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May 14, 2012

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-AD08 – Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades

Dear Mr. Stawick,

Vanguard [1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**" or "**Commission**") with our views regarding the recently released further notice of proposed rulemaking and request for comments concerning the criteria for identifying separate swap categories and the approach for setting appropriate minimum block sizes with respect to such categories[2] (the "**Proposal**") 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 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.

As noted in our comment letter to the CFTC dated February 7, 2011[3] as well as in our comment letter to the SEC dated January 18, 2011[4], we believe that the goal of enhanced price

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[1] Vanguard is a Securities and Exchange Commission ("**SEC**") registered investment adviser with more than $1.5 trillion in assets under management. Vanguard offers more than 170 U.S. mutual funds and serves approximately 9 million shareholders.

[2] Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 77 Fed. Reg. 15,460 (proposed March 15, 2012) (amending 17 CFR Part 43).

[3] Letter from Gus Sauter and John Hollyer to David A. Stawick, Secretary, CFTC (February 7, 2011) (discussing Vanguard's views on the CFTC's proposed rules on Swap Data Recordkeeping and Reporting and Real-time Public Reporting of Swap Transaction Data), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27634.

transparency (to be realized through an exchange-trading mandate for swaps) must be balanced against the potential for a significant negative impact on market liquidity or pricing or both caused by the premature imposition of a fundamental paradigm shift in the trading practices for swaps. Particularly as the CFTC has rejected our proposed 24 hour delay in public reporting and has mandated an extremely tight 30 minute delay (dropping to 15 minutes in the second year), we feel it is imperative for there to be adequate time to collect and analyze relevant data to construct swap categories and appropriate block sizes that will allow for price transparency without sacrificing market liquidity.

For the reasons outlined below, Vanguard supports a phased implementation allowing time for data assessment, swap categorization and block size determinations to preserve liquid swap trading that is fundamental to financial markets and risk management:

- **While critical risk issues presented by the market events of 2008 are appropriately targeted by reforms addressing non-public reporting, margining, and central clearing; the more aspirational goal of enhanced competitiveness through price transparency must be tempered by the fundamental objective of preserving market liquidity.**

- **Given the extremely short time delay proposed for the public reporting of market-moving block trades, it is imperative to focus on the size and volume of trades in each swaps category that can be immediately publically reported without market-moving impact.**

- **Notwithstanding the CFTC's expanded list of swaps categories, a much more granularized approach is needed to recognize distinct liquidity pools in assessing appropriate block trade sizes for each category.**

- **The CFTC's uniform, and seemingly arbitrary block size formula must be rejected in favor of a much more nuanced approach focused on minimizing market impact, where the block size is tailored for each swaps category with the possibility for all trades in a particularly illiquid category to achieve block treatment.**

[4] Letter from Gus Sauter and John Hollyer to Elizabeth M. Murphy, Secretary, SEC (January 18, 2011) (discussing Vanguard's views on the SEC's proposed Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information), *available at:* http://www.sec.gov/comments/s7-34-10/s73410-22.pdf.

I. While non-public reporting, margining and central clearing address key risk areas, changes to trading practices and market transparency should be carefully implemented over time so as not to negatively impact liquidity.

Our view is based on our experience gained in addressing the risks presented during the market turmoil of 2008, our trading practices in executing large vanilla swaps and our reading of the Dodd-Frank Act.

Given restrictions mandated by the SEC on derivatives usage by registered funds, as well as our own prudent risk management practices, Vanguard funds' limited derivatives usage has benefitted from exposure netting and full collateralization, with such collateral held by a third party custodian in a segregated account. Full collateralization proved particularly effective during the 2008 market turmoil to mitigate potential losses in default scenarios.

Based on that experience, Vanguard has consistently supported market reforms including non-public reporting (to allow regulators to spot risk concentrations), margining (to cushion losses upon a counterparty default) and central clearing (to guarantee trade settlement and portability).

While rules encouraging more transparent trading practices may ultimately prove to enhance competitiveness and, thereby, liquidity, we strongly believe an abrupt change in trading practices could have the opposite effect.

Fund managers such as Vanguard generally engage in the most vanilla swaps for portfolio hedging as well as for more favorable cost and execution considerations. Trade sizes tend to be large and are typically executed with a trusted market-maker who then needs time to offset the large position by entering into a series of trades of a more liquid size. We are very concerned with the possible unintended negative impact on market liquidity likely to arise from rules focusing on both pre-trade transparency (where non-block trades may be mandated to request pricing from at least five market-makers) and post-trade transparency (where non-block trades must be immediately reported to the public).

As noted in comment letters consistently provided by both buy and sell-side market participants, the concerns are two-fold. Sending trading requests to a minimum of five market-makers effectively serves to tip the four who lose the bid that a large, illiquid trade is about to be executed. Mandating too short of a delay for public reporting of large, illiquid block trades, will not provide the winning market-maker with enough time to offload the position before the market is alerted to the imminent trading.

In either case, a "winner's curse" is likely to result in either higher pricing (to offset expected higher prices of subsequent trading) or lower liquidity (as market-makers become more reluctant to execute large, illiquid trades) or both. Higher prices and/or reduced liquidity will

have a direct impact on our investors who will ultimately bear the increased costs or inefficiencies incurred by splitting large trades into more liquid sizes.

In directing the CFTC to formulate an approach to achieve greater price transparency in the swaps market, Section 727 of the Dodd-Frank Act cautioned that delayed reporting for block trading "***take into account whether public disclosure will materially reduce market liquidity***."[5] Such a pronouncement serves to underline the importance of a robust cost-benefit analysis where the benefits of transparency must be assessed against the costs of reduced liquidity.

We do not believe the CFTC's current proposal adequately addresses the required balancing as we believe too limited a pool of data was assessed, and little, if any, attention was given to the respective liquidity levels across swaps categories.

II. Given the extremely limited delay for public reporting, it is imperative for the analysis to focus on the size and volume of trades in each swaps category that can be executed and immediately publically reported without moving the market.

We believe the Dodd-Frank Act's emphasis on the liquidity implications of block trade rules reflects the more aspirational goal of enhanced transparency as compared to the more risk mitigating focus of the rules relating to non-public reporting, margining and clearing. When assessing liquidity implications, the block trade approach needs to be considered in terms of two buckets of trading within specific swaps categories.

The first bucket relates to the size of trading that the market can digest moment-to-moment as trade details will be required to be reported in full immediately upon trade execution. The market can handle trade sizes within such levels without material pricing implications. Rather than set an arbitrary percentage of trading across all swaps categories, time and care must be given to assess the average trading over time and peg block sizes at that level.

The second bucket relates to the mandated 30 minute public reporting window. For this bucket, the market will need to separately assess the capacity for trading within any given 30 minute period. This assessed level is likely to be the outer limit of the size of a relevant block as it is the limit a market-maker will be able to transact within the 30 minute period. Larger trades are likely to be broken down into components within this upper size limit.

Using this approach, we expect the appropriate block thresholds to be considerably smaller than those produced using the CFTC's proposed formula. We also expect the upper size limit on block trading to be likewise reduced as the market performs its own assessment of relative liquidity over any given 30 minute period.

[5] 7 U.S.C. Section 2(a)(13)(E) (emphasis added).

We emphatically disagree with the comments in the Proposal that a more granular, nuanced approach to setting block sizes cannot be justified in terms of the costs of such an assessment. Firstly, as noted above, rather than focusing on the costs involved in determining appropriate block sizes, the actual cost to be considered is the impact on liquidity balanced against the benefits of price transparency. Secondly, given the extremely limited delay for public reporting already mandated by the CFTC, the downside risk of establishing too large of block sizes is accentuated. Given the relatively low volume of trading in the over-the-counter swaps markets (as compared to the futures markets), it is likely that relatively small block trade sizes will be required so as to avoid a material impact on liquidity.

In a recent study published by ISDA, the average daily trading volume for all interest rate derivatives is 6,800 trades, of which 2,500 are new price-forming trades. The most popular interest rate derivative, the U.S. Dollar ten-year swap, trades on average 200 times each day. In contrast, about 2 million Eurodollar futures contracts are traded every day at The CME Group. For the CDS market, ISDA's survey shows the average daily trading volume across CDS trading is 6,400, split between 4,100 single-name CDS and 2,300 index trades (of which 5 indices account for 60% of trading). This is in contrast to 685,000 trades entered daily on the London Stock Exchange's UK Equities Order Book.

Rather than simply applying an arbitrary fixed threshold to establish block sizes across all swaps categories, to fulfill the Dodd-Frank Act's mandate, a thorough assessment of the relative liquidity present in the market for swaps with similar characteristics must be performed.

III. Notwithstanding the CFTC's expanded list of swaps categories, a much more granularized approach is needed to recognize distinct liquidity pools in assessing appropriate block trade sizes for each category.

While we appreciate the greater granularity proposed by the CFTC in terms of swaps categories, we believe a much more nuanced approach is needed in recognition of relative liquidity levels across swaps markets.

To begin with, the tenor buckets must be much smaller. For interest rate swaps, buckets of 0 - 3 months, 3 - 6 months, 6 - 18 months, 1.5 – 3 years, 3 – 7 years, 7 – 12 years, 12 – 20 years, 20 – 30 years and 30 + years is preferable. For CDS, the 4 – 6 year bucket should be subdivided into 4 – 4.5 years 4.5 – 5 years, 5 – 5.5 years, and 5.5 – 6 years.

Additional characteristics that should be applied are as follows:

- **"On-the-run" vs. "off-the-run" CDS indices.** CDS indices trade with considerably different liquidity depending on whether the appropriate index series is current (or "on-the-run") or has been superseded with a new series (an "off-the-run" series). Notwithstanding similar tenors, liquidity will differ markedly depending on whether the series is on or off-the-run.

- **Optionality or other special characteristics in interest rate swaps.** Unique characteristics added to interest rate swaps will significantly impact liquidity. For that reason, we recommend that distinctions should be made between “plain vanilla,” “interest rate options”, and “other.”

- **Individual currency for interest rate swaps.** We believe currency to be a significant distinguishing characteristic and recommend that interest rate swaps (and foreign exchange swaps) should be divided into individual currency buckets. At minimum, the “super-major” category should be split between each category to reflect the actual relative liquidity.

- **Major floating rate indices for interest rate swaps.** Swaps on different floating rate indices exhibit different liquidity characteristics. For those currencies in which swaps are traded across several major floating rate indices, separate categories should also be assessed.

We likewise do not agree that block size treatment is irrelevant with respect to equity swaps as we perceive that liquidity levels differ depending particularly on the underlying equity index related to each swap. For this reason, we urge the CFTC to study the data collected on equity swaps trading and identify relative liquidity buckets depending on differing trade characteristics including the underlying equity index – consistent with the approach recommended for all other swaps.

As noted above, we disagree that the cost associated with assessing liquidity on a more granular level is excessive. Quite the contrary, we believe that the failure to establish swaps categories with similar liquidity profiles could have a significant impact on both pricing and liquidity levels for the relevant swaps.

IV. The CFTC’s uniform, and seemingly arbitrary block size formula must be rejected in favor of a much more nuanced approach focused on minimizing market impact, where the block size is tailored for each swaps category with the possibility for all trades in a particularly illiquid category to achieve block treatment.

As noted above, we appreciate the CFTC’s efforts to construct a more granular approach to assessing trade categories and to set a smaller size threshold in the block trade Proposal.

Nevertheless, it is clear that such an exercise cannot be performed on a fully-informed basis or with a high degree of certainty absent an adequate data source and time for assessment. To rush a highly prescriptive result based on limited data at best compromises the legitimacy of the exercise and, at worst, invites the type of material, negative liquidity impact which the Dodd-Frank Act sought to avoid.

As noted in our comment letter to the CFTC dated November 11, 2011,[6] we believe it prudent to adopt a phased implementation schedule where a lengthy period of non-public reporting serves to establish a robust data source to inform an appropriately nuanced approach to the trading mandate and block trading rules. In addition, rather than focusing on establishing an arbitrary uniform percentage of trading as a block size across swap categories, the assessment of data should instead highlight the average size and number of trades executed moment-to-moment during the testing period to identify the exact point at which trading will either be easily digestible by the market or will instead produce the prohibited material reduction in market liquidity.

Ahead of such an informed assessment, we urge the CFTC to consider applying block status to all trading for a one year period. Particularly as the market will still gravitate to smaller size trading in light of the overall 30 minute public reporting delay, applying block status to all trades for one year will ameliorate the likely liquidity impact of an ill-informed assessment of block sizes.

In lieu of adopting block treatment for all swaps in the first year, we urge consideration of establishing an initial very low threshold, using a 25% notional calculation methodology. Liquidity levels can then be assessed on a quarterly basis with the methodology tightened or loosened depending on gathered data. Furthermore, with respect to swap categories that trade fewer than 14 times per business day (at least once per 30 minutes on average), all trades should receive block treatment.

As noted above, we do not accept that the cost of such a detailed assessment is excessive, and, to the contrary, believe that in the absence of such a more thoughtful analysis costs will undoubtedly rise and liquidity will be reduced. Moreover, as liquidity levels may fluctuate greatly over time, we believe the assessment should be made on the basis of data recorded over a rolling three-month period for each swaps category. Given the potential critical impact on market liquidity, we likewise believe the CFTC should perform this analysis and make the results available instantly over its website.

Finally, rather than set the reporting cap for block trades at a different level than the block trade threshold, we believe it is essential that the cap match the threshold for each swaps category. To do otherwise would compromise the liquidity protections afforded by the nuanced assessment of block trade thresholds.

In sum, while we have been staunch supporters of the rulemaking related to non-public reporting, margining and clearing of swaps, and we have been highly engaged in market efforts to effectuate the new market paradigm, we have serious reservations about the potential impact

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[6] Letter from Gus Sauter and John Hollyer to David A. Stawick, Secretary, CFTC (November 4, 2011) (discussing Vanguard's views on the CFTC's proposed rules on Compliance and Implementation Schedules for Clearing, Trade Execution, Documentation and Margin), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=49935.

on cost and liquidity which could result from the premature roll-out of the rules related to pricing transparency. For these reasons, we press the CFTC to adopt a more measured, informed approach so that liquidity can be preserved and the market has time to adapt to appropriate reforms.

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We'd like to thank the Commission for the opportunity to comment on the proposed criteria for identifying swaps categories and for setting block trade sizes 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, Senior 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 Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott D. O'Malia
The Honorable Mark P. Wetjen