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Re: CFTC: Comment Letter on the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (RIN 3038-AC97)
OCC: Comment Letter on the Margin and Capital Requirements for Covered Swap Entities [Docket ID: OCC–2011–0008]
Board: Comment Letter on the Margin and Capital Requirements for Covered Swap Entities [Docket ID: R-1415] (RIN 7100 AD74)
FDIC: Comment Letter on the Margin and Capital Requirements for Covered Swap Entities [Docket ID: RIN 3064-AE21]
FCA: Comment Letter on the Margin and Capital Requirements for Covered Swap Entities
FHFA: Comment Letter on the Margin and Capital Requirements for Covered Swap Entities [Docket ID: RIN 2590-AA45]

Dear Ladies and Gentlemen,

Vanguard[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") and the U.S. prudential regulators (the "**Prudential Regulators**", together with the CFTC, the "**U.S. Regulators**") with our views on the most recent proposed rules regarding uncleared swap margin requirements (respectively, the

[1] Vanguard offers more than 170 U.S. mutual funds with total assets of more than $3 trillion. We serve approximately 9 million shareholder accounts.

"CFTC Proposal"[2] and the **"Prudential Regulators' Proposal"**[3] and, collectively, the **"U.S. Proposals"**).

Vanguard is fully supportive of the mandate of the derivatives title (**"Title VII"**) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **"Dodd-Frank Act"**) to bring much-needed transparency and regulation to the derivatives markets including subjecting derivatives to regulatory oversight, requiring the clearing of standardized swaps, and requiring standard margin practices for uncleared swaps.

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

We commend the U.S. Regulators in large part for having significantly revised their earlier proposals both to reflect comments received as well as to come into closer harmony with the recommendations in the guidance published in the international framework on margin rules released by the Basel Commission on Banking Supervision (the **"Basel Commission"**) and the Board of the International Organization of Securities Commissions (**"IOSCO"**) (together with the Basel Commission, **"BCBS/IOSCO"**) in September 2013 (the **"BCBS/IOSCO Framework"**). In particular we agree with the move by the U.S. Regulators to a fully bilateral margin regime which both reflects long-standing market practice and provides the strongest safeguards to mitigate credit risk for all participants.

Our comments in this letter emphasize the need for strict global harmonization on margin rules as the best means to advance risk mitigation while at the same time avoiding market fragmentation. We will also raise several points to advocate for a more appropriate global approach than was recommended in the BCBS/IOSCO Framework and U.S. Proposals. Our recommendations spring from our conviction that the decades-long market standard margin practices served the industry very well during the global financial crisis and it was several prominent outliers from such practices that contributed to the disruptions. Rather than introducing revolutionary change, we believe the U.S. Regulators should aim to hew more closely to existing market practice in codifying the best practices to support the industry.

Vanguard's comments on the U.S. Proposals can be summarized as follows:

- **Eligible collateral for variation margin must be expanded to include a broad range of assets in addition to cash:**
    - Cash-only variation margin is inconsistent with market practice.
    - Cash-only variation margin will raise costs and negatively impact performance.
    - The calculation method for variation margin must reflect mid-market replacement costs.

[2] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59,898 (Oct. 3, 2014).

[3] Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57,348 (Sep. 24, 2014).

- **The initial margin thresholds must be significantly revised:**
  - The material swaps exposure ("**MSE**") threshold should be harmonized with the BCBS/IOSCO Framework.
  - Aggregating swaps activity across immaterial affiliates to assess implementation phasing, the MSE threshold and the initial margin threshold is neither workable nor appropriate, especially for managed funds.
  - Application of the MSE threshold to managed funds must be limited to managed "sleeves" of assets and must not cross managers.
  - If position aggregation is to be required, it should comport with the approach to aggregation used to address other Title VII concepts such as for the determination of major swap participant ("MSP") status
- **Eligible collateral for initial margin must be expanded.**
- **Initial margin risk-offsets must be expanded to cover assets subject to the same master netting agreement**
- **Rehypothecation of initial margin must be prohibited**
- **The liquidation horizon for calculating initial margin should be shortened**
- **Limitations on custodians for initial margin are impractical**
- **Margin transfer timing is too short.**
- **Implementation of new margin rules must be extended to allow adequate time to adjust practices.**
- **Counterparties should be able to agree which of their jurisdictions' approved margin requirements will apply to their trades.**

I. Current proposals must be informed by present practices and market experience:

Ahead of addressing the current proposals in greater detail, we believe it is important to set forth the foundational background on which we have built our position.

Most Vanguard mutual funds are registered under the Investment Company Act of 1940 (the "**1940 Act**") and are thereby regulated by the Securities and Exchange Commission ("**SEC**"). As swap dealers generally perceive the credit quality of SEC-registered mutual funds to be very high, the risk of their non-performance to be very low and the volume and complexity of their OTC swaps portfolios to be modest, swap dealers do not generally assess initial margin on OTC swaps traded with an SEC-registered mutual fund. Section 17(f) of the 1940 Act requires SEC-registered mutual funds to maintain their securities and other investments with qualified custodians under conditions designed to assure the safety of the fund's assets.[4] In the context of uncleared swaps, this results in collateral being segregated and held pursuant to tri-party collateral agreements.

In terms of margin for uncleared swaps, our position springs from the long-established, highly protective and largely market consistent regime historically applied to margin for over-the-counter swaps ("**OTC swaps**"). At present, and for many years, OTC swaps used by Vanguard funds are subject to the exchange of variation margin on a ***bilateral*** basis with net exposures calculated ***daily*** by both our dealer and ourselves, variation margin exchanged on a ***next-day*** basis, and a ***two-day grace period*** for any variation margin defaults (with all swap payments

[4] *See* 17 CFR § 270.17f-4.

stopping during such grace period). Variation margin is comprised of a range of assets to which appropriate haircuts are applied based on each asset's relative liquidity. Variation margin from both the dealer and the fund is ***held by the fund's custodian*** in accordance with a collateral control agreement.

When a counterparty to our OTC swaps defaulted during the global financial crisis, Vanguard funds immediately terminated the outstanding trades, calculated their replacement values, determined the net amount outstanding under the applicable master netting agreement and reached out to our custodian to liquidate the assets held as margin and apply the proceeds to the net amount owed by our defaulted counterparty. There was no long delay in calculating the replacement cost of our OTC swaps, nor to liquidating the assets held as margin, and the entire process, while unexpected and unwelcome, did not result in a significant loss for our funds. Replacement trades were quickly identified and executed to replace the hedging impacted by the counterparty default. This result was a testament to the robustness of margin practices developed and refined over decades in support of the OTC swaps market.

II. Eligible collateral for variation margin must be expanded to include a broad range of assets in addition to cash:

The BCBS/IOSCO Framework recommended that eligible collateral for variation margin should be both highly liquid and able to hold value in times of stress. Among the wide range of recommended forms of eligible collateral is cash, high-quality government and central bank securities, high-quality corporate bonds, high-quality covered bonds, equities in major stock indices and gold. The US Proposals limit eligible collateral for variation margin to only cash.

A shift to cash-only variation margin is completely inappropriate and unwarranted. The OTC swaps market has been functioning well for decades with the exchange of a broad range of eligible collateral, with haircuts applied to valuations to reflect relative liquidity. It is common for participants to negotiate the right to exchange specific assets held in managed portfolios as eligible collateral to avoid the need to engage in collateral transformation. If the U.S. margin rules only allow the transfer of cash, participants may be forced to consider migrating trading to jurisdictions with a broader range of eligible collateral to avoid the significant cost differential occasioned by the need to transform existing asset holdings to cash.

A. Cash-only variation margin is inconsistent with market practice:

We could not disagree more with the CFTC's statement that cash-only variation margin "is appropriate because it better reflects that counterparties to swap transactions generally view variation margin payments as the daily settlement of their exposure(s) to one another."[5] Not only is that view not borne out by the tax and accounting treatment afforded to margin pledged to secure swap obligations, but market standard documentation for swaps margin makes it clear that a transfer of margin involves no more than the granting of a security interest in favor of the secured party.

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[5] CFTC Proposal at 59,913.

The 1994 New York Law Credit Support Annex (the "**CSA**") published by the International Swaps and Derivatives Association ("**ISDA**") codified the long-standing market practice of transferring a broad range of eligible collateral subject to valuation haircuts to address the relative liquidity of the specific forms of collateral. The exchange of collateral under an ISDA CSA is specifically intended to provide security for non-performance and is not meant as the settlement of a payment obligation.

At paragraph 2 of the CSA each party grants the other a security interest in lien on and right of set-off against all collateral. Paragraph 8(a) of the CSA specifies that following a default, and unless the pledgor has paid in full all of its obligations, the secured party may liquidate the collateral and apply the proceeds to any unpaid obligations. Paragraph 8(d) of the CSA provides that when no amounts are payable, the secured party will return all collateral to the pledgor. These clauses make clear that the transferred assets are no more than collateral, are not paid in settlement of an obligation, and can only be accessed if a party fails to meet its obligations.

This long-standing approach, which is supported by a well-functioning infrastructure, has been extremely effective in addressing counterparty defaults. To the extent collateral other than cash is transferred, the haircuts applied to less liquid collateral effectively mean the secured party is always over-collateralized. The party transferring such collateral accepts the consequence of its overcollateralization as it remains the title holder of such assets and continues to reflect its ownership on its books and records and to receive distributions and other rights attendant to such ownership.

We also disagree with the CFTC's suggestion that moving to cash-only margin will sharply reduce the potential for margin disputes. While collateral disputes occur from time to time, they most commonly arise from discrepancies in portfolio recordkeeping (e.g., noting a recently terminated trade) rather than from differences in valuing positions or collateral. Indeed, when ISDA developed new dispute resolution procedures, the first step mandated by such procedures targeted the reconciliation of portfolios as that was well-known to be the basis for most disputes. Avoidance of disputes is therefore no justification for moving to cash-only variation margin.

In light of the robust, well-functioning and long-standing market practice, there is no reason to limit variation margin to cash and to do so will have serious negative consequences in terms of the cost to pledgers of collateral transformation in selling managed assets to raise cash margin.

B. Cash-only variation margin will raise costs, negatively impact performance, and raise custodian credit risk:

While the transfer of cash, U.S. Treasury securities and U.S. Agency securities as collateral supporting OTC swaps is most common, participants often negotiate the right to transfer a broader range of eligible collateral (and associated haircuts) so as to be able to transfer assets that comprise existing holdings. When such haircutted assets are transferred as collateral, they remain a part of the holdings of the pledgor which continues to receive all distributions and to benefit from all rights of ownership of the pledged asset.

Asse managers in particular seek the right to transfer fund holdings to avoid the need to liquidate assets and transfer the proceeds as collateral. By transferring fund holdings, the investment profile of the fund is not altered and the cost of collateral transformation is avoided. Index-tracking funds are loathe to hold assets outside of the fund's investment strategy as in so doing, the ability to track the target index is compromised and "tracking error" is incurred.

Limiting, if not eliminating, "tracking error" is viewed as one of the key indicators of fund performance for index-tracking funds. To mandate cash as the only form of eligible collateral will necessitate the liquidation of fund holdings to raise cash – and thereby raise the fund's "tracking error" to the benchmark index in a manner outside of the manager's discretion. Fund performance will suffer and shareholder returns will be directly compromised.

To the extent variation margin is held by a custodian (as is required for SEC-registered mutual funds under Section 17(f) of the 1940 Act), the transfer of cash raises custodian credit risk given the limited protections transfers of cash receive in the event of the custodian's demise.

We acknowledge recent industry developments to promote the use of a cash-only ISDA CSA which has primarily gained traction in the inter-bank swaps market. The intention is to take advantage of swap pricing benefits if parties agree to the exclusive transfer of cash which is more easily rehypothecated. For SEC-registered mutual funds, as rehypothecation is not permitted, moving to cash-only margin provides no benefits. As noted otherwise it also raises both costs and tracking error which makes it anathema in the context of fund management.

Given the long-standing robust performance of the collateral regime for OTC swaps, and its well-developed infrastructure to transfer, value and liquidate a broad range of eligible collateral, limiting such collateral to cash is meritless and will directly lead to increased costs and negative fund performance with no corresponding benefit.

C. The calculation method for variation margin must reflect mid-market replacement costs:

While the BCBS/IOSCO Framework notes initial margin should cover mark-to-market exposure, the CFTC focuses on the need for alternative fall-back trade valuation methods and the Prudential Regulators call for margin to cover the value of the OTC swaps portfolio to the covered swap entity.

Although robust valuation tools are critical, the target valuation for determining variation margin must be consistent with long-standing market practice: namely the mid-market price for replacement transactions. Especially as variation margin is not intended as a payment in settlement of an obligation, and margin is transferred back and forth between the parties as the value of the underlying trade shifts over time, the use of a mid-market valuation is the mos fair as neither party is significantly over-, or under-collateralized at any point.

The Prudential Regulator proposal is especially troubling as it raises a fundamental shift to calculating margin at the swap dealer's side of the market. If that was adopted, it would guarantee that the customer was always either over-collateralizing the dealer's exposure or being under-collateralized with respect to its exposure. This would constitute a significant over-all increase in risk to customers in the event of a swap dealer default, where they would be left as

either a general unsecured creditor with respect to excess variation margin transferred to the defaulted dealer or short of variation margin to cover amounts owed by the defaulted dealer.

It is for these reasons that we urge the U.S. Regulators to adopt a consistent calculation approach based on decades-long market practice whereby variation margin is determined at the mid-market amount that would be paid for replacement transactions.

III. The initial margin thresholds must be significantly revised:

We have supported the views of each of the Investment Company Institute ("**ICI**") and the Asset Management Group ("**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") that initial margin should be assessed based on the relative risk presented by a counterparty with highly-regulated entities such as SEC-registered mutual funds, ERISA plans, government pension plans and foreign pension funds exempt from the initial margin mandate due to the low risk (and low leverage) they present.

In lieu of such an exemption, we recognize the pragmatic approach recommended in the BCBS/IOSCO Framework whereby uncleared swaps usage below a series of fixed thresholds would be deemed to present insufficient risk to warrant the application of initial margin.

Notwithstanding the BCBS/IOSCO Framework, each of the U.S. Regulators has proposed a significantly lower fixed threshold together with an excessive exposure aggregation requirement that makes it much more likely initial margin will apply – even for market participants that enter into few, if any, swaps for which any margin requirements apply. This approach, while influenced by studies which themselves are suspect, will mandate initial margin requirements for participants and trades for which relatively little relevant risk is presented.

In so doing, the direct cost of margin, coupled with the attendant cost of a much more complex margin infrastructure, will raise the costs of hedging, and negatively impact investor returns with little attendant value. As a consequence, participants may seek to trade in jurisdictions where the more appropriate BCBS/IOSCO Framework is followed, thus negatively impacting U.S. participants and increasing market fragmentation.

A. The material swaps exposure ("MSE") threshold should be harmonized with the BCBS/IOSCO Framework:

The U.S. Proposals requiring initial margin from parties with average daily aggregate notional non-cleared OTC derivatives activity of USD 3 billion with a dealer or covered swap entity ("**CSE**") (and its 25% owned or controlled affiliates) present a significantly lower threshold from the approximately USD 11 billion MSE amount recommended by the BCBS/IOSCO Framework. Initial margin would be required at a USD 3 billion threshold when trading with a U.S.-regulated CSE but not until relevant trading reached USD 11 billion with an offshore CSE.

Having significantly diverging MSE exemption levels could reasonably lead participants to elect to trade in jurisdictions and with counterparties subject to the higher threshold. Such trade migration would negatively impact liquidity providers and participants in jurisdictions with unreasonably high thresholds. In the managed fund world, trade fragmentation is another likely

result as previously aggregated trading orders across commonly managed funds would be disaggregated where a sub-set of funds would seek to benefit from the most favorable margin regime available to relevant market participants – with simultaneous execution for best price sacrificed in the process.

The U.S. Proposals ignore the policy goals articulated by the BCBS/IOSCO Framework including: (a) exempting small-scale users of swaps from the burden of initial margin and (b) limiting the effects of the margin rules on the overall liquidity of collateral. Using the significantly lower MSE threshold, initial margin could be required for very small swap portfolios solely due to either or both of the position aggregation rules and the requirement to include foreign exchange (**"FX"**) deliverable forwards and swaps in assessing whether the applicable threshold is met. Moreover, the U.S. Proposals are based on studies which suggest using a US 11 billion MSE threshold for exemption will fail to capture parties with uncleared swaps portfolios presenting volatility risk in excess of the initial margin threshold of USD 65 million.

Given the complexities of the interaction of the rule proposals related to the inclusion of FX forwards and swaps, the aggregation of trading across affiliates, and the aggregation of trading across CSE counterparties, it is unclear whether a strict application of appropriate rules would generate a significant list of missed counterparties. Indeed, it is these very complexities which focus less on risk presented by participants and heir relevant trades, and more on whether artificial guardrails for such risks are met. The MSE test and the initial margin test are themselves apples and oranges as the MSE test looks at notional amounts including FX while the initial margin test looks only at the volatility of swaps for which initial margin could apply.

We disagree with each of the U.S. Proposals and BCBS/IOSCO Framework recommendations that include in the overall MSE test FX forwards and swaps, which are exempt from initial margin requirements and are also among the more commonly used forms of derivatives. To require participants that enter into significant volumes of FX hedging, but few marginable swaps, to establish compliance regimes and initial margin capabilities when they and their limited swaps usage present little risk cannot be justified from a cost-benefit analysis.

In proposing a threshold of less than half of that recommended by the BCBS/IOSCO Framework, especially when continuing to include deliverable FX forwards and swaps, the U.S. Proposals will require a far-greater number of participants to incur the costs associated with implementing all of the legal, operational and risk-management capabilities associated with an initial margin regime while they may never need to actually transfer initial margin.

While we support the BCBS/IOSCO Framework with an MSE threshold of USD 11 billion including FX trading, if FX was carved out of the test, it might be reasonable for the U.S. Regulators to consider a lower MSE threshold in a future rule re-proposal for notice and comment. For the purposes of these proposals however, we strongly disagree with the use of a much lower MSE threshold while still including FX forwards and swaps in the relevant calculations.

B. Aggregating swaps activity across immaterial affiliates to assess the compliance phase-in, the MSE threshold and the initial margin threshold is neither workable nor appropriate, especially for managed funds:

Although we are generally in favor of the BCBS/IOSCO Framework, we do not support the requirement for the aggregation of all trades across all affiliates, counterparties and counterparty's affiliates for various purposes including the phasing of implementation, the assessment of the MSE threshold and the assessment of the initial margin threshold. For both implementation phasing and the initial margin threshold, the BCBS/IOSCO Framework defers to the approach appropriate to each jurisdiction's market conditions, and appears to accept that a definition of affiliates requiring 51% ownership. The U.S. Proposals apply the "affiliate" test to the MSE determination in a manner which effectively serves to capture immaterial affiliates for which risk aggregation is at least inappropriate if not completely unworkable.

For the purpose of identifying relevant "affiliates" for inclusion, the U.S. Proposals define "control" as (i) ownership, control, or power to vote 25% or more of a class of voting securities of the company, directly or indirectly or acting through one or more other persons; (ii) ownership or control of 25% or more of the total equity of the company, directly or indirectly or acting through one or more other persons; or (iii) control in any manner of the election of a majority of the directors or trustees of the company.

The aggregation proposal is unreasonable, especially for financial end-users affiliated with multinational companies. It would require the development and implementation of global compliance tests to identify such affiliations and to consolidate and report all derivatives trading across all "affiliates" with each dealer and all of the dealer's "affiliates". Such efforts would be further complicated by the reality that different derivatives regulations are likely to apply to "affiliates" in each jurisdiction.

With respect to managed funds, the 25% "control" test could capture an investor which owns in excess of 25% of such fund – and extend to all other funds in which such investor owns at least a 25% interest. All trades of such funds and of those of the individual investor – which could extend to include trades of other companies, funds or pension plans in the event the investor is such an entity – would be required to be aggregated. Each fund – or its investment advisor – would be required to track not only its investors, but also the ownership percentages of its investors in all of their other investments.

Similarly, corporate sponsors of pension plans that engage in derivatives would be captured and could be required to aggregate derivatives trading with that of all pension plans of such sponsor globally. Notwithstanding that each plan has separate beneficiaries, assets and investment strategies, their derivatives usage would be required to be aggregated and reported for the purposes of the test. Likewise, advisors or sponsors that initially invest in or "seed" a fund could be captured – as well as all funds which such advisor or sponsor "seeds".

While the intent of both the BCBS/IOSCO Framework and the U.S. Regulators would appear to be to capture the overall risk presented by the default of a global financial enterprise, the reality is that by aggregating the positions of "affiliates", especially at the 25% "control" test level, an overly broad net is cast to capture trades involving entities with little or no credit connection. "Affiliates", especially at the 25% "control" level, are likely to present individual

and unique credit profiles and engage in different derivatives strategies for a variety of hedging and other needs that serve to raise little, if any, correlated risk. Not only is it inappropriate to look at trading so broadly, but to implement such a regime would require significant operational changes including the full sharing of confidential trading information across marginally-related entities. We do not believe such an effort would prove warranted following a full cost-benefit analysis.

Absent some contractual credit connection, such as a guarantee or other form of credit support, individual swap market participants stand on their own with a dealer having no recourse to any other party. While the U.S. Regulators suggest that the purpose for aggregation is to address the risk that trading could be split between affiliates to avoid the margin rules, the ultimate protection is that a swap dealer will not engage in swaps unless it has confidence its counterparty will perform. If such entity cannot stand on its own, the swap dealer will insist on a guarantee and it would not be unreasonable to capture positions across entities to which a shared recourse applies.

Particularly with respect to managed funds, Vanguard urges the CFTC to explicitly confirm that it agrees with the Prudential Regulators and the BCBS/IOSCO Framework[5] that multiple funds managed by a common manager that are legally segregated will be treated as separate and unaffiliated entities for the purposes of calculating each funds threshold for both the overall exemption test as well as for the initial margin threshold amount. For investment funds and vehicles, the rule for MSE and threshold should be ha these numbers are applied at each fund level as long as another entity is not collateralizing or guaranteeing the funds obligations.

We urge the U.S. Regulators to abandon the aggregation of positions for assessing implementation phase-in, the MSE test and the initial margin test.

C. Application of the MSE threshold to managed funds must be limited to managed "sleeves" of assets and must not cross other "sleeves" and/or other managers:

Separately managed accounts, or "investment sleeves" managed by different asset managers, are particularly inappropriate for the application of aggregation for the various tests related to initial margin. Such arrangements involve certain funds or institutional clients engaging an asset manager to manage separate pools of assets using unique investment strategies for unique investment results.

Notwithstanding that all such "sleeves" have the same beneficial owner, counterparty recourse is contractually limited to the assets under management with respect to the specific asset pool and does not extend beyond the "sleeve" to other "sleeves" or to the sponsor itself. Trades within "sleeves" are subject to individual master netting and collateralization agreements with credit assessments typically made based solely on the assets under management with respect to the specific "sleeve".

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[6] *See* footnote 10 to the BCBS/IOSCO Framework: 'Investment funds that are managed by an investment advisor are considered distinct entities that are treated separately when applying the threshold as long as the funds are distinct legal entities that are not collateralised by or are otherwise guaranteed or supported by other investment funds or the investment advisor in the event of fund insolvency or bankruptcy."

To require aggregation for the various initial margin tests would effectively require asset managers to aggregate swap exposures across multiple separately managed accounts, in some cases managed by other investment managers, despite not having any access to such information. The sharing of such information would also likely violate the managers' contractual or fiduciary obligations to the separate account sponsor.

For the foregoing reasons, attempting to consolidate these numbers across investment "sleeves" would be unworkable for market participants, would create severe operational challenges and could present asset managers with the conundrum of either violating their contractual or fiduciary obligations or violating the U.S. Regulators' requirements for calculating MSE for margin purposes.

D. If position aggregation is to be required, it should comport with the approach to aggregation used to address other Title VII concepts such as for the determination of major swap participant ("MSP") status:

While the aggregation requirement appears unworkable, if the U.S. Regulators are unwilling to abandon the concept, we urge them to adjust the definition of "affiliates" for these purposes to be more consistent with the definition of major swap participant ("MSP").[7] The aspects of the MSP test that are most appropriate for these purposes include:

- A "***majority of ownership***" (51%) definition for affiliates.
- Attribution of swap positions of a subsidiary or affiliate to a parent, other affiliate or guarantor for the MSP analysis ***only to the extent the counterparties would have recourse to that other entity in connection with the position, including through a guarantee.***
- ***Non-aggregation of separately managed accounts*** managed by asset managers or investment advisers.
- Aggregation of individual accounts of a beneficial owner ***only if the counterparty to the swap has recourse to the beneficial owner.***

Through leveraging the aggregation concepts in the MSP test, participants need not adopt new and divergent approaches addressing the same concept. If aggregation is to be required for the purposes of assessing initial margin, it is appropriate to address the issues in the same manner as already used to assess MSP status.

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[7] *See* 17 C.F.R. § 1.3(hhh)-(jjj) ("Major Swap Participant," "Category of swaps; major swap category;" "Substantial position"); 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), http://cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-10562a.pdf.

IV. Eligible collateral for initial margin must be expanded.

The U.S. Proposals are highly prescriptive with respect to the types of assets eligible for use as initial margin. This contrasts with the BCBS/IOSCO Framework which follows a more principles-based approach emphasizing liquidity and ability to hold value in periods of financial stress.

While we strongly prefer the principles-based approach, if the U.S. Regulators retain the concept of a list, such list should be expanded to also include interest in money market mutual funds and certificates of deposit.

These types of assets are especially useful in the case of initial margin being held by a custodian. In such situations, cash margin is exposed to custodian credit risk unless it is invested in securities. Money market mutual funds and certificates of deposit have historically been used for this purpose and we urge the U.S. Regulators to add these types of assets to the list of eligible collateral.

V. Initial margin risk-offsets must be expanded to cover assets subject to the same master netting agreement:

The U.S. Proposals and the BCBS/IOSCO Framework mandate initial margin risk offsets that are too narrow in scope and fail to recognize the full benefits of netting across asset types governed by a single master netting agreement.

The Prudential Regulators limit cross-asset netting due to a perceived weakness in the correlation of netting across unrelated asset categories over time. The CFTC appears to limit cross-asset risk offsets out of a desire to encourage participants to abandon uncleared trading.

We find neither of these justifications to be compelling. As to the Prudential Regulators' fears, initial margin is to be determined daily with CSEs able to adjust the netting benefit should market forces no longer support cross-asset risk offsets. Limitations on netting also ignores the decades-long benefit of cross-product netting under a master netting agreement as the best, and most recognized, means to reduce risk. It will also lead to significant burdens for market participants in terms of renegotiating long-standing contracts, developing new operational infrastructure based on limited netting rights, and committing ever greater levels of margin to collateralize previously offset risks.

Such costs and operational challenges must be considered as a part of the cost-benefit analysis and we believe whatever benefits may be perceived in limiting cross-asset class risk offsets cannot be justified.

VI. Rehypothecation of initial margin must be prohibited:

Vanguard strongly prefers the overall prohibition on the rehypothecation of initial margin in the U.S. Proposals and does not support the limited rehypothecation allowed by the BCBS/IOSCO Framework.

While variation margin represents the market value of trades and therefore can be netted against the obligation to pay market value, initial margin represents the volatility of the positions and thereby constitutes excess margin, unable to be offset in the event the secured party defaults.

To allow the rehypothecation of initial margin would serve to increase credit risk to the secured party and is therefore contrary to the intention of margin (e.g., the mitigation of credit risk).

VII. The liquidation horizon for calculating initial margin should be shortened:

The 10-day horizon mandated for the calculation of initial margin by both the U.S. Regulators and the BCBS/IOSCO Framework is overly excessive considering the length of time actually needed for market participants to liquidate a defaulted trade and determine its value. While the justification for such a long volatility horizon is that some illiquid swaps make take a long time to liquidate and replace, we believe the assessment of the need for an extended look-back horizon beyond a mandated minimum time-horizon should be at the discretion of the parties and not mandated by law.

We would be much more comfortable with a mandated minimum time-horizon of 5 days with parties charged with assessing a longer period when appropriate. To require initial margin to cover 10 days of volatility in all circumstances will serve to tie-up significant amounts of assets as margin with little to no added benefit. It would be far more sensible for parties to assess the risk parameters of each other and of each trade to determine the reasonable approach for each specific circumstance.

VIII. Limitations on custodians for initial margin are impractical:

Each of the U.S. Proposals and the BCBS/IOSCO Framework require initial margin to be held by a custodian that is an unaffiliated third party. The U.S. Proposals also require the custodian agreement to be enforceable in insolvency proceedings. While each of these requirements is well-intentioned, neither is workable.

Firstly, there are simply too few custodians and swap dealers to eliminate one or the other due to a custodian-related swap trading desk. Banks have long played multiple roles and the industry has long accepted that the swap trading desk may be in the same corporate entity as the custodian. In such cases, regular due diligence is performed to assess the correlated risk of one party playing two roles. In the event of a perceived weakening of such a joint dealer / custodian, parties can take action to novate trades o a new dealer or to identify a new custodian.

The ISDA CSA includes detailed provisions whereby parties can agree on a minimum credit rating and other requirements for a custodian to hold collateral. If such thresholds are breached, the secured party has 5 days after notice to identify and move collateral to a new custodian. Failure to comply is an event of default allowing the pledgor the right to terminate all outstanding agreements. Therefore, the market standard documentation provides adequate protection with respect to custodians, including those that also may enter into swaps.

Secondly, it will be expensive in the least, and overwhelmingly difficult to obtain a legal opinion confirming the enforceability of custodian agreement. We question whether such a

requirement would add any value – especially as most U.S. custodians operate under a well-understood legal regime. U.S. Regulators should clarify that legal opinions as to enforceability would not be required so long as market participants have a reasonable basis to conclude that such agreements are enforceable in an insolvency proceeding.

Of course in more complex situations (e.g., a custodian in an emerging jurisdiction with counterparties in other jurisdictions), parties may opt for confirmation of enforceability. But such an opinion should not be mandated by law and parties should be free to assess whether or not the issues merit legal vetting.

We also believe that the definition of "Eligible master netting agreement" should be clarified to confirm that it does not intend to override standard conditions precedent provisions in master netting agreements that permit a party to suspend ongoing performance in situations where an event of default or potential event of default has occurred and is continuing. For example, Section 2(a)(iii) of the ISDA Master Agreement ("**Section 2(a)(iii)**") provides that a non-defaulting party may suspend performance to a counterparty if such counterparty is defaulting. Of course, Section 2(a)(iii) does not serve to lessen or eliminate the value of a transaction to a defaulting party, it merely suspends ongoing payments and deliveries until the defaulting party either remedies its default or the agreement is terminated. We believe that the Prudential Regulators and the CFTC should clarify that the definition of "Eligible master netting agreement" is not intended to restrict conditions to ongoing payments and deliveries, such as Section 2(a)(iii).

IX. Margin transfer timing is too short:

While the BCBS/IOSCO Framework is vague with respect to timing, the Prudential Regulators require variation margin on T + 0 and the CFTC requires it on T + 1. There is consistency with respect to initial margin with the U.S. Regulators requiring it on T + 1.

These time lines neither compor with existing market practice, nor do they present a workable alternative.

For OTC swaps, value has historically been assessed as of the market close on the previous business day. The ISDA CSA has standard margin transfer timing provisions which provide tha if a demand for margin is made before a fixed deadline, margin must be transferred by the market close on the next business day. If the demand is made after the fixed deadline, margin need not be transferred until the market close on the second following business day.

To mandate a faster timeline for margin transfer would require a fundamental change in approach with operational capabilities to be significantly amended. Even with such changes to allow for margin on T + 1, there would appear to be no reason to move to T + 0, as most trades would have little to no market value on their trade date.

It is for this reason tha for parties and custodians in the same jurisdiction, we recommend that margin calls be made no later than T + 1 with margin transfer occurring on T + 2 unless the demand is made after the agreed time. In situations involving multiple time zones, T + 2 may present additional challenges and parties should be required to transfer margin as soon as reasonably practicable.

X. Implementation of new margin rules must be extended to allow adequate time to adjust practices:

The December 1, 2015 compliance date for the implementation of the new variation margin regime and the first phase of the initial margin rules is too early considering the long list of changes required. Such changes may include, but may not be limited to:

- negotiation of agreements for separation of initial margin and variation margin collateral flows;
- negotiation of third party custodial agreements and their inclusion as credit support documents;
- rethinking of netting sets covered by master agreements and existing cross product master netting agreements (including handling non-swap transactions);
- aggregating thresholds across affiliates and disclosure about methodologies;
- amendments to ISDA Master Agreements, Credit Support Annexes and similar agreements to include specific types of collateral allowed under the final rules, new minimum transfer amounts as allowed under the final rules, time zone issues associated with posting and collecting collateral and similar changes; and
- amending or adopting policies, procedures and systems and implementing training and education relating to the above operational issues.

We advocate a delay of 18 months following the publication of final rules to initiate the new regime to allow all participants adequate time to adjust.

XI. Counterparties should be able to agree which of their jurisdictions' approved margin requirements will apply to their trades:

Given the complexities involved in determining which rule set to apply in the case of parties operating from different jurisdictions, we support parties having the right to select a single rule-set to apply from among the potential rule sets applicable to the parties.

The need to successfully and consistently address cross-border issues is yet another reason that global rule sets must be fully harmonized. While in individual circumstances, one rule-set approach may be perceived as having merit over another, for the derivatives market to continue to flourish, and for the risk-mitigating benefits of regulatory reform to have the greatest impact, consistency in approach must be a primary objective.

In sum Vanguard enthusiastically endorses the margin proposals promulgated by each of the CFTC and Prudential Regulators – especially with respect to the move to bilateral margining and the limits on rehypothecation for initial margin. Other aspects of the proposals require rethinking to strengthen their effectiveness and limit adverse unintended consequences. Especially as the decades-long market-standard margin practices proved so effective during the global financial crisis, the U.S. regulators are well-advised to amend their proposals to reflect the market approach, and also to perform detailed cost / benefit assessments should they consider an alternative approach.

* * *

In closing, we thank the CFTC and the Prudential Regulators for the opportunity to comment on the proposals regarding margin for uncleared swaps and appreciate the consideration of Vanguard's views. If you have any questions about Vanguard's comments or would like additional information, please contact William Thum, Principal, at (610) 503-9823.

Sincerely,

/s/ Tim Buckley	/s/ John Hollyer
Managing Director and Chief Investment Officer Vanguard	Principal and Head of Risk Management and Strategy Analysis Vanguard

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