29]

Municipal bonds are exempt securities[30] under federal securities laws and are typically characterized by prolonged settlement cycles with significant variation: our survey of

[27] *Id.* at 4455.

[28] Municipal notes are short-term municipal bonds typically maturing in 365 days or less.

[29] *Financial Accounts of the United States – Z.1*, L.212 Municipal Securities, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Dec. 12, 2019), *available at* https://www.federalreserve.gov/releases/z1/20191212/z1.pdf.

[30] 15 U.S.C. § 78c(a)(29).

primary offerings of municipal notes during 2019 found settlement cycles ranging from 1 to 43 days after pricing, with an average delay of approximately 13 days and a median delay of approximately 14 days. This is permitted under an exemption which specifically excludes municipal bonds from federal regulations pertaining to standardized settlement cycles.[31] As such, the municipal bond market can be described as wholly lacking a "standard" settlement cycle, which may suggest that *all* municipal bond settlements are non-standard.

As noted above,[32] the Commission has previously stated that securities settling under a delayed or non-standard settlement cycle may be considered a "firm commitment agreement" of the type captured under the definition of "derivatives transactions" in the proposed rule 18f-4. A literal interpretation of this language could be viewed as including municipal notes with non-standard or delayed settlement cycles, and be perceived as prohibiting such investments by money market funds. We believe the Commission does not intend this result as such an interpretation would be inconsistent with the objectives of proposed rule 18f-4.

Municipal notes with delayed or non-standard settlement cycles are not derivatives and do not trigger the leverage concerns raised by the Commission.[33] Municipal notes do not share economic characteristics of a forward contract[34] and are not purchased for the purpose of speculation or leveraging to magnify gains and losses.[35] Further, municipal notes do not implicate margin rules which assume the extension of credit when a customer purchases a security from or through a broker-dealer but defers payment beyond the standard settlement cycle. In these deferred payment scenarios, an extension of credit is deemed to occur because the customer immediately realizes the consequences of their position at the time of execution.[36] That is not the case when a customer purchases a municipal note. Purchasing a municipal note does not involve the exchange of cash or securities until the moment of final settlement, at which point securities are delivered against payment therefor in a manner consistent with most other non-derivatives bond transactions.

We therefore ask that the Commission reconsider the effect of proposed rule 18f-4 in repealing Release 10666 without clarifying whether money market funds may continue to

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[31] 17 C.F.R. § 240.15c6-1.

[32] *See supra* notes 24-26 and accompanying discussion.

[33] *See id.* at 4448 (noting the proposal's intent of limiting fund leverage risk); *see also id.* at 4449 ("A common characteristic of most derivatives is that they involve leverage or the potential for leverage").

[34] *Id.* at 4456 & n.91.

[35] *See id.* at 4449 ("Many fund derivatives transactions . . . involve leverage or the potential for leverage because they enable the fund to magnify its gains and losses compared to the fund's investment").

[36] *See* Regulation T, 12 C.F.R. Part 200.8(b) ("*Delivery against payment.* If a creditor purchases for or sells to a customer a security in a delivery against payment transaction, the creditor shall have up to 35 calendar days to obtain payment if delivery of the security is delayed due to the mechanics of the transaction and is not related to the customer's willingness or ability to pay.").

invest in "derivatives transactions" that are permissible under rule 2a-7, including securities with delayed or non-standard settlement cycles. Absent such a reconsideration, portfolio managers and their legal counsel will face uncertainty when deciding whether these securities will later be judged to constitute senior securities under Section 18. The consequential effect from such regulatory uncertainty may result in money market funds declining to purchase municipal notes, depriving the fund of a critical source of 2a-7-eligible investments and removing a significant class of investor from the municipal bond market.

B. When-Issued U.S. Treasury Securities Also Should Not Be Considered "Derivatives Transactions"

When-issued U.S. Treasury securities provide an essential source of investment returns and liquidity for taxable money market funds, particularly government money market funds, which are required to invest 99.5% or more of their total assets in cash, U.S. government securities, and/or repurchase agreements fully collateralized by cash and U.S. government securities.[37] The Commission has previously acknowledged that there is nothing inherently inconsistent with these investments for money market funds in light of their objectives, nor has the Commission suggested that these investments are inconsistent with rule 2a-7.[38]

The primary distinguishing feature of when-issued U.S. Treasury securities is the process by which they are sold. Typically announced every Thursday, when-issued U.S. Treasury securities are sold at auction on the following Monday under a standard "T+3" settlement cycle. However, money market funds may purchase U.S. Treasury securities on a when-issued basis after the auction announcement but before the actual auction. The benefit to money market funds is realized during this period of price discovery prior to the auction. If money market funds cannot purchase U.S. Treasury securities on a when-issued basis, they could be forced to do so at a later time, whether in the auctions or in secondary-market transactions, on potentially less economically advantageous terms.

Additionally, money market funds commonly purchase when-issued U.S. Treasury securities to match maturity rollovers, with each new purchase marked against a current holding scheduled to mature the same day. If money market funds cannot access the when-issued U.S. Treasury market prior to auction, it increases the risk of insufficient supply remaining to satisfy the money market funds' needs, potentially forcing the funds to purchase additional U.S. Treasury securities on the secondary market at increased cost and diminishing returns to investors.

Otherwise, when-issued U.S. Treasury securities are functionally equivalent to any other debt security issued in the primary market and do not share the typical characteristics of

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[37] Rule 2a-7(a)(14).

[38] *See* Revisions to Rules Regulating Money Market Funds, 56 Fed. Reg. 8113, 8120 (Feb. 27, 1991) (extending the maximum allowable maturity for an investment from 12 months to thirteen months to accommodate securities purchased by money market funds on a when-issued basis).

"firm commitment agreements"[39] captured under the definition of "derivatives transactions" in proposed rule 18f-4. Like most other debt securities, including municipal notes, the material terms of when-issued U.S. Treasury securities (including price, yield, CUSIP and final settlement) are fixed at the time of sale. No leverage is employed with these instruments, and there is also no future commitment tending to evidence indebtedness, as purchasing a when-issued U.S. Treasury security at auction is not a future commitment to purchase a security: it is a *present* purchase of a security that will settle in a consistent and standardized settlement cycle.

We encourage the SEC to prevent any potential adverse effect by issuing guidance that the definition of "derivatives transaction" does not include municipal notes with delayed or non-standard settlement cycles or when-issued U.S. Treasury securities, and/or amending proposed rule 18f-4 to clarify that money market funds may continue to invest in "derivatives transactions" to the extent permissible under rule 2a-7. We respectfully suggest that the Commission narrowly draft any amendments to proposed rule 18f-4 so that the rule would not require money market funds to comply with the other conditions of the rule, because the stringent risk-limiting conditions of rule 2a-7 already provide sufficient protection to money market fund shareholders. Requiring money market funds to comply with other conditions in proposed rule 18f-4 would impose costs while conferring no benefits on these funds' shareholders.

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[39] *See* Release 10666 at 25130 & n.10 (including when-issued securities in the definition of firm commitment agreements).

Vanguard appreciates the opportunity to comment on the Proposal and encourages the Commission to finalize rule 18f-4, subject to the modifications described above, in the near future. If you have any questions or would like to discuss our views further, please contact George Gilbert, Senior Counsel, at [redacted] or [redacted] or Matthew Klein, Senior Counsel, at [redacted] or [redacted]

Sincerely,

/s/ Joseph Brennan

Joseph Brennan
Managing Director and Chief Risk Officer
The Vanguard Group, Inc.

/s/ Gregory Davis

Gregory Davis
Managing Director and Chief Investment Officer
The Vanguard Group, Inc.