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September 30, 2011

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: RIN 3038-AD51 – Customer Clearing Documentation and Timing of Acceptance for Clearing

Dear Mr. Stawick,

Vanguard[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") with our views on the Notice of Proposed Rulemaking (the "**Proposed Rules**")[2] on the form of documentation between a client and a futures commission merchant ("**FCM**") that clears swaps[3] on behalf of the client, and the timing of acceptance or rejection of trades for clearing by derivatives clearing organizations ("**DCOs**") and clearing members with respect to the new regulatory regime enacted by the derivatives title ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

Vanguard is fully supportive of the mandate of Title VII to bring much-needed regulation to the derivatives markets including subjecting derivatives to regulatory oversight and requiring the clearing of standardized swaps. As a part of the prudent management of our mutual funds and other portfolios, we enter into over-the-counter swaps, and exchange-traded futures and options (collectively, "**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 agree with the Commission that the Proposed Rules shall serve to prohibit arrangements that would:

- disclose the identity of a client's executing party ("**Executing Party**"),
- limit the number of Executing Parties with which a client could trade,
- restrict the position a client could transact with an executing party (except for an overall position limit),

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[1] Vanguard is a Securities and Exchange Commission ("**SEC**") registered investment adviser with more than $1.4 trillion in assets under management. Vanguard offers more than 170 U.S. mutual funds and serves approximately 9 million shareholders.

[2] Commission Notice of Proposed Rulemaking on "Customer Clearing Documentation and Timing of Acceptance for Clearing," 76 Fed. Reg. 45730 (Aug. 1, 2011) (the "**Proposing Release**"), available at: http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-19365a.pdf.

[3] For the purposes of this comment letter, "swaps" (as defined at Section 1(a)(47) of the Commodity Exchange Act ("**CEA**")) and "security-based swaps" (as defined at Section 3(a)(68) of the Securities Exchange Act of 1934) shall be referred to collectively as "**swaps**".

- impair a client's execution on the best terms available, and
- prevent compliance with specified time frames for clearing.

Two fundamental objectives of the Dodd-Frank Act are significantly advanced by the Proposed Rules. Open-access to clearing by all market participants will facilitate both market transparency and market efficiencies as participants have ample liquidity to easily move in and out of positions and reduce counterparty risk. Mandates to avoid conflicts of interest are achieved with clear walls between clearing and trading activities involving FCMs and their affiliates.

In addition, and perhaps most importantly, for the vision of swaps clearing to be fully realized, it is critical that the process associated with clearing presents virtually no latency between the time a trade is executed and time it is accepted for clearing. Such latency raises the potential for market movement which could lead to unacceptable breakage risks for one or both of the parties to the trade. Vanguard fully supports the Commission's Proposed Rules as the best means to ensure full open access to clearing as well as the real-time clearing of trades, resulting in the elimination of counterparty credit risk related to market movements during the clearing approval process.

As an active participant in industry efforts to develop the infrastructure for a robust future state for swaps clearing, we share the Commission's concerns with a form of the Cleared Derivatives Execution Agreement recently published by the Futures Industry Association ("**FIA**") and the International Swaps and Derivatives Association ("**ISDA**") that includes as a party the clearing member to one or both of the trading parties (the "**Tri-party Agreement**"). While not specifically targeting the Tri-party Agreement, the Proposed Rules establish a principles-based approach which address concerns raised by the agreement and promotes the overall objectives of the Dodd-Frank Act.

The rationale for our support for the Proposed Rules can be summarized as follows:

- **The Tri-party Agreement is patterned on the swaps intermediation model and is inappropriate for use in swaps clearing.**

- **The Tri-party Agreement fails to recognize both existing and planned technologies to achieve real-time clearing approval.**

- **The Tri-party Agreement raises the potential for unwarranted and unacceptable control by the FCM over a client's open access to swaps clearing and actually serves to increase the risk of clearing approval latency it is intended to address.**

- **The Tri-party Agreement will introduce significant costs and delays to the time-line for swaps clearing implementation as parties are forced to execute a myriad of documents as a pre-condition to clearing and trading.**

I. The Tri-party Agreement is patterned on the swaps intermediation model and is inappropriate for use in swaps clearing.

As an active participant in the FIA / ISDA working group (the "**Working Group**") on clearing infrastructure, we have joined counterparts on both the buy and sell sides to advance the market's readiness for the implementation of the Dodd-Frank Act's regulatory reforms directed at swaps clearing

and trading. At the outset of the group's efforts, well in advance of the enactment of the Dodd-Frank Act, it was far from apparent which clearing and trading model would be adopted by the ultimate rules. When considering historical precedents, in addition to the bilateral voice execution model for swaps trading, the market had also developed an intermediation model ("**Swaps Intermediation**") where swaps were traded with the street to ultimately be transferred or "given-up" to a client's swaps prime broker ("**Swaps PB**").

Swaps Intermediation involves a Swaps PB effectively serving as an intermediary between its client and its client's trading partners (each, an "**Executing Party**") with the Swaps PB exposed to credit risk with respect to each of the parties to the trade. To address this risk, a tri-party execution or "give-up" agreement was used whereby the parties agreed terms for the Swaps PB to communicate the trade types and limits it was amenable to accept and for the client and Executing Party to establish remedies should a trade not be successfully "given up" to the Swaps PB. Key to the success of this trading approach was the Swaps PB's careful monitoring and communication of its clients' trading limits.

The Swaps Intermediation approach effectively served as a template for the Working Group's efforts, with the document drafters emphasizing the need for the dealer to carefully control the trade types and limits it was prepared to accept for clearing. On that basis the Tri-party Agreement was developed to both afford the dealer control over trading limits and to provide remedies should a trade not be accepted for clearing (due to the dealer's failure to honor its confirmed position limits, the client's breach of such position limits, or the Executing Party's failure to abide by the position limits imposed by its dealer). Remedies upon a failure to clear were viewed as especially important given the length of time required to confirm the acceptance for clearing following trade execution. Such delays raised the prospect for market movement and the likelihood of one party or the other suffering a loss should a trade need to be broken due to its failure to clear.

Following the enactment of the Dodd-Frank Act, and the identification of the futures clearing model as the mandated approach for derivatives clearing and trading, it became apparent that the FCM would not be playing an intermediation role in swaps clearing. Once a trade was executed, it did not need to be "given up" to the client's FCM, but rather it would be submitted through each of the client's FCM and Executing Party's FCM to the DCO for clearing approval. As the FCM would have no credit risk to the client's Executing Party it was plain that the only documentation required included a clearing agreement between an FCM and its client and, to address any potential latency in the clearing approval process, a bilateral execution agreement between the client and the Executing Party to provide remedies upon breakage for a non-cleared trade (the "**Bilateral Agreement**").

Notwithstanding that the futures clearing model required no contractual relationship between a client's FCM and the Executing Party, some members of the Working Group suggested the Tri-party Agreement should remain an option to allow the FCM to communicate trading limits to its client's Executing Parties. Armed with such information, it was argued that both parties would have a greater confidence that proposed trades would fall within limits and readily clear. While many Working Group members did not view this concern to be legitimate, the optional approach was adopted and both the Bilateral and Tri-party Agreements were published.

Thus, the Tri-party Agreement adopted from the Swaps Intermediation model is not consistent with the futures clearing model and, for the reason's set forth below, is not needed to achieve prompt clearing approval, and actually serves to raise the potential for heightened clearing approval latency as well as limited access to clearing.

II. The Tri-party Agreement fails to recognize both existing and planned technologies to achieve real-time clearing approval.

The contention that the Tri-party Agreement is the best means to communicate clearing limits is not borne out either by the methods used in existing cleared markets or those under development by DCOs and swap execution facilities ("**SEFs**") to achieve streamlined clearing approval. Two clearing approval methods in use today solve the problem of clearing approval latency and avoid the risk of market movement and resulting breakage associated with non-cleared trades.

In the energy swaps market, the Chicago Mercantile Exchange ("**CME**") developed the Clearport platform in 2002 to allow for immediate post-trade clearing assessment and approval. Upon submission of a trade for clearing, the DCO makes an immediate assessment as to whether the trade is of a type approved by the FCM as well as whether the trade fits within the limits established by the DCO for the FCM and by the FCM for the FCM's client. Approval or denial is immediately confirmed, thereby effectively eliminating the risk of market movement and breakage. We understand this model is being adopted by both the CME and the Intercontinental Exchange ("**ICE**") to address the exact same concern in the cleared swap market for trades executed off-exchange, through use of a request for quote system or by voice trading, or on a Designated Contract Market ("**DCM**") or SEF.

In addition, for trades executed through a central limit order book ("**CLOB**") on a DCM or SEF, pre-approval for clearing is presently provided in the CME Globex and ICE Energy models where a client trades through an FCM who effectively guarantees clearing to other participants on the trading platform.

Pre-trade, or immediate post-trade clearing approval processes eliminate the possibility for clearing approval latency as well as any related market movement leading to breakage risk. Only recently, following the drafting and publication of the Tri-party Agreement, has the Working Group met with each of the likely DCOs and SEFs involved in swaps clearing and trading. From such meetings, it is apparent that these platforms are actively working to implement the same fixes to eliminate clearing approval latency. With solutions already in existence and also in development across all platforms, there is no longer any reasonable argument that a Tri-party Agreement is necessary.

III. The Tri-party Agreement raises the potential for unwarranted and unacceptable control by the FCM over a client's open access to swaps clearing and actually serves to increase the risk of clearing approval latency it is intended to address.

In addition to the absence of any justification for the use of a Tri-party Agreement, it is also apparent that the Tri-party Agreement raises the potential for an FCM to limit the open access of its clients to the cleared swaps market.

Such limitations are both contrary to competitive open markets and specifically prohibited by the Dodd-Frank Act as noted above. If FCMs are permitted to require Tri-party Agreements, we perceive there to be real risk that an FCM would have the ability to control which (and how many) Executing Parties can be used, and could set low position limits and/or higher fees on trading with non-affiliated Execution Parties.

With respect to derivatives trading entered into by Vanguard on behalf its funds, provided trades are executed within our overall limits, we must have access to the best execution in terms of trade structure and pricing through reaching the broadest range of liquidity providers. An FCM's requirement

to either limit or delay execution of Tri-party Agreements with certain Executing Parties, or to assign lower position limits or higher pricing for trades executed with non-affiliates, means that best execution is likely to be impeded. Moreover, through so limiting the range of Executing Parties, FCMs could effectively serve to deny entry to the market by new liquidity providers which could constitute an unreasonable restraint of trade or material anti-competitive burden in contravention of the Dodd-Frank Act.

Even in the event the Tri-party Agreement is not used to limit access to Executing Parties, it necessarily reduces liquidity and increases the risk of latency in the approval process. Whereas existing market approaches allow for immediate post-trade approvals to be centralized within a DCO or pre-trade approvals to work on a CLOB, if the approvals controlled by each FCM relationship, there will be a fragmentation of limits as distributed to each Executing Party (and, perhaps, each SEF). While a large-sized trade may easily fit within the overall limit maintained by a DCO, there may be delays executing such trades if the individual limits allocated to each Executing Party are not large enough to accommodate a sizeable trade absent further checking with the FCM.

We are unaware of any specific clarification by FCMs of how the process would work for communicating limits to Executing Parties; particularly as such limits may also have to be divided among trades across a variety of products types and trading platforms. While under existing methods, DCOs have established robust connectivity to allow for the daily upsizing or downsizing of client limits, and even the use of a so-called "kill switch" whereby an FCM can immediately cut off clearing lines, it appears the FCMs contemplate fairly rudimentary means of communication not unlike those used within the context of Swaps Intermediation. Such approaches could not be completed in the immediate timeframe achieved within the Clearport model, and it is likely clearing approval latency could extend to hours or more and thereby introduce the risk of significant market movements.

Given the increased latency introduced by the Tri-party Agreement and the FCM control over specific limits for each Executing Party, it must be questioned whether Executing Parties will be motivated to remain in the market, let alone quote their best pricing. If Executing Parties are forced to limit their trading or raise their prices, the Tri-party Agreement could have a significant negative impact on trade liquidity.

IV. The Tri-party Agreement will introduce significant costs and delays to the time-line for swaps clearing implementation as parties are forced to execute a myriad of documents as a pre-condition to clearing and trading.

Recently, the Commission released a proposed implementation timeline for the reporting, clearing and trading of swaps.[4] Depending on counterparty type, mandates must be met between 90 and 270 days following final rulemaking under Title VII. Among other issues Vanguard takes with the proposed implementation timeline, there is the simple logistical roadblock associated with negotiating and executing the Tri-party Agreement across the range of clients, FCMs, and Executing Parties.

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[4] Commission Notice of Proposed Rulemaking on "Swap Transaction Compliance and Implementation Schedule: Clearing and Trade Execution Requirements under Section 2(h) of the CEA," 76 Fed. Reg. 58186 (Sept 20, 2011) (the "**Implementation Release**"), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-09-20/pdf/2011-24124.pdf.

For example, in any given year, Vanguard might enter into a dozen or so new trading agreements between a limited number of managed funds and their trading counterparties. To be able to clear swaps, each managed fund will have to (a) enter into new futures agreements (or upgrade existing futures agreements to cover cleared swaps) with each FCM, (b) sign a cleared swaps addendum for each such futures agreement, and (c) execute a Tri-party Agreement with each FCM and Executing Party. Assuming 200 managed funds each with 2 FCMs and 10 Executing Parties, a minimum of 4800 documents will need to be negotiated and executed within whatever period is mandated for implementation.

This process is so intensive partly because there is no market standard form of futures agreement and the agreements differ dealer to dealer and change from time to time. Contrast this with the bilateral swaps market where the parties globally can execute a single form of documentation protocol which would serve to amend the standard form of ISDA Master Agreement published by ISDA and signed by every protocol adherent. Even without the Tri-party Agreement, the documentation exercise will be daunting. It is yet to be seen if FCMs, with limited resources and negotiation bandwidth, will be able to execute new suites of documents with every client desirous of trading swaps in the cleared world. Absent such documentation, parties risk being shut out of the clearing and SEF trading – thereby raising the significant risk of diminished market liquidity.

For all of these reasons, we urge the Commissioners to support the Proposed Rule as written as the best means possible to achieve the overall objectives of Title VII: namely to open access to derivatives markets for all parties with robust clearing and trading methodologies designed to minimize market and credit risk and provide best execution and ample liquidity across products.

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We'd like to thank the Commission for the opportunity to comment on the form of documentation between a client and an FCM that clears on behalf of such client, and the timing of acceptance or rejection of trades for clearing by DCOs and FCMs under Title VII and appreciate the Commission's consideration of Vanguard's views. If you have any questions about Vanguard's comments or would like additional information, please contact William Thum, Principal, at (610) 503-9823 or Michael Drayo, Associate Counsel at (610) 669-4294.

Sincerely,

/s/ Gus Sauter

Managing Director
and Chief Investment Officer
Vanguard

/s/ John Hollyer

Principal and Head of Risk Management
and Strategy Analysis
Vanguard

cc: Commodity Futures Trading Commission
The Honorable Gary Gensler
The Honorable Michael Dunn
The Honorable Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott D. O'Malia