Vanguard®

Submitted via E-mail to:
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7 April 2014

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

Re: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Dear Sirs,

We very much appreciate the opportunity to provide our comments on the proposed high level framework and methodologies for identifying non-bank, non-insurer global systemically important financial institutions ("**NBNI G-SIFIs**"). We strongly believe that the public comment process provides regulators with important insights and considerations to improve proposals as important and complex as the one before us. We commend the Financial Stability Board and IOSCO for allowing the Consultative Document to be evaluated and addressed in such a manner.

We would very much welcome a meeting with the Financial Stability Board and IOSCO at your earliest convenience at which we might discuss much of the content of the Consultative Document and further engage with the Financial Stability Board and IOSCO on this critically important issue.

Background on Vanguard

The Vanguard Group, Inc. ("**VGI**") began operations in the U.S. in 1975 and is headquartered in Valley Forge, Pennsylvania, U.S. Today VGI (together with its affiliates, as appropriate, "**Vanguard**") operates in the U.S., Europe, Asia, Australia and Canada. As at 31 December 2013, Vanguard managed more than U.S.$ 2.7 trillion in assets worldwide (making it one of the world's largest investment management companies).

VGI is structured with one single purpose—to build wealth for its clients and only for its clients. As such, VGI is owned by certain U.S. domiciled funds that it manages, which in turn are owned by their shareholders/investors. In other words, Vanguard is structured as a "mutual" mutual fund company. We believe it is the only firm in the industry that works this way. The unique structure aligns Vanguard's interests with those of its clients. Given Vanguard's core purpose is to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success, Vanguard has advocated for responsible asset management regulations for more than 30 years.

Vanguard's primary business is in respect of funds and exchange traded funds ("**ETFs**") that are subject to comprehensive risk-limiting provisions, for example pursuant to the U.S. Investment Company Act of 1940 and the EU UCITS Directive[1] ("**comprehensively regulated investment funds**"). As a result we are responding to this Consultative Document with a focus on such comprehensively regulated investment funds. We are not responding in respect of alternative investment funds or separately managed accounts. There are material differences between the regulatory framework and investment profile of comprehensively regulated investment funds and those of other funds.

Executive Summary

Existing regulation already mitigates risk of comprehensively regulated investment funds

We strongly believe that the regulatory regimes applicable to comprehensively regulated investment funds already effectively manage the risk that any one such fund could pose to global financial markets. Existing regulatory requirements that exist under such regimes in respect of leverage, transparency, asset valuation and liquidity mechanisms serve to prevent such funds being exposed to "forced sales" and "runs" on assets. In the limited cases where justified concerns have been raised in respect of the effectiveness of such regimes (for example, in respect of institutional money market funds) such concerns have already been (or are in the process of being) addressed by regulators.

Comprehensively regulated investment funds should fall outside the scope of this framework

We consider that comprehensively regulated investment funds should be excluded from consideration by the Financial Stability Board and IOSCO. Existing regulations are well-tailored, and a regulatory regime designed for highly leveraged and interconnected institutions such as banks is inappropriate, even unworkable, for unleveraged comprehensively regulated investment funds. Such a regulatory mismatch would do nothing to enhance the stability of the financial system, but would threaten to disrupt the capital markets and increase the cost of investing for millions of investors who use comprehensively regulated investment funds to invest for retirement, college, and other long-term goals.

The Financial Stability Board and IOSCO's objective must remain targeted on genuine ***systemic*** risk concerns. The goal should not be distracted by considerations of ***idiosyncratic*** risk[2], market price declines and investment fund redemptions – these are a normal and acceptable function of basic capital markets.

Where necessary, activities-based regulation offers the best form of protection against systemic risk

Notwithstanding the risk-limiting provisions of the regulatory regimes applicable to comprehensively regulated investment funds, we recognise that during times of rare and extreme market distress

[1] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ("**UCITS Directive**").

[2] An idiosyncratic risk is a risk that is isolated, involving a much more limited impact to individual investors or institutions. It may, for example, affect a single asset manager, single asset class, or single fund.

certain activities performed by market participants could exacerbate deteriorating market conditions. We believe strongly that investors and the financial markets would be best served by activities-based regulatory efforts aimed at mitigating risk taking measures in respect of these market activities. Such an approach would enhance controls across market participants and ensure a level playing field.

If entity-based regulation is pursued, the focus should be on leverage, not size

To the extent that the Financial Stability Board and IOSCO consider that entity-based regulation is appropriate in respect of comprehensively regulated investment funds, it would be most appropriate for this framework to focus on individual investment funds, rather than on groups of funds, individual asset managers or asset managers together with their funds.

In assessing the type and level of systemic risk associated with investment funds, we fundamentally disagree that size should be the primary indicator. The proposed materiality threshold should serve to identify the financial entities which pose the greatest risk to the stability of the overall financial market, and not simply those which are the biggest. Size alone is both an ineffective and misleading indicator, as it is both under and over-inclusive. Instead, regulators should focus on leverage, as leverage and interconnectedness created through such leverage can result in "forced sales" that could have a significant impact on other market participants.

Specific Comments on the Consultative Document

1. **We believe that the strength of the regulatory regimes applicable to comprehensively regulated investment funds, particularly in the U.S. and EU, already effectively mitigates the risk that any one fund can pose to the financial markets.**

1.1 As recognised by the Financial Stability Board and IOSCO in the Consultative Document[3], systemic risk is one so grave that, if left unattended, its consequences would require government intervention and potentially taxpayer contribution to rescue the private enterprises exposed to such a risk. It begins in one institution and is then transmitted, typically in arrangements involving leverage, across the financial system to other institutions, impairing financing throughout the economy and posing an excessive threat to the financial stability of the overall market. As noted by former Federal Reserve Chairman Ben Bernanke, a systemic risk is not that which affects *"just...one or two institutions."*[4]

1.2 In a number of jurisdictions (e.g., in the U.S. under the Investment Company Act of 1940 and in the EU under the UCITS Directive) there are specific regulatory restrictions that significantly limit the ability of comprehensively regulated investment funds to engage in activities that could transform idiosyncratic risk into a risk that threatens the financial system. For example, the Investment Company Act of 1940 imposes a variety of limits and controls, including:

Limits on leverage

The Investment Company Act of 1940 Act restricts the ability of U.S. mutual funds to engage in leveraged transactions—short sales, the purchase of securities on margin, derivative transactions—unless those transactions are covered by liquid assets or offsetting transactions[5].

Figure 1 compares the leverage of a representative U.S. bank and a U.S. mutual fund as measured by their assets/equity ratio. The bank holds U.S.$ 11 in potentially risky assets for every U.S. $1 in shareholder's equity. The mutual fund, by contrast, has almost no leverage, about U.S.$ 1 in assets for every U.S.$ 1 in equity.

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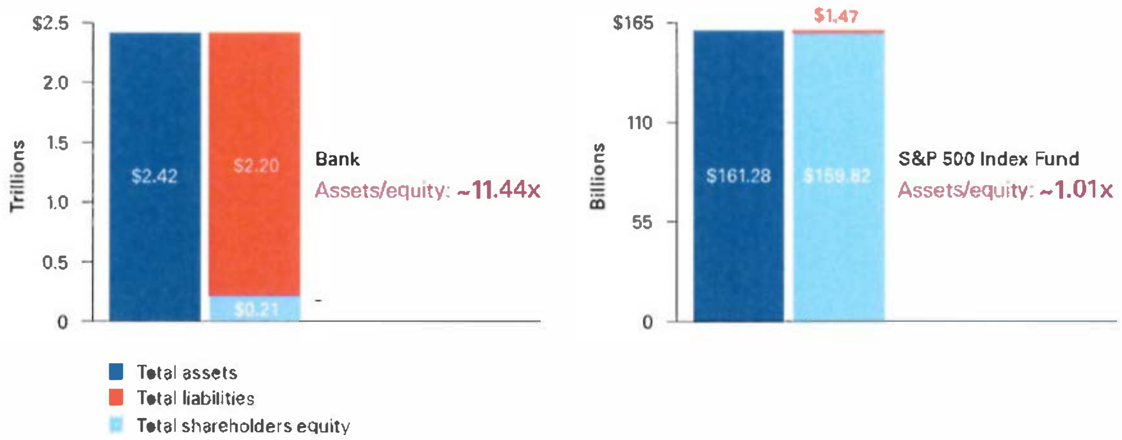
3 FSB/IOSCO Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, Proposed High-Level Framework and Specific Methodologies, dated 8 January 2014 at page 1: *"Systemically important financial institutions (SIFIs) are institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity"*.

4 Former Fed Chairman Ben Bernanke defined systemic risk as *"developments that threaten the stability of the financial system as a whole and consequently the broader economy, not just that of one or two institutions."* Bernanke, Ben, letter addressed to Senator Bob Corker, October 30, 2009.

5 Funds are permitted to enter into leveraged transactions provided they maintain a continuous asset coverage ratio of at least 300% during the term of the transaction. The Securities and Exchange Commission does not require daily calculated 300% asset coverage in respect of a transaction if the fund (a) covers its exposure by entering into an offsetting transaction, or (b) segregates liquid assets equal in value to the fund's obligation under the transaction. The value of segregated assets is marked to market on a daily basis.

Figure 1. Leverage of a bank and a mutual fund



Note: Bank is JPMorgan (2013 10K); mutual fund is Vanguard S&P 500 Index Fund (2013 annual report). The asset, liability, and equity figures reflect rounding to two decimal places. The ratio is calculated before rounding.

Liquidity requirements

U.S. mutual funds must hold at least 85% of their assets in liquid securities, securities that can be sold within seven days at a market price.

Daily mark-to-market valuation of fund assets

U.S. equity and bond mutual funds must value their assets on a daily basis using available market values. If market values are not readily available, the fund's board of trustees must ensure that the fund has a disciplined, accurate process for determining a security's "fair value." Daily valuation minimizes any incentive for one shareholder to redeem before any other shareholder as in a proverbial "run on the bank".

Separate custodians for fund assets

Every U.S. mutual fund must maintain its assets with a qualified custodian, typically a U.S. bank. The Investment Company Act of 1940 requires the custodian to "physically segregate" the fund's assets from other assets held at the bank. If the custodian bank was declared bankrupt, the bank's creditors would have no recourse to the fund's securities held in custody.

We have included in the Appendix to this letter a more comprehensive overview of risk-limiting provisions that apply to comprehensively regulated investment funds in the U.S. and EU.

1.3 These risk-mitigating regulations effectively mean that situations requiring the "forced sale" of assets for comprehensively regulated investment funds are highly unlikely. Comprehensively regulated investment funds do not employ significant leverage and are not interconnected with other systemically important companies as a result of that leverage. Such regulations also mean that there is no risk of a "run" on a comprehensively regulated investment fund. As fund assets are financed entirely with fund shareholder capital, a comprehensively regulated investment fund satisfies redemptions from the assets of the fund itself. Since equity and bond mutual funds use daily mark-to-market valuation for their assets, accelerated redemption of fund shares offers no advantage to an investor. Redemptions are satisfied at the current mark-to-market valuation. To quote former Fed Chairman Ben Bernanke, equity mutual funds are "not runnable."[6]

1.4 We believe that the application of such comprehensive risk limiting regulatory regimes should be considered a determining factor in excluding comprehensively regulated investment funds from being considered as NBNI G-SIFIs. Given the importance of identifying true sources of systemic risk and the limited resources available to that task, eliminating such highly regulated funds from consideration will serve to free up resources to identify institutions that present true systemic risk.

1.5 In addition to equity and bond funds, money market funds[7] are typically constituted as comprehensively regulated investment funds. Although it has been suggested that certain money market funds demonstrated a degree of risk during the global financial crisis in 2007 to 2008[8], it is worth recalling that in 2010 the U.S. Securities and Exchange Commission ("**SEC**") instituted regulatory changes for U.S. money market mutual funds that significantly bolstered their ability to withstand significant shareholder redemptions. These reforms included daily and weekly liquidity minimums, portfolio maturity limitations, enhanced disclosure of portfolio holdings, and stress testing[9]. Furthermore, the SEC is expected to adopt additional regulatory changes in the way many money market mutual funds price their shares and/or limit shareholder redemptions when a fund has limited liquidity reserves. These regulatory changes are expected to further mitigate the risks associated with redemptions from U.S. institutional money market funds. Similarly, the European Commission has recently proposed an EU Regulation to reduce the perceived risks associated with European domiciled money market funds[10].

1.7 A review of historic evidence in respect of U.S. mutual funds shows that events involving U.S. equity and bond mutual funds are overwhelmingly idiosyncratic – isolated to a single firm or a small number of firms and not systemic as they do not transmit stress to other firms. For example, in late 2003, U.S. federal and state securities regulators filed civil fraud charges against one of the largest U.S. mutual fund companies at that time[11]. The company's

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6 Bernanke, Ben, 2014 American Economic Association Annual Meeting, Webcasts of Selected Sessions, January 3-5, 2014.

7 U.S. money market mutual funds are investment vehicles that commonly price their shares at U.S.$ 1 and provide daily liquidity for investors' cash management needs. These funds invest in highly liquid, short-term government bonds and instruments issued by financial institutions of high credit quality, as determined by a credit ratings agency. These characteristics of U.S. money market mutual funds distinguish them from U.S. equity and bond mutual funds.

8 For example, one institutional U.S. money market mutual fund had exposure to commercial paper issued by Lehman Brothers, which caused the fund's investors to suffer a loss of 1 U.S. cent per share when Lehman filed for bankruptcy. Other institutional prime money market funds also experienced high levels of stress as shareholders redeemed their fund shares at significant rates.

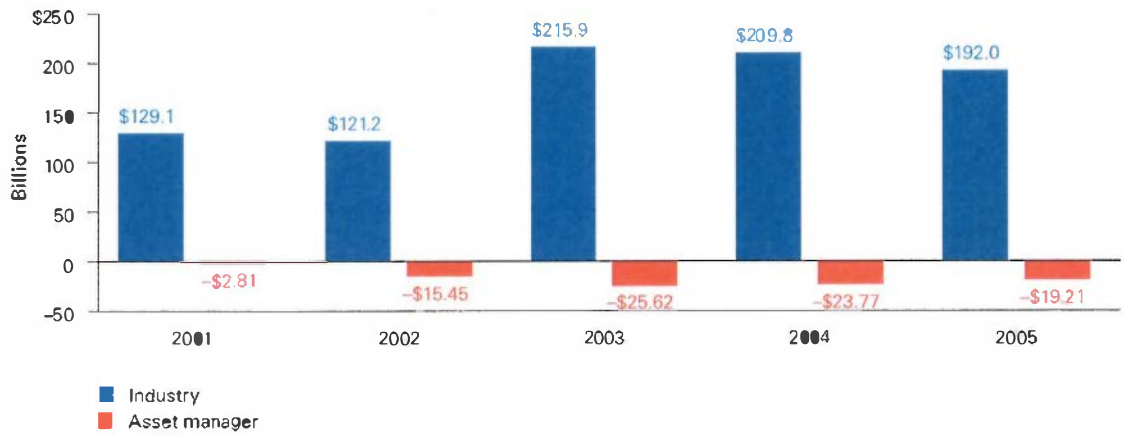
9 See 17 CFR Parts 270 and 274; SEC Release No. IC-29132, *"Money Market Fund Reform"*. The applicable rule governing U.S. money market mutual funds is rule 2a-7 under the Investment Company Act of 1940. See also Vanguard Comment Letter to the SEC, dated January 10, 2011.

10 http://ec.europa.eu/internal_market/investment/money-market-funds/index_en.htm.

11 McCabe, Patrick E., *"The Economics of the Mutual Fund Trading Scandal"*, Finance and Economics Discussion Series Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C., 2009-06, at 8.

portfolio managers market-timed its mutual funds, a breach of their fiduciary duty that diluted the returns of the shareholders in mutual funds advised by the company[12]. Although investors responded to the news with significant redemptions of their shares in mutual funds advised by the company, this idiosyncratic risk failed to produce a systemic wave of redemptions across the mutual fund industry, as demonstrated in **Figure 2**[13]. Moreover, we've found no evidence that the activity led to broad declines in asset prices. From October 2003 through December 2003, in fact, the stock market rallied and bond prices held steady.

Figure 2. Long-term net cash flow of asset manager versus industry



Note: Asset manager is Putnam Investments. Data does not include money market funds.
Source: Vanguard calculations based on Morningstar data.

1.8 Nor was there evidence of systemic risk arising from that mutual fund manager's decline in reputation, even though the manager was then a prominent name in the U.S. mutual fund industry with more than U.S.$ 100 billion in assets under management, according to Morningstar. Shareholders in mutual funds advised by the company redeemed their fund shares and presumably moved their investments to other mutual funds. The idiosyncratic impact remained contained, harming shareholders in mutual funds advised by the company and the management company itself, but posing no threat to the financial system.

1.9 The example is illustrative, but not unique. Unlike banks and highly leveraged institutions, comprehensively regulated investment funds have meaningful constraints in their ability to amplify an idiosyncratic risk into a threat to the broader financial system.

1.10 Figures 3 and 4 below further demonstrate that U.S. mutual funds have experienced relatively stable cash flows in recent decades and there is no evidence of mass redemptions, even upon the occurrence of significant negative market events. Mutual funds are owned by tens of millions of individual investors, each with their own time horizons, risk preferences, and investment goals. **Figure 3** shows the historical redemptions from U.S. equity mutual funds as a percentage of mutual fund assets. Even in periods of profound

[12] Ibid. p. 8, citing Professor Peter Tufano's analysis of the full cost of the Putnam trading scandal.

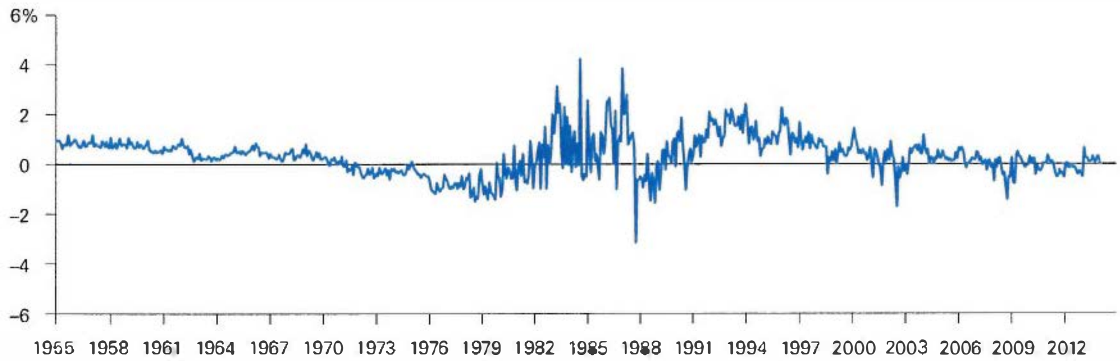
[13] From October 28 to November 7, 2003, almost $6 billion was withdrawn from Putnam by public pension investors. *"Withdrawals from Putnam Set Heavy Pace"* The New York Times, November 7, 2003, available at http://www.nytimes.com/2003/11/07/business/withdrawals-from-putnam-set-heavy-pace.html.

financial stress, the data does not reveal evidence of mass redemptions. For example, during October 1987, when the S&P 500 Index returned –21.5%, U.S. equity mutual fund investors made net redemptions totalling about 3% of U.S. equity mutual fund assets.

1.11 From October 31, 2007 to February 27, 2009, the S&P 500 Index returned –50.9%, the worst stock market decline since the Great Depression. Over this same period, investors redeemed a net U.S.$ 281 billion from U.S. equity mutual funds, just 4.1% of equity assets at the start of the period.

Figure 3. No evidence of a run on U.S. equity mutual funds

Net flows to stock mutual funds as percentage of stock fund assets



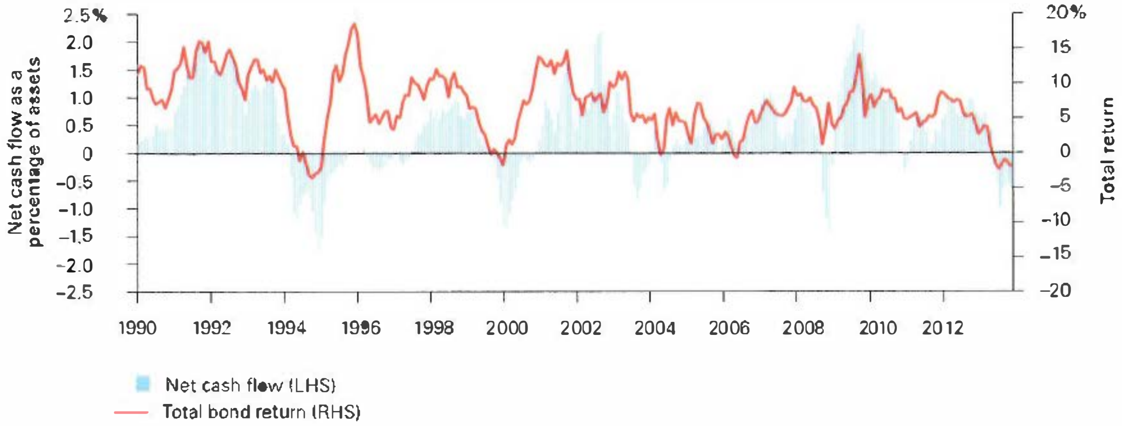
Source: Investment Company Institute. Monthly net flows as a percentage of stock fund assets at the start of the month.

1.12 Bond fund activity tells a similar story. From February 1994 to February 1995, the Federal Reserve raised its target for short-term interest rates by a full 3 percentage points. Bond prices declined, as yields increased. Over the 12 months, the Citigroup Broad Investment Grade Bond Index returned -2.2%, a notable break with the previous ten years, when the index had produced an average annual return of 11.8%.

1.13 As **Figure 4** indicates, however, U.S. bond mutual fund shareholders made steady redemptions over the same period. From February 1994 to February 1995, net redemptions amounted to 11.3% of U.S. bond mutual fund assets at the start of the period. Although not an insignificant number, it is certainly not indicative of a mass exodus. The data from 2007 to 2009 is consistent with previous experience and suggest a relatively subdued response by U.S. bond mutual fund shareholders to the worst financial crisis since the Great Depression.

Figure 4: No evidence of a run on U.S. bond mutual funds

Net cash flow as a percentage of bond fund assets



Source: Investment Company Institute, Citigroup. Net new cash flow to bond funds plotted as a 3-month moving average of the share of net new cash flow in previous month assets. The data exclude flows to high-yield bond funds. Total return is year-over-year change in the Citigroup Broad Investment Grade Bond Index.

1.14 In any case, it is important to recognise that large scale redemptions by investors in comprehensively regulated investment equity and bond funds are not a source of systemic risk, either for the funds or the asset managers of such funds.

1.15 A redemption is a decision on the part of an investor to sell his or her investment at the current mark-to-market valuation. Investors may redeem their shares for any number of reasons:

- to switch fund managers (because of a manager's deteriorating reputation or performance, a desire for lower fees, or the need for better services);
- to change their asset allocation (for example, to switch from equities to bonds); or
- to obtain cash (for example, to make a down payment on a house).

The decision by an investor to reallocate assets or raise cash would occur whether he or she held assets in a comprehensively regulated investment fund or held equities and bonds directly.

1.16 Redemptions are not the same as "forced sales", which are driven by leverage and interconnectedness, and can result in a rapid spiral of price declines. Any price declines driven by redemptions are simply evidence of a basic capital markets function: to discover the price at which buyers and sellers are willing to exchange risk. Moreover, losses associated with redemptions do not infect the broader financial markets. Rather, they are shouldered by the funds' investors, who have agreed to accept the risk of loss. Even a large amount of redemptions by shareholders of comprehensively regulated investment funds are not, as noted previously, similar to "runs" on bank assets and do not, under any market scenario, have the potential to raise systemic risk. With U.S.$ 1 of capital for each U.S.$ 1 of assets, a U.S. mutual fund can absorb significant – in effect total – losses and still remain solvent. The goal of systemic risk regulation should not be to prevent market price declines, but rather to ensure that financial institutions are resilient to market price fluctuations.

2. **Notwithstanding such risk-mitigating regulatory regimes, during times of rare and extreme market distress certain activities performed by market participants could exacerbate deteriorating market conditions. Focused, activities-based regulation is the most effective way to address this risk.**

2.1 We strongly endorse a focus on activities as the most effective way to address systemic risk. Effective regulation of potentially risky activities enhances controls across all market participants and ensures a level playing field. We welcome the opportunity to work with the SEC, Financial Conduct Authority, Australian Securities and Investments Commission and other systemic risk regulators on such matters.

2.2 Recent regulatory reform of the OTC derivatives markets, both in the U.S. and the EU[14], provides a good example of how activities-based regulation can contribute to the mitigation of derivatives-based systemic risk. In the U.S., Title VII of the Dodd-Frank Act provided a framework for the reform of OTC derivatives markets that was mandated by the G-20 following the 2009 summit in Pittsburgh. The reforms fall into four main categories:

- New swap data reporting and recordkeeping requirements provide both the Commodity Futures Trading Commission and SEC with a clear window into the market to monitor trading and to identify abuses and risk concentrations.
- The uniform requirement for both initial and variation margin for cleared and uncleared swaps serves to mitigate counterparty risk and limit leverage.
- Central clearing of the most standardized swaps further limits counterparty risk, while mandatory exchange trading is intended to enhance liquidity and improve pricing through greater market transparency and competition.
- Increased capital requirements and enhanced risk management practices serve to reduce the likelihood of a dealer's derivatives-related insolvency.

As these changes are fully implemented in the U.S. and abroad, we believe that the derivatives markets will operate on a much more stable, controlled platform and will present far less potential for derivatives-related systemic risk.

14 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

3. **If there is a need for an entity-based approach, it should be applied on a fund-by fund basis.**

3.1 If, despite our comments above regarding the strength of comprehensive risk-limiting regimes applicable to certain investment funds and the merits of an activities-based approach, the Financial Stability Board and IOSCO decide to proceed with an entity-based approach, we agree with the rationale given in section 6.2.2 of the Consultative Document. It would be far more appropriate for this framework to focus on individual investment funds, rather than on groups of funds, individual asset managers or asset managers together with their funds.

3.2 Unlike banks, asset managers are not principal investors, do not provide guarantees and have little to no leverage. Nor do they offer credit to or engage in transactions with the funds they manage. Asset managers do not own fund assets, which are recorded on the fund's balance sheet (and not the asset manager's balance sheet). Asset managers act as agents of the funds and provide management services to them in a fiduciary capacity. If the fund produces gains, these gains belong to the fund shareholders. If the fund produces losses, these losses belong to the fund shareholders. The profit and losses experienced by fund shareholders have no direct impact on the asset manager's financial stability.

3.3 Comprehensively regulated investment funds are separate and independent legal and economic entities[15]. This separation and independence is fundamental because it means that among comprehensively regulated investment funds managed by the same asset manager, losses and liabilities of one fund are not the responsibility of any other fund managed by the same manager. Even if one fund winds down or is redeemed, this does not raise a domino or connecting effect in respect of other funds (or the fund management company). Similarly, if a manager of a comprehensively regulated investment fund was declared bankrupt, that manager would have no access to fund assets or to the assets of other funds managed by the same manager. For example, in 2004, when Strong Financial (a U.S. mutual fund advisory firm) collapsed as a result of a trading scandal, the boards of trustees appointed to the funds managed by Strong Financial appointed another manager (Wells Fargo) to manage the funds[16].

4. **Leverage, coupled with interconnectedness, is the true indicator of systemic risk**

4.1 We assert that the Financial Stability Board and IOSCO should view leverage as the primary "impact factor" (rather than size) against which any investment fund assessment pool is evaluated. Leverage does not simply amplify the potential for "forced sales" and market distortions[17], but may itself be a determinant of systemic risk. As such, we welcome the fact

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15 Indeed, commingling of assets would violate Section 17 of the Investment Company Act of 1940. Fund assets are subject to strict custody requirements and cannot be used to satisfy the obligations of the asset manager that provides services to them or to satisfy obligations of other funds managed by the same asset manager.

16 Diamond, Randy, 2012. *One-time powerhouse Strong Financial down to a staff of 1*. Available at: http://www.pionline.com/article/20120806/PRINT/308069980/one-time-powerhouse-strong-financial-down-to-a-staff-of-1#.

17 The Consultative Document states (on page 29) that "*the potential for forced liquidations and market distortions may be amplified by the use of leverage by funds*".

that the Consultative Document recognises that funds with little or no leverage are unlikely to have a substantial impact on counterparties or markets in the event of their liquidation.

4.2 The history of financial crises, including that of 2007 to 2008, demonstrates that systemic risks typically originate in entities that possess at least one of two characteristics:

- significant leverage and interconnections with other systemically important companies through such leverage;
- a significant mismatch between the terms, or maturities, of assets and liabilities.

These characteristics act as mechanisms that can transmit financial distress from one institution to another, and potentially to the financial system as a whole. For this reason, we consider that the designation of NBNI G-SIFIs should focus on the extent to which an institution demonstrates either of these two criteria.

4.3 Leverage and interconnectedness can transmit risk across the financial system by compelling "forced sales". If an institution is unable to meet margin or capital calls (e.g., collateral due to support derivatives trading or other financial obligations, such as liquidity commitments), it may be forced to sell assets at dislocated prices to raise cash. These "forced sales" can potentially lead to broad asset price declines, causing other institutions to face margin or capital calls, thereby accelerating a systemic downward spiral in asset prices that puts other leveraged institutions at risk. In many cases, systemic risk requires government intervention to break the cycle of "forced sales" and asset price declines.

4.4 As former Federal Reserve Board Chairman Alan Greenspan explains in *The Map and the Territory*, leverage can transform a risk that harms a single group of investors into a threat to the financial system: *"It was not subprime mortgages alone that caused the crisis. Subprimes were indeed the toxic asset, but if they had been held by mutual funds or in 401(k)s, we would not have seen the serial contagion we did. It is not the security that is critical, but the degree of leverage of the holders of the asset."*[18]

4.5 In an asset-liability mismatch, an institution's long-term assets (such as home mortgage loans to customers) are funded with short-term liabilities (such as demand deposits). If the institution experiences a sudden, large-scale withdrawal of other funding sources (a loss of access to the commercial paper market, for example) it can experience a "run on the bank". In this scenario, depositors fear the institution's failure and withdraw their funds before withdrawals by other depositors exhaust the institution's liquid assets. The institution's relatively illiquid assets, such as mortgage loans, can't generate enough cash fast enough to satisfy depositor withdrawals. The result of this mismatch can be a default and, depending on the institution's degree of interconnectedness, the transmission of stress across the financial system.

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[18] Greenspan, Alan, 2013. *The Map and the Territory: Risk, Human Nature, and the Future of Forecasting*. New York, N.Y.: Penguin Press. Quotation is from an edited excerpt, available at: http://www.american.com/archive/2014/march/how-to-avoid-another-global-financial-crisis.

4.6 Neither comprehensively regulated investment funds nor the asset managers that provide management services to them present such systemic risks as they simply do not possess either of these two characteristics.

4.7 We firmly believe that the Financial Stability Board and IOSCO must employ leverage as the primary filter in its methodology to identify systemically important investment funds. Failing to focus on leverage in a methodology to identify systemically important funds would result in the misidentification of institutions presenting true systemic risk within the global financial system. For this reason, we call on the Financial Stability Board and IOSCO to study and develop: (1) a globally consistent method to measure a fund's leverage; and (2) a threshold amount of leverage presumed to present systemic risk using such measure, and include both in the methodology to identify systemically important investment funds.

4.8 Developing a method and threshold amount for leverage in investment funds would be consistent with global risk-limiting regulations for banks and for other financial institutions. Regulatory frameworks around the world widely acknowledge that leverage and interconnectedness with other systemically important companies through such leverage is a source of risk.

4.9 As proposed by the Consultative Document[19], a measure of fund leverage should begin by calculating the fund's balance sheet leverage ratio (gross assets divided by net assets). We recommend that the Financial Stability Board and IOSCO work with fund industry participants and regulators supervising U.S. and European fund managers in developing and implementing such a measure.

4.10 We also believe calibrating a threshold amount of leverage used to identify a systemically important fund will require careful study by the Financial Stability Board and IOSCO. As a starting point, the Financial Stability Board and IOSCO may wish to consider consistency with the limitations placed on bank leverage under current global banking regulations and the non-bank SIFI leverage indicator applied by the U.S. Financial Stability Oversight Council (that is, a ratio of 12-15 times to 1).

4.11 Each of the size, interconnectedness, substitutability and complexity factors proposed by the Financial Stability Board and IOSCO should only be used to assess the potential systemic risk of an investment fund that has already been identified as a result of its level of leverage.

4.12 We do not consider that a materiality threshold based on the level of assets under management (nor the proposed U.S.$ 100 billion threshold) to be appropriate for providing an initial filter with respect to investment funds. Size reveals very little about whether an investment fund could pose risk to the global financial system. Indeed, as noted previously, size alone is both an ineffective and misleading indicator, as it is both under and over-inclusive, leading to both false positive and negative results.

4.13 In terms of being under-inclusive, it seems questionable whether the proposed U.S.$ 100 billion materiality threshold for investment funds would capture small but highly-leveraged

[19] Consultative Document at page 34, "Indicator 2-1: Leverage ratio".

funds whose failure could have a material systemic impact. For example, the U.S.$ 100 billion threshold would not have captured the 1998 Federal Reserve organised bailout[20] of Long-Term Capital Management (**"LTCM"**) (a highly leveraged hedge fund[21] that had a capital base of U.S.$ 2.3 billion in equity at the time of its troubles). Indeed, LTCM demonstrates the propensity for a small, highly leveraged fund to pose systemic risk to the stability of the overall financial system. While today, the risk of a disorderly wind-down similar to that experienced by LTCM is arguably less likely due to regulatory and supervisory improvements, it is by no means without risk.

4.14 In terms of being over-inclusive, simply applying a U.S.$ 100 billion test as at the date of this letter to Vanguard's fund range would result in the preliminary identification of six U.S. domiciled Vanguard funds (five of which are broad based index-tracking funds, with the sixth being a prime money market fund). In actuality, the risk presented by these funds is already considerably mitigated as a result of:

- Being large, broadly diversified funds that operate in highly liquid and diverse global financial markets;
- Having little to no leverage - the maximum balance sheet leverage[22] of any of these funds as at 31 December 2013 was 1.08;
- Being highly substitutable;
- Having little exposure to derivatives – derivatives are typically only used to: (a) equitize cash; (b) hedge; (c) reduce transaction costs; or (d) achieve exposure to certain markets where direct exposure is not practicable;
- Having vast and diverse investor bases, spread across retail, institutional and intermediated/advised clients; and
- Being subject to the U.S. Investment Company Act of 1940's regulations with respect to leverage, transparency, asset valuation, liquidity and other protections.

4.15 We also oppose the use of cross-jurisdictional activities as an indicator of systemic risk for investment funds. Diversification has long been a foundation of risk mitigation (rather than an indicator of systemic risk). By spreading the activities of a business or the investments in a portfolio more widely, the impact to the whole of a problem in any one area is reduced.

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20 Due to losses on its leveraged positions in the credit markets and a large bet on stock market volatility, the portfolio managed by Long-Term Capital Management experienced accelerated losses. This was compounded by the fact that Long-Term Capital Management had also employed a number of derivative trades with various broker-dealers, with a notional principal amount of over U.S.$ 1 trillion, creating the potential for large losses for counterparties in the event that the associated collateral were to be liquidated. In order to minimise market impact, the Federal Reserve organized a bailout of Long-Term Capital Management by 14 banks, which included making an investment of approximately U.S.$ 3.6 billion into the fund in return for a 90% stake in the firm in order to prevent a disorderly wind-down.

21 With a leverage factor of 25 that at one stage increased to around 50 – P. Jorion "*Risk Management Lessons from Long-Term Capital Management*", at page 1 and page 5.

22 Total assets divided by total net assets, rounded to two decimal places.

Conclusion

Given Vanguard's core purpose of taking a stand for all investors, to treat them fairly, and to give them the best chance for investment success, we support appropriate regulation to ensure the resiliency and efficacy of the global financial system. As such, we are very keen to continue to engage with the Financial Stability Board and IOSCO on the critically important issue of designing the correct framework and methodologies for identifying NBNI G-SIFIs.

Unfortunately, we consider that the methodology proposed in the Consultative Document is not appropriate to identify NBNI G-SIFIs in the investment management sector. The focus on size of assets under management means that no account is taken of the fact that existing regulation already mitigates the risk of comprehensively regulated investment funds. Comprehensively regulated investment funds should fall outside the scope of this framework entirely. Where necessary, activities-based regulation offers the best form of protection against systemic risk.

The Financial Stability Board and IOSCO's objective is to identify institutions whose distress or disorderly failure would cause significant disruption to the wider financial system and economic activity – that is, genuine systemic risk. As a result, the proposed methodology should serve to identify the NBNIs which pose the greatest risk to the stability of the overall financial market and not simply those which are the biggest. It is imperative that the framework's focus should be on leverage, as leverage and interconnectedness created through such leverage can result in "forced sales" that could have a significant impact on other market participants.

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If you would like to discuss these comments further, you can contact Richard Withers at richard.withers@vanguard.co.uk or +44 207 489 6909.

Yours faithfully,

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The Vanguard Group, Inc.

John Hollyer
Principal, Head of Risk Management Group
The Vanguard Group, Inc.

cc:

Securities and Exchange Commission:
The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
Norm Champ, Director, Division of Investment Management

Financial Stability Oversight Council:
Chairman Jacob J. Lew, Secretary of the Treasury
Janet L. Yellen, Chairman of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Thomas J. Curry, Comptroller of the Currency
Melvin L. Watt, Director of the Federal Housing Finance Agency
Mark P. Wetjen, Acting Chairman of the Commodity Futures Trading Commission
Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation
Debbie Matz, Chairman of the National Credit Union Administration
S. Roy Woodall, Jr., Independent Insurance Expert

Appendix

Overview of certain aspects of regimes that exist for open-ended regulated mutual funds in the U.S. and EU

	United States	European Union
Regulatory regime	Investment Company Act of 1940	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities ("**UCITS**") ("**UCITS Directive**")
Relevant financial services regulator	Securities and Exchange Commission ("**SEC**")	Relevant national financial services regulator, such as the UK Financial Conduct Authority ("**FCA**") and the Central Bank of Ireland ("**CBI**")
Leverage limits	Section 18(f) of the Investment Company Act 1940 prohibits SEC registered funds (i.e., open-ended mutual funds) from issuing senior securities except that a fund may: (1) borrow from a bank if it maintains asset coverage of at least 300% for all borrowings, and (2) borrow money for temporary purposes in an amount not exceeding 5% of the value of the fund's total assets at the time the loan is made. The Investment Company Act defines a senior security as "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness". Through a series of no-action letters and interpretive guidance, the SEC staff has identified certain instruments (e.g., puts, calls, futures, forward settling transactions) and trading practices (e.g., reverse repurchase agreements, short selling)	The management company of a UCITS must ensure that the fund's global exposure relating to derivative investments does not exceed the total net value of its portfolio (UCITS Directive, Article 51(3)). The UCITS management company is required to calculate the fund's global exposure on at least a daily basis using the commitment approach, value-at-risk ("**VaR**") or other advanced risk management methodologies as may be appropriate (Article 41 of Commission Directive 2010/43/EU of 1 July 2010, implementing the UCITS Directive ("**UCITS IV Implementing Directive**")). EU member states may only authorise borrowing by UCITS funds provided that such borrowing is: 1. on a temporary basis and represents no more than 10% of its assets; or

	United States	European Union
	that could raise senior security concerns. The SEC has stated that it will not treat such transactions as senior securities provided a fund (1) "covers" the transaction by entering into an offsetting position (e.g., owning shares of stock that are subject to a short sale), or (2) segregating liquid securities in an amount equal to 100% of the fund's potential exposure. Transactions that involve a leveraging component that are not specifically addressed in SEC guidance (e.g., swaps) are viewed as senior securities subject to the 300% asset coverage requirement unless a fund covers or segregates liquid assets in respect of 100% of its potential exposure of the transaction.	2. to enable the acquisition of immovable property essential for the direct pursuit of its business and represents, in the case of an investment company, no more than 10% of its assets. Where a UCITS is authorised to borrow under (1) or (2) above, such borrowing shall not exceed 15% of its assets in total (UCITS Directive Article 83). UCITS Directive Article 89 prohibits uncovered sales of transferable securities, money market instruments or certain financial instruments (as listed in UCITS Directive Article 50(1), (e), (g) and (h)).
Funds transparency/ disclosure requirements	**Disclosure to investors** An SEC registered fund's prospectus discloses all material facts concerning a fund's operations, including the following: • The fund's primary investment strategies and risks, including derivatives usage. The fund's statement of additional information will generally include more detail on potential derivatives investments, the 300% continuous asset coverage test as well as the alternative cover and 100% asset segregation approaches (see "Leverage limits" row above). • The detailed procedures that a shareholder	**Reporting to investors** The management company must, for each of the UCITS it manages, publish a prospectus and a key investor information document ("**KIID**") that includes the information necessary for investors to be able to make an informed judgement of the investment proposed to them, and, in particular, of the risks attached thereto. Amongst other things, the prospectus must include: 1. information about the risk related to derivatives (for example, the existence of leverage risk and the corresponding level of risk taken) (UCITS Directive Article 70); 2. procedures and conditions for repurchase or

	United States	European Union
	should follow to redeem their shares. The prospectus will typically also disclose that redemptions may be paid "in kind", and that the fund has the right to suspend payment of redemption proceeds for up to 7 calendar days. • The way portfolio securities are valued (e.g., market value if quotes are available) and also how the fund's NAV is calculated, and in particular that the NAV is not calculated on U.S. holidays or when the NYSE is closed. **Periodical reports** Fund shareholders receive annual reports containing audited financial statements within 60 days after the end of the fund's fiscal year, and semi-annual reports containing unaudited financials within 60 days after the fiscal year mid-point. These reports must contain updated financial statements, a list of the fund's portfolio securities including derivatives contracts, management's discussion of financial performance, and other specified information. **Reporting to regulators** A mutual fund is required to send its prospectus, and any amendments thereto, and its annual and half-yearly financial statements to the SEC. Following their first and third quarters, funds file an additional form with the SEC, Form N-Q, disclosing their complete portfolio holdings. These quarterly	redemption of units, and circumstances in which repurchase or redemption may be suspended; 3. description of the UCITS' investment objectives, including its financial objectives, investment policy, any limitation on that investment policy and an indication of any techniques and instruments or borrowing powers which may be used in the management of the UCITS; 4. rules for the valuation of assets; and 5. determination of the sale or issue price and the repurchase or redemption price of units. **Periodical reports** The management company must, for each of the UCITS it manages, prepare an annual report for each financial year and a half-yearly report, covering the first six months of the financial year. **Reporting to regulators** A UCITS is required to send its prospectus, and any amendments thereto, and its annual and half-yearly reports, to the competent authorities of its home member state and, to the competent authorities of its management company's home member state on request.

	United States	European Union
	portfolio holdings disclosures include the segregation of any assets for derivatives or securities lending transactions, such as assets posted as collateral. They also list open derivatives positions, including terms of the contracts, their notional value and fair value.	
Valuation	Mutual funds, which largely hold marketable assets valued on Level 1 and Level 2 bases, perform daily mark-to-market valuations of fund assets and disclose such valuations in the form of an NAV.	UCITS Directive Article 85 requires that the rules for the valuation of assets and the rules for calculating the sale or issue price and the repurchase or redemption price of the units of a UCITS be laid down in the applicable national law, in the fund rules or the instruments of incorporation of the investment company. UCITS IV Implementing Directive Article 8(3) requires management companies to establish appropriate procedures to ensure the proper and accurate valuation of assets and liabilities of the UCITS. UCITS Directive Article 76 requires that a UCITS make public in an appropriate manner the issue, sale, repurchase or redemption price of its units each time it issues, sells, repurchases or redeems them, and at least twice a month.
Liquidity mechanisms	**85% liquidity requirement** To ensure that a fund has sufficient assets available to meet daily redemptions, SEC guidelines require a mutual fund to have at least 85% of its assets in liquid securities. A security is generally deemed to be liquid if it can be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the fund valued it.	The tools and processes a management company employs will depend upon a number of factors such as the UCITS documentation, the types of asset held, market conditions and investor behaviour. In taking action, the management company should balance the interests of all unitholders – incoming, outgoing and continuing.

	United States	European Union
	Restrictions on suspending redemptions Section 22(e) of the Investment Company of 1940 Act prohibits SEC-registered mutual funds from suspending redemptions, or suspending payment of redemption proceeds for more than seven days after receipt of a redemption request. This seven day period may be extended (1) for any period (A) during which the New York Stock Exchange is closed other than customary weekend and holiday closings or (B) during which trading on the New York Stock Exchange is restricted; (2) for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or (3) for such other periods as the SEC may by order permit for the protection of security holders of the company.	**Regulatory tools available** (i) *Frequency of redemptions* Pursuant to UCITS Directive Article 76, units must be redeemable not less than twice a month. The competent authorities may, however, permit a UCITS to reduce the frequency to once a month on condition that such derogation does not prejudice the interests of the unit-holders. Both the FCA in the UK, and the CBI in Ireland, require at least one dealing day per fortnight. (ii) *Redemption charge* There is no regulation of the use of exit or redemption charges at the UCITS Directive level. Member States have implemented national regulations on this subject. For example, both the FCA and the CBI require that any redemption charge must be disclosed in the UCITS prospectus and should not be such that it could be reasonably regarded as restricting any right of redemption. (iii) *Deferred redemption* UCITS Directive Article 84(1) requires that a UCITS shall repurchase or redeem its units at the request of any unit holder. The FCA has not specified the longest notice period that can be imposed on redeeming investors although redemption proceeds must be settled within four business days of the relevant dealing day. The FCA allows a gate to be imposed where the fund is daily dealing and redemptions received exceed 10% (or some other reasonable proportion as set out

	United States	European Union
		in the UCITS offering documents) of the net asset value. The CBI requires that the maximum delay between the deadline for receipt of redemption requests from investors and the settlement of redemption proceeds cannot be more than a total of 10 business days (or 14 calendar days). The CBI allows a gate to be imposed where redemptions received exceed 10% of the net asset value. (iv) *Suspension of redemptions* UCITS Directive Article 84(2) permits that, in exceptional cases where circumstances so require and where suspension is justified having regard to the interests of the unit-holders, a UCITS may, in accordance with the applicable national law, the fund rules or the instruments of incorporation of the investment company, temporarily suspend the repurchase or redemption of its units. UCITS Directive Article 98 provides a power for competent authorities to require the suspension of issue, repurchase or redemption of units in the interests of unit-holders or the public. The management company should refer to the rules of the relevant competent authority for details of the circumstances in which it must, or may, suspend dealings in units. The UCITS prospectus should disclose the circumstances in which redemptions may be suspended. In the UK, the management company must inform the FCA and unit-holders of a suspension and the reason for the same. There is technically no limit on how long a fund may

	United States	European Union
		be suspended in the UK, but the management company must review the suspension at least every 28 days and inform the FCA of the results of such review. It should be noted that the Investment Management Association (representing the UK investment management industry) considers that it is unlikely to be viewed as acceptable by a competent authority that a suspension has become necessary as a result of poor liquidity management. (v) *In specie redemption* The FCA permits redemptions to be settled in specie where (i) the depositary has taken reasonable care to ensure that the property concerned would not be likely to result in any material prejudice to the interests of unit-holders; and (ii) permitted by the fund rules. (vi) *Local solutions on dilution levies* In the UK, anti-dilution levies, although designed to reimburse the UCITS for the impact of dealing charges on large subscriptions or redemptions (i.e., dilution) can have the practical effect of deterring redemption. Contingent deferred sales charges ("**CDSC**") are permitted but not common, although a "stepped" redemption fee reducing over time of holding an investment is feasible. In Ireland, the effect of a redemption charge can be increased by using a CDSC of up to 4%. If the CDSC is used, an initial fee cannot be charged, however, if required, the redemption fee can be supplemented by an anti-dilution levy.

	United States	European Union
Investment diversification	SEC-registered funds must disclose whether they are diversified or non-diversified. Under Section 5(b) of the Investment Company Act, at least 75% of the value of a diversified fund's total assets must be in (1) cash and cash items (including receivables), (2) U.S. Government securities, (3) securities of other investment companies, and (4) other securities limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of such fund and to not more than 10% of the outstanding voting securities of such issuer. Non-diversified funds are not subject to these limitations but are subject to U.S. tax diversification rules. *Inter alia*, these stipulate that: (A) at least 50% of the value of a fund's total (gross) assets must consist of (i) cash; (ii) cash items (including receivables); (iii) U.S. government securities; (iv) securities of other regulated investment companies; or (v) investments in other securities that, with respect to any one issuer, do not represent more than 5% of the value of the fund's total assets or more than 10% of the issuer's outstanding voting securities; and (B) a fund cannot invest more than 25% of the value of the fund's total (gross) assets (i) in the securities (other than U.S. government securities or regulated investment company shares) of any one issuer, or	Article 52, UCITS Directive sets out various limits for investments in specific eligible asset classes including the following: (i) a UCITS may not invest any more than 10% of its assets in transferable securities or money market instruments issued by the same body and those positions (in the same issuer) which exceed 5% must not in aggregate exceed 40% of the UCITS' assets (the 5/10/40 rule); (ii) a UCITS may not invest any more than 20% of its assets in deposits made with the same body; (iii) the risk exposure to a counterparty of the UCITS in an OTC derivative transaction must not exceed either 10% of its assets when the counterparty is a credit institution, or 5% of its assets in other cases. For these purposes the credit institution must either have its registered office in a member state or, if its registered office is in a third country, the credit institution must be subject to prudential rules considered by the competent authorities of the UCITS home member state as equivalent to those laid down in community law; (iv) the 5% rule is raised to 35% (or, in certain circumstances, 100%) in relation to government and public securities and 25% in relation to covered bonds; (v) a UCITS may generally not invest more than 25% in government and public securities (**"GAPS"**) issued by a single body but can invest more than 35% provided it holds a maximum of 30% in a single issue and holds securities from at least six issues;

	United States	European Union
	two or more issuers the fund controls (defined by 20%+ ownership) and that are engaged in the same, similar, or related trades or businesses or (ii) in one or more qualified publicly traded partnerships.	(vi) the above rules cannot be combined (i.e., the maximum exposure to a single issuer cannot exceed 35%, i.e., the limit for GAPS); (vii) a UCITS may not invest more than 20% in a combination of (i), (ii) and (iii) with the same issuer; and (viii) a UCITS may not invest any more than 10% (a member state may raise this limit to 20%) in a single UCITS or other single collective investment undertaking (investments made in units of collective investment undertakings other than UCITS may not exceed in aggregate 30% of the assets of the UCITS). Provided the principle of risk spreading is observed, UCITS may be allowed to derogate from the above spread rules for a period of six months following the date of authorisation. Member states may raise the limits laid down in the UCITS Directive, Article 52, to a maximum of 20% for investment in shares or debt securities issued by the same body when, according to the fund rules or instruments of incorporation, the aim of the UCITS' investment policy is to replicate the composition of a certain stock or debt securities index which is recognised by competent authorities, on the following basis: (i) its composition is sufficiently diversified; (ii) the index represents an adequate benchmark for the market to which it refers; and (iii) it is published in an appropriate manner.

	United States	European Union
		Member states may raise the 20% limit to 35% where justified by exceptional market conditions in particular in regulated markets where certain transferable securities or money market instruments are highly dominant. The investment up to that limit shall be permitted only for a single issuer.
Counterparty limits	There is no Investment Company Act Rule that specifically targets counterparty exposure. However, counterparty exposure is limited by rules restricting investments in security related issuers. Section 12(d)(3) of the Investment Company Act generally prohibits SEC-registered funds from investing in securities-related issuers (i.e., advisors, broker-dealers, and those engaged in the business of underwriting). However, Investment Company Act Rule 12d-3 allows a fund to purchase securities of, and enter into transactions with, that issuer if immediately after purchase: (1) of any equity security, the fund owns not more than 5% of the outstanding securities of that class of issuer's equity securities; (2) of any debt security, the fund owns not more than 10% of the outstanding principal amount of the issuer's debt securities; and (3) the fund has invested not more than 5% of the value of its total assets in the securities of the issuer.	Please refer to "Investment diversification" row above. Where a UCITS enters into a derivatives contract, collateral in the form of margin can be posted with the counterparty (or broker) either by way of a transfer of assets or by way of a charge over assets. Where margin is posted by way of transfer of assets, the legal and beneficial ownership of the assets comprising the margin is transferred to the counterparty which will be under a contractual obligation to return equivalent assets to the UCITS. The UCITS has no proprietary interest in the assets comprising the margin, which are therefore at risk and must be taken into account in the 5%/10% counterparty exposure risk limit although usually this can be netted against the value of the obligations that the UCITS owes to the counterparty. As a practical matter, it is therefore excess margin that will need to be taken into account in the 5%/10% limit. It should be remembered that this exposure cannot exceed 20% if combined with deposits (and any transferable securities or money market instruments) held with the counterparty. While this is the position adopted by many regulators, the matter has not been explicitly dealt with at European

	United States	European Union
	The SEC has issued a No-Action letter that allows an index fund to have more than 5% of its total assets in a securities-related issuer to the extent necessary to track its target index provided the fund complies with certain conditions.	Commission level. In the CESR Guidelines on Risk Management and the Calculation of Global Exposure for UCITS, CESR states that initial margin and variation margin receivable from a broker relating to OTC (and exchange traded) derivatives which is not protected by client money rules or similar arrangements to protect the UCITS against the insolvency of the broker must be calculated within the OTC counterparty limits. It is common for counterparties to require a UCITS to post initial margin in the form of cash (an "Independent Amount" in ISDA terminology) in addition to the variation margin in respect of the daily mark-to-market changes in the counterparties' exposure to the UCITS. This initial cash margin protects the counterparties from large shifts in their exposure to the UCITS in the period between calls for variation margin. Since this initial cash margin effectively acts as a "buffer", it will normally constitute excess margin and therefore must be taken into account in the 5%/10% counterparty exposure risk limit. In order to avoid initial cash margin counting towards that counterparty exposure risk, a UCITS could post the initial cash margin to its own custodian (rather than to the counterparty) and then create a charge over the cash in favour of the counterparty. As the cash will no longer be held by the counterparty, it should not count towards the 5%/10% counterparty exposure limit, yet will still be available to the counterparty as collateral for the UCITS' obligations under the derivatives contract. It should be remembered that the initial cash margin held at the

	United States	European Union
		custodian will constitute additional exposure to the custodian and that this exposure cannot exceed 20% if combined with deposits held with the custodian.