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July 13, 2020

Submitted electronically to
https://comments.cftc.gov

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

Re: Part 190 Bankruptcy Regulations (RIN 3038-AE67)

Dear Mr. Kirkpatrick:

Vanguard[1] appreciates the opportunity to provide our comments to the Commodity Futures Trading Commission (the "**Commission**") on its recent proposal (the "**Proposal**") to amend the bankruptcy regulations in Part 190 of Title 17 of the Code of Federal Regulations ("**Part 190**").[2] The Proposal seeks to modernize the existing insolvency procedures governing futures commission merchants ("**FCMs**"), while also distinguishing updated procedures for derivatives clearing organizations ("**DCOs**") – previously grouped together with procedures for FCMs as commodity brokers.

As a part of prudent management, Vanguard funds enter into derivatives contracts, including swaps and futures, to achieve a number of benefits for our investors, including hedging portfolio risk, lowering transaction costs, managing cash, and achieving more favorable execution compared with traditional investments. Vanguard has been fully supportive of global regulatory reform efforts that have served to bring more transparency, efficiency, and financial stability to the swaps market throughout the Commission's rulemaking process, including subjecting derivatives to regulatory oversight and requiring the reporting, margining, and central clearing of standardized swaps, and exchange-trading of the most liquid standardized swaps.

Given the global clearing mandate, and the consequent migration of the majority of Vanguard's derivatives from the former bilaterally traded model to the centrally cleared model, Vanguard has a significant interest in the overall resiliency of the cleared market, and in the insolvency rules applicable to FCMs and DCOs. Absent the ability to negotiate contractual protections with clearing houses, and lacking a clear window into CCP risk management practices, Vanguard looks to the Commission to complement the clearing mandate with an FCM and DCO insolvency regime that is highly protective of customer

[1] Vanguard is one of the world's leading investment management companies, offering a diverse selection of low-cost investment products, with aggregate assets of approximately $5 trillion.

[2] *Bankruptcy Regulations*, 85 Fed. Reg. 36000 (June 12, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-06-12/pdf/2020-08482.pdf ("Proposal").

interests, including the interests of Vanguard shareholders investing to buy a house, to pay for college, or to provide for a secure retirement.

While Vanguard supports the Commission's proposals regarding updating and clarifying the commodity broker insolvency process, there are several proposed amendments where Vanguard notes opportunities for the Commission to further strengthen customer protections. Vanguard is also supportive of the desire to address nuances particular to DCOs, to better provide a clear governing framework for what would happen in a DCO insolvency.

However, Vanguard is concerned with the manner by which the Proposal addresses the insolvency of the DCO. While Vanguard appreciates the Commission incorporating many of the fundamental constructs of the FCM insolvency process into that of the DCO provisions; Vanguard does not support the deference granted to DCO rulebooks which effectively allows individual DCO rules on wind-down and liquidation to override the proposed Part 190 rules. Absent clear and prescribed procedures that would govern the DCO liquidation, and a comprehensive review and revision of the DCOs' respective rules to be consistent with the Part 190 procedures, the Proposal's deference has the potential to sacrifice core customer protections.

Summary of Vanguard's Comments:

- **Support for Proposed Enhancements to Core Concepts.** Vanguard strongly supports the Proposal's refinements to certain aspects of the FCM and DCO insolvency procedures. Specifically:

    - *Prioritization of Public Customer Claims over those of Non-public Customers.* Customers that are unaffiliated with FCMs must have priority over those that are affiliated.
    - *Application of FCM Residual Interest to Customer Claims.* The trustee must apply the FCM's residual interest assets to pay customer claims, consistent with the mandate for FCMs to maintain sufficient residual interest buffers in segregated accounts.
    - *Protection of Customers from Fellow Customer Risk during FCM Liquidation Proceedings*. The trustee must credit customers for margin transferred at the trustee's request and liquidate customer accounts in deficit or with margin fails during FCM liquidation proceedings.
    - *Reinforcement of Equitable Treatment of Customers*. The Trustee must be prohibited from making margin payments that would exceed the customer's funded account balance or transfer a customer's transactions or property that would increase the exposure of other customers.
    - *Facilitation of Porting.* The trustee must allow the transferee FCM up to six months to complete new customer due diligence, and the documentation between the transferor FCM and customer will govern the new relationship pending execution of a new agreement.

- **Recommendations to Further Strengthen Customer Protection**: Vanguard calls on the Commission to incorporate additional protections for non-defaulting customers. Specifically:

    - *Limit Non-defaulting Customer Exposure to Defaulting Customers***.** Extend LSOC non-defaulting customer benefits presently applicable to derivatives to apply to futures, foreign futures, and options thereon.
    - *Enhance Porting.* Work with other regulators to minimize existing barriers to porting, including flexibility on both additional due diligence requirements and timing constraints, and allow partial transfers of customer positions, including those of separately managed accounts.
    - *Credit Customer for Gains Haircutting*. To the extent the DCO or trustee has haircut gains due to a non-defaulting customer, given the extreme negative consequences to the customer, such haircutting must be severely limited, be overseen by the resolution authority, and the customer must receive compensation superior to that of other creditors.
    - *Require Trustee to use "Best Efforts" to Protect Customers.* The Proposal's shift to "reasonable efforts" may provide useful flexibility, but cannot come at the sacrifice of the core goals of protecting customer interests.
    - *"Skin in the Game".* To align interests in risk-mitigation and to encourage customer confidence in the protections afforded upon a DCO's insolvency, the shareholders of publically-owned DCOs must not be insulated from the DCO's failure and must contribute funding to be applied to a DCO's default and insolvency.

- **Prohibit Broad Deference to DCO rules.** The Commission must prohibit the trustee from deferring to the wind down and liquidation procedures in the failed DCO's rulebook unless they fully conform to certain core customer protection principles. To enhance that likelihood, the Commission must significantly increase the governance and oversight associated with DCO risk management and rulebook revisions to ensure a robust consultative process and regulatory vetting; there should be no divergence between Part 190 rules and the DCO's rules that implement the Part 190 rules.

I. Background

Vanguard funds enter into derivatives contracts, including swaps and futures, to achieve a number of benefits for our investors, such as hedging portfolio risk, lowering transaction costs, managing cash, and achieving more favorable execution compared with traditional investments.

With mandatory clearing of such swaps and futures, Vanguard has no choice but to engage in the cleared ecosystem with its attendant risks related to margin security, variation margin gains haircutting and partial tear-ups. Moreover, clearing participants like Vanguard have limited transparency into the risk practices of our FCMs and DCOs to be able to make informed decisions as to who we clear through and where we clear. The existing DCO governance regime provides us with no meaningful voice in critical DCO risk management practices and new cleared product introductions – and we have seen DCOs unilaterally amend their rulebooks, introduce new cleared products, and make sudden shifts in initial margin requirements, each of which significantly increases the risk to the market generally and specifically to Vanguard investors.

As we experience such limited FCM and DCO transparency, have no meaningful role in DCO risk governance, and possess only a very limited ability to mitigate clearing risks contractually, we therefore rely heavily on the Commission to protect the interests of our investors in the mandated cleared market.

While in the bilateral space we are certainly exposed to insolvency risk from our counterparts, our mandated margin exchanges are held by third-party custodians completely isolated from counterparty insolvency or fellow-customer risk. Ideally, mandated central clearing should be at least as protective as bilateral trading.

II. Vanguard appreciates the Commission's commitment to existing core customer protection principles embedded in the FCM insolvency rules and extended to DCOs.

A. *Prioritization of Public Customer Claims over those of Non-public Customers.*[3]

Vanguard commends the Commission for reinforcing the core customer protection that public customers will have priority over all non-public claimants, including affiliates of the FCM or DCO.

We appreciate the Proposal's affirmation of this concept, and definition of a public customer as any customer of an FCM whose commodity account is subject to the Commission's segregation requirements and, for a DCO, a person whose account with the FCM is not classified as a proprietary account.

Likewise, for an FCM insolvency, we support the Proposal's clarification that protected "customer property" includes any cash, securities, and other assets that the FCM is required to set aside for the benefit of its customers, whether or not the FCM has segregated such assets.[4]

For a DCO insolvency, we also support the clarification that customer property other than FCM property is reserved to satisfy the net equity claims of an FCM on behalf of its public customers,[5] and the allocation of guarantee deposits and assessments first to customer property, and only then to FCM property if all of the public customer account classes are fully funded.[6] We are also pleased to see that any excess funds in any account class would first be allocated to customer property, and only then to FCM property if there are sufficient resources remaining to satisfy all claims on account of public customers.[7]

As noted above, public customers, such as Vanguard funds, are disadvantaged by the limited transparency and governance voice into FCM and DCO risk management and have no insight into the risks presented by other customers of the FCM. The Commission's prioritization of public customers ahead FCM and DCO affiliates, and clarification of additional assets prioritized for customer claims, demonstrates an advancement in core customer protections, for which Vanguard is supportive.

[3] Proposed §§ 190.09(a)(1)(ii)(G) and (L).
[4] Proposed § 190.09(a)(1)(ii)(G).
[5] *See* 17 C.F.R. §§190.08, 190.09.
[6] Proposed §§ 190.18(b)(1)(iii), (c)(1).
[7] Proposed § 190.18(c)(3).

B. *Application of FCM Residual Interest to Customer Claims.*[8]

Vanguard appreciates the clarification that an FCM's residual interest is to be applied to public customer claims.

The Proposal states that a trustee must apply residual interest provisions "in a manner appropriate in the context of their responsibility as bankruptcy trustee" and "in light of the existence of a surplus or deficit in customer property available to pay customer claims".

FCM residual interest is a valuable buffer to insulate FCM customers from the risk of delayed or failed margin transfers from other customers. As its purpose is to enhance core customer protections, we are pleased the Commission has confirmed that while fronted by FCMs, it must be used to support customers through an FCM insolvency.

C. *Protection of Customers from Fellow Customer Risk during FCM Liquidation Proceedings.*[9]

Vanguard is supportive of modifications which reduce the extent by which a non-defaulting customer must bear responsibilities for another customer's default.

We appreciate the Proposal's clarification that customers will recover any margin requested by the trustee post-petition, as any concerns as to the ability to fully recover margin would surely de-incentivize customers to post additional margin in critical times. This objective is furthered by the requirement for the trustee to fully credit the customer's funded balance for any margin payment made by a customer in response to trustee's margin call.

In addition, we support the Commission's requirement for the trustee to liquidate any customer account in deficit and to promptly liquidate any customer account when a customer fails to meet a margin call in a reasonable time or where any payment of margin from the account would result in an account deficit.

D. *Reinforcement of Equitable Treatment of Customers.*

We appreciate the Commission's efforts to address situations where the trustee could allow certain customers to avoid the core customer protection of *pro rata* treatment at the expense of other customers.

In particular, we support the Proposal's confirmation that the trustee is prohibited from making margin payments that would exceed the customer's funded account balance or transfer a customer's transactions or property that would increase the exposure of other customers.

Likewise, customers who post letters of credit ("**LCs**") should not thereby be able to avoid *pro rata* treatment due to limitations on drawdowns conditioned on the default of the customer. As such conditions might not be met by the insolvency of an FCM or DCO, we are pleased the Commission has empowered the trustee to demand substitute margin so that other customers' margin need not be accessed to meet any shortfall occasioned by the inability to draw on the LC.

[8] Proposed § 190.05(f)
[9] Proposed §§ 190.04(b)(3) and (4).

E. *Facilitation of Porting.*[10]

Porting has long been viewed as one of the most important tools in addressing an FCM failure and has been successfully used in the past.

We are grateful the Commission has addressed certain practical challenges in porting that could hamper its successful deployment.

We fully support the Proposal's new provisions confirming the trustee must allow the transferee FCM up to six months to complete new customer due diligence. And given the challenges in quickly agreeing new contracts with the transferee FCM, we fully agree with the acknowledgment that the documentation between the transferor FCM and customer will govern the new relationship pending execution of a new agreement.

III. Vanguard calls on the Commission to incorporate additional protections for non-defaulting customers to further strengthen core customer protections.

A. *Limit Non-defaulting Customer Exposure to Defaulting Customers*.

Following the bankruptcy of MF Global (2011) and Peregrine Financial Group (2012), the Commission moved forward by mandating a new segregation regime for cleared derivatives to mitigate fellow customer risk. "Legally segregated operationally commingled" ("**LSOC**") confirmed that absent an FCM insolvency, one customer's margin could not be used to satisfy another customer's obligations. While not providing complete protection for customer margin, LSOC represented a significant upgrade in the Commission's rules supporting core customer protection principles.

While we appreciate steps the Commission has taken in the proposal to tighten certain practices generally in support of customer protection (as noted above), we continue to firmly support the extension of LSOC non-defaulting customer benefits presently applicable to derivatives to also apply to futures, foreign futures, and options thereon.

Not only do we remain troubled that Vanguard fund margin in the futures account could be used to address failures by fellow customers of our FCMs, we believe the dissonant treatment across derivatives and futures complicates the incentives of customers like non-defaulting Vanguard funds to remain with an FCM suffering other customer failures.

B. *Enhance Porting*.

In addition to the steps advanced in the Proposal to address certain practical challenges with porting, we recommend the Commission work with other regulators to minimize existing barriers to porting.

Particularly for FCMs dually registered as broker-dealers, additional due diligence requirements are likely to complicate porting, and the flexibility advanced by the Commission should be harmonized across other regulatory regimes applicable to FCMs.

[10] Proposed § 190.07.

Likewise, we understand that if an FCM becomes subject to proceedings under the Orderly Liquidation Authority, porting could be further compromised due to strict timing and other constraints, as well as the requirement to port "all or none" of the positions. We urge the Commission to work through these issues with the FDIC to advance flexibility as to the timing of porting and to allow partial transfers of customer positions, including those of separately managed accounts.

C. ***Credit Customer for Gains Haircutting*.**

Vanguard strongly believes that any application of non-defaulting customer gains haircutting, or any other margin haircutting, should be prohibited as being fundamentally at odds with normal insolvency practice and highly counterproductive to incentivizing customers not to abandon a failing DCO.

Particularly if gains haircutting is applied in recovery situations, non-defaulting customers are harmed well ahead of contributions from other DCO creditors. And as customers have a very limited window in to the financial health and risk management practices of the DCO, and have no voice in risk decisions, the prospect of unlimited gains haircutting would drive customers away and exacerbate an already highly stressed situation. Customers would undoubtedly leave to avoid the prospect for their own default and potential failure should they not receive expected gains which they will need to address complimentary losses elsewhere.

If gains haircutting is to be allowed at all, it must be limited in scope and duration, it must be overseen by the DCO's resolution authority and/or the systemic risk authority, and the customer must receive full compensation in the form of a credit or equity claim against the DCO, superior to that of other creditors.

Further, in the event the debtor DCO either (i) does not have "reverse the waterfall" rules or (ii) has "reverse the waterfall" rules that do not address each level of the debtor DCO's waterfall, we request that the Commission provide that the net equity claims of the debtor DCO's clearing members and customers will be calculated as though the debtor DCO in fact has "reverse the waterfall" rules that address each level of the DCO's waterfall.

D. ***Require Trustee to use "Best Efforts" to Protect Customers*.**

The Proposal includes a number of changes intended to increase the flexibility for the trustee to quickly and efficiently address diverse significant issues.

While we appreciate the need for flexibility, we are concerned to the extent that such flexibility compromises core customer protections. For this reason, we highly recommend that the Commission revert to a "best efforts" standard for the trustee to:

- comply with the CEA and Commission regulations;
- compute the funded balance for each customer account containing open commodity contracts or other property on a daily basis;
- make margin calls;
- provide account statements for customer accounts containing open commodity contracts or other property; and
- comply with the Commission's residual interest provisions.

To the extent discretion is otherwise afforded, it should be made clear that such discretion must be employed to achieve the greatest recovery for, and the least disruption to, public customers.

In addition, while discretion may take the form of requested exemptions from certain procedural requirements, it must be made clear that there can be no departure from substantive core customer protections. To allow substantive divergences would compromise the credibility of the clearing framework.

E. "*Skin in the Game*".

Under the present rule set, the incentives applicable to for-profit DCOs are completely misaligned as DCO shareholders have limited exposure to the risks occasioned by potential failed risk management practices, misguided product launches, and inadequate protections for non-default losses. Especially given the limited transparency and governance associated with DCO risk decisions, it is untenable for DCO shareholders to experience the upside profits of clearing while assigning FCMs and customers the downside risk of loss.

This is not to say that FCMs and customers should not bear the risk associated with their cleared trades and credit decisions, and initial margin levels and pricing models may need to be right-sized to mitigate those risks. However, DCO shareholders must be accountable for the management decisions of the DCO. Absent such accountability, there is an enhanced risk that commercial decisions could lead to the setting of lower initial margin levels, inappropriate product introductions, and poor risk-mitigation practices and thereby increase the systemic nature of the risk presented by the clearing model.

Vanguard firmly believes that increased levels of DCO "skin-in-the-game" must be required as a foundational incentive for the DCO to set appropriate margin levels and avoid clearing illiquid or highly volatile products. DCO capital should be required to backstop clearing risk should the assets available for DCO recovery prove inadequate.

A debtor DCO's skin in the game should be available to satisfy the net equity claims of the debtor DCO's clearing members and customers. We request that the Commission explicitly provide that customer property includes property a debtor DCO contributes to its default waterfall.

And all of a DCO's property (except the property excluded from customer property under proposed § 190.18(b)(2)) should be available to satisfy the claims of the DCO's clearing members and customers in respect of gains which have been haircut and non-default losses that were not explicitly allocated to such clearing members and customers under the DCO's rules.

IV. The Proposal's new DCO insolvency provisions are misguided in their broad deference to DCO rules and present the clear risk that the Commission's intended support for core customer protection principles will be compromised. [11]

While many of the structural concepts of the FCM insolvency rule set serve as the basis for the DCO rules, the Proposal prohibits the DCO trustee from stopping any action taken by the DCO that was "reasonably within the scope" of the DCO's recovery and wind down plans. The bankruptcy trustee is expressly instructed to implement and follow the DCO's default rules and procedures where "reasonable and practicable" including but not limited to the termination, close-out and liquidation provisions. In

[11] Proposed §§ 190.15(a) and (c).

effect, the DCO could override the fundamental customer protections intended by Part 190. Vanguard strongly disagrees with this notion and requests that proposed § 190.15(a) should be removed.

The deference to the DCO rules, as they currently exist, lacks necessary specificity and detail to provide certainty to FCMs and customers, or to the trustee, as to what would follow a DCO insolvency/liquidation. The DCO rulebooks set forth a variety of powers the DCO may employ – assessments, variation margin gains haircutting, and tear-ups, which in turn may create uncertainty for customers and contribute to further market stresses during a critical time. And as they do not set forth a comprehensive roadmap to dealing with DCO insolvency, Vanguard believes it would be imprudent to give deference to such uncertain rules.

Further, in the DCO context, the Proposal requires the trustee's calculation of DCO members' net equity claims to include full application of DCO loss allocation rules and procedures[12] – thus, a customer would only be entitled to such a *pro rata* share to the extent the DCO rules did not modify the distribution of the DCO's assets, whether pre- or post-petition, through measures such as variation margin gains haircutting or partial tear-up of transactions.

And as mentioned above, there is currently a wholly inadequate governance regime for changes to the DCO rulebooks. Neither FCMs nor customers are adequately protected in terms of a requirement for the solicitation of views, a consultation on material risk decisions and product launches, and the provision of FCM and customer feedback to the Commission for consideration. Thus, the risk exists that as the DCO begins to fail, otherwise prudent rules could be changed without the appropriate vetting by FCMs and customers who presently bear an inordinate share of the risk.

For this construct to facilitate the orderly and efficient liquidation of a DCO, there needs to be a robust initiative to review and update to the DCO rulemaking process, including:

i. Governance / Oversight. DCO rulebooks are subject to change without adequate advance notice and a meaningful ability to comment. Vanguard feels strongly that FCMs and customers must be better able to participate in the rule-making process. Only through enhanced transparency and robust governance can FCMs and customers have confidence core protections will not be eroded and risk not be materially increased.

ii. Consistency. Rules related to termination, close-out and liquidation vary widely across DCOs. It is ill-advised to defer to rules that will likely yield various results in application. Such an approach can only lead to confusion and uncertainty in the market place.

iii. Core Principles. It would be best to ensure that all DCO rulebooks hew consistently to core customer protection principles. While business and operational issues may vary somewhat, the rules related to termination, close-out and liquidation must be foundationally consistent and reflect a robust attentiveness to customer protection. Absent such a foundation, the Commission's efforts to achieve a clear and consistent insolvency regime for DCOs will be compromised.

In sum, Vanguard commends the Commission on its overhaul of the Part 190 regulations as significant changes have occurred in the market since the rules were first adopted in 1983. While Vanguard generally supports the Proposal's approach to an FCM insolvency, we have serious reservations with respect to the DCO insolvency procedures. Significant revisions are required for these procedures to

[12] Proposed § 190.17(b)(1).

serve as the clear and effective roadmap they are intended to be. Vanguard has been continuously vocal in highlighting the inadequacies of the existing DCO rules and advocating for many of the above-referenced changes, including but not limited to increased governance/oversight as well as DCO capital contribution, in order to effectively mitigate risks. [13] Especially given the clearing mandate, the limited transparency customers have into DCO risk practices, and the absence of a role for customers in DCO governance, customers are wholly dependent on the Commission to set clear and consistent rules for a DCO insolvency that include core customer protection principles.

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Vanguard appreciates the opportunity to comment on the Commission's Proposal. If you have any questions about Vanguard's comments or would like any additional information, please contact William C. Thum, Principal, at (610) 503-9823 or william_thum@vanguard.com or Patricia Marckesano, Associate Counsel, at (610) 503-2796 or patricia_marckesano@vanguard.com.

Sincerely,

/s/ Gregory Davis
Managing Director
and Chief Investment Officer
Vanguard

/s/ Joseph Brennan
Managing Director
and Chief Risk Officer
Vanguard

cc: The Honorable Heath P. Tarbert
The Honorable Brian D. Quintenz
The Honorable Rostin Behnam
The Honorable Dawn DeBerry Stump
The Honorable Dan M. Berkovitz

[13] *See* white paper, *A Path Forward for CCP Resilience, Recovery and Resolution*, dated October 24, 2019 ("**White Paper**"), jointly issued by Vanguard along with representatives from both the asset management and clearing member community.