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Filed Electronically

Ms. Nancy M. Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Proposed rules regarding Exchange-Traded Funds ("ETFs")
Investment Company Act Release No. 28193
File No. S7-07-08

Dear Ms. Morris:

The Vanguard Group, Inc. ("Vanguard") appreciates the opportunity to comment on the Securities and Exchange Commission's recent release proposing new rules and amendments to existing rules to accommodate the operation of ETFs (the "Proposing Release").[1] Vanguard is the sponsor and manager of more than 150 mutual funds, with assets of approximately $1.3 trillion. Vanguard issued its first ETF, Total Stock Market Index ETF, in 2001. As of May 31, 2008, Vanguard offered thirty-seven ETFs with total assets in excess of $50 billion. Each of Vanguard's ETFs is structured as a separate share class of an open-end investment company that offers at least one class of conventional – *i.e.,* not exchange-traded – shares.

As a general matter, Vanguard believes that the Commission should facilitate the introduction of new and innovative investment products that benefit investors. The Investment Company Act clearly affords the Commission that flexibility when a new product, like the ETF, is consistent with the public interest and the protection of investors. The time is right to make use of this regulatory flexibility with respect to ETFs through adoption of an exemptive rule, as the Commission did in 1983 with money market funds and Rule 2a-7. ETFs have now been operating for more than fifteen years and, as of May 31, 2008, have gathered more than $600 billion in assets. The Commission and investors have had ample time to familiarize themselves with ETFs, and the product has become thoroughly integrated into the investing practices of retail and institutional investors. Accordingly, Vanguard enthusiastically supports the initiatives set forth in the Proposing Release, although we recommend some changes. Our major comments are:

- We support adoption of a rule, like proposed Rule 6c-11, that will permit sponsors to offer new ETFs without the necessity of procuring an exemptive order from the Commission.

[1] Investment Company Act Release No. 28193 (March 11, 2008).

  - However, as applied to index ETFs, we strongly oppose the requirement to publish security holdings daily. Such disclosure has the potential to harm fund shareholders. It is inappropriate for the Commission to encourage funds to adopt a potentially harmful practice by making it a condition of an important exemptive rule. The benefit of daily holdings disclosure is the promotion of efficient arbitrage, and for index funds that result can be (and currently is being) achieved through other means.
  - We recommend deleting from the definition of "creation unit" the requirement that a creation unit be reasonably designed to facilitate arbitrage because the requirement is vague. It also is unnecessary because market forces impel ETF sponsors to design creation units that facilitate arbitrage.

- We support the amendment of Form N-1A to include provisions that apply specifically to ETFs. In particular, we support changing the focus of ETF prospectus disclosure from the few institutional investors who transact directly with the fund to the overwhelming majority of investors, including retail investors, who purchase ETF shares on the secondary market.
  - We do not support elimination of the requirement that index-based ETFs compare their performance to that of a broad-based index.
  - In order to have consistent disclosure for all ETFs, we recommend that the definition of ETF in Form N-1A be modified to include all ETFs, not just those that are fully transparent.

- We applaud the Commission's willingness to liberalize, in proposed Rule 12d1-4, the conditions for allowing funds to acquire ETF shares in excess of the limits provided in Investment Company Act Section 12(d)(1) and we support adoption of the rule with some minor modifications of those conditions. In addition, we strongly recommend that the rule be made available to all ETFs, not just those that are fully transparent, and we urge the Commission to clarify the scope of Rule 12d1-4 by stating unambiguously that it will apply to acquisitions of ETF shares by unregistered as well as registered investment companies.

I. Comments on Proposed Rule 6c-11

Vanguard wholeheartedly supports adoption of a rule that will permit sponsors to offer new ETFs without the necessity of procuring an exemptive order from the Commission.

A. Daily holdings disclosure/transparency

As proposed, Rule 6c-11 would require an ETF either (a) to disclose its portfolio holdings daily on its website, or (b) if it is an index fund, to track a target index whose sponsor discloses the index constituents daily on its website.[2] Hereafter, we refer to such funds or indexes as being "fully transparent."

➢ Index transparency

Vanguard opposes limiting the availability of Rule 6c-11 to index ETFs that track fully transparent indexes. Some index providers make only limited disclosure of index constituents and place similar limits on disclosure by funds that track their indexes. In addition, fully transparent indexes will not have the desired effect of facilitating arbitrage for index ETFs that sample rather than replicate.

➢ Fund transparency

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[2] Proposed rule 6c-11(e)(4)(v).

Vanguard supports the requirement of daily holdings disclosure for actively managed ETFs but opposes it for index ETFs.

The proposed requirement to disclose fund holdings daily is based on the premise that full transparency promotes effective arbitrage, which should help keep premiums and discounts small and spreads narrow. Although full transparency has these beneficial effects, the same results can be – and in fact are being – obtained by index ETFs offered by Vanguard and others that are not fully transparent. Moreover, the Commission has acknowledged that frequent holdings disclosure can harm fund investors.[3] To avoid this harm, and in light of index ETFs' demonstrated history of effective arbitrage even in the absence of full transparency (discussed below), we urge the Commission to eliminate the requirement that index ETFs disclose their holdings daily.

We are cognizant of the Commission's concern that lack of full transparency theoretically could impede the efficiency of the arbitrage process and lead to wider bid-asked spreads on ETFs. However, years of market experience demonstrate that a well-constructed basket whose performance closely tracks the performance of an index ETF promotes efficient arbitrage even in the absence of full transparency. Vanguard's real-world experience is instructive. None of Vanguard's ETFs are fully transparent, yet the spreads on these funds are quite narrow.[4] In addition, the market prices of Vanguard ETFs typically are extremely close to NAV and the tracking error of Vanguard ETFs in most cases is equal to or lower than comparable ETFs that are fully transparent.[5] Clearly, the lack of full transparency has not materially impeded the ability of institutional investors to effectively arbitrage Vanguard ETFs or the ability of market makers and specialists to maintain organized markets featuring narrow spreads.

The ETF exemptive orders the Commission issued to Vanguard do not require daily holdings disclosure. In fact, such disclosure is prohibited under the index license agreements for most of Vanguard's thirty-seven ETFs. Even those Vanguard ETFs that are not so constrained by license agreements do not provide daily holdings disclosure because Vanguard believes that such disclosure would promote "front-running" that is detrimental to the funds and their shareholders.

Although often associated with actively managed funds, front running can be a concern for index funds as well. Professional traders know that index funds have to buy and sell securities in response to publicly announced corporate actions and index reconstitutions. The portfolio managers for Vanguard's index funds work hard to trade securities in a manner that will thwart the efforts of professional traders to front-run the funds' trades. If those funds disclosed holdings daily, the managers' efforts would no longer be effective. In addition, Vanguard is very concerned that daily holdings disclosure would permit sophisticated institutional investors to "reverse engineer" our trading processes and allow them to front-run our index funds with impunity.

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[3] In 2004, announcing adoption of Form N-1A changes requiring funds to disclose portfolio holdings quarterly rather than semi-annually, the Commission said: "We have determined to adopt the proposed requirement for quarterly disclosure of portfolio holdings with a 60-day delay. We are not requiring more frequent portfolio disclosure, or a shorter delay, because we take seriously concerns that frequent portfolio holdings disclosure and/or a shorter delay for the release of this information may expand the opportunities for predatory trading practices that harm fund shareholders." *Final Rule: Shareholder Reports and Quarterly Disclosure of Registered Management Investment Companies,* Investment Company Act Release No. 26372 (Feb. 27, 2004).

[4] Most of Vanguard's domestic stock ETFs have spreads of 10 basis points or less. Depending on the fund, our international stock ETFs have spreads that typically range between 5 and 15 basis points, while our bond ETFs have a broader range that can go from below 10 to approximately 25 basis points.

[5] Information about premiums and discounts and performance versus target index are available for every Vanguard ETF at www.vanguard.com.

For the reasons set forth above, Vanguard believes that making Rule 6c-11 unavailable to index ETFs that do not or cannot disclose their full portfolios every day unnecessarily slows the introduction of such ETFs without material compensating benefit to the public.

Actively managed ETFs are a different matter, and for these ETFs we support the Commission's proposal to require daily holdings disclosure. Neither the Commission staff nor the market has experience with actively managed ETFs that are not fully transparent, and it is unclear whether the arbitrage mechanism for all such ETFs will operate successfully to maintain narrow spreads without full transparency. In the absence of real world data demonstrating the effectiveness of basket construction techniques for active ETFs, we think it best to proceed through the exemptive process. This will allow the Commission staff the opportunity to consider the level of transparency and its likely impact on arbitrage. As experience with these ETFs accumulates, it may be possible in the future for the Commission to develop standards that can be incorporated into Rule 6c-11.

In contrast to active ETFs, and as noted above, we believe that index ETFs have amply demonstrated their ability to construct baskets that promote effective arbitrage, and so we urge the Commission to eliminate the requirement in proposed Rule 6c-11 that an index ETF disclose its portfolio holdings daily. For index ETFs, the objective of effective arbitrage can be accomplished without the potential disadvantages of full transparency.

B. Creation Unit size

Vanguard agrees with the Commission's decision not to set a specific minimum or maximum number of shares in a creation unit. However, we disagree with the requirement, incorporated in the proposed definition of "creation unit," that each ETF establish a creation unit size that is "reasonably designed to facilitate [arbitrage]." This standard seems vague and we are uncertain how an ETF would document compliance with the standard. In our view, it is unnecessary for the rule to address the issue of creation unit size.

The Proposing Release expresses concern that a low creation unit size would make the ETF look just like a traditional mutual fund, except that its shares would trade on an exchange. For the vast majority of ETFs, the use of an in-kind creation/redemption process with baskets containing dozens or hundreds of securities effectively requires that creation units have a very high dollar value. Even conceding that a handful of ETFs might establish all-cash baskets with extremely low minimums, we fail to see how this would cause harm to the ETF or its shareholders.

The Proposing Release also expresses concern that a high creation unit size could reduce the willingness or ability of arbitrageurs to engage in creation unit purchases or redemptions, potentially disrupting the arbitrage process and causing higher premiums or discounts. Precisely because a creation unit size set too high could impede arbitrage (and therefore the success of the ETF), while offering no countervailing advantages, an ETF would have no incentive to set such a high threshold.

C. Use of Summary Prospectuses

Vanguard supports the Commission's proposal to phase out the Product Description and instead allow the use of the summary prospectus as the primary disclosure document for retail investors.

II. Amendments to Form N-1A

The Commission proposes several amendments to Form N-1A that are designed to make the prospectus a document tailored to the needs of retail investors who purchase ETF shares in the secondary market rather than the

needs of institutional investors who purchase shares directly from the ETF. We support this approach. It is our experience that Authorized Participants and other institutional investors who purchase and redeem creation units do not use the prospectus or statement of additional information ("SAI") as a primary source of information, particularly about the creation/redemption process and attendant transaction fees. Vanguard, like most ETF sponsors, communicates with large institutional investors through (a) internal and external wholesalers and other employees dedicated to the needs of such investors; and (b) informational and marketing pieces directed specifically to such investors. Accordingly, re-focusing the prospectus as proposed should benefit retail investors without restricting the flow of information to institutional investors.

A. Definition of "Exchange-Traded Fund" in Form N-1A

The Commission is proposing to add a definition of "Exchange-Traded Fund" in the General Instructions to Form N-1A, as follows: "'Exchange-Traded Fund' means a Fund whose shares are traded on a national securities exchange *and satisfies the criteria set forth in rule 6c-11(e)(4)*." [emphasis added] Among other things, paragraph (e)(4) of Rule 6c-11 requires an ETF to be fully transparent or be an index fund that seeks to track a fully transparent index. Whether or not the Commission sees fit to modify paragraph (e)(4) before adopting Rule 6c-11, as we recommend in Part I.A of this letter, we strongly urge the Commission to modify the definition of "exchange-traded fund" in Form N-1A to de-link it from the definition in Rule 6c-11. If the definition in Form N-1A is not modified, the disclosure requirements proposed to be added to Form N-1A would not apply to ETFs that are not fully transparent (or are otherwise unwilling or unable to satisfy the criteria set forth in Rule 6c-11(e)(4)) and that rely instead on exemptive orders issued by the Commission. We assume this is not the Commission's intention, and therefore recommend that the definition of "Exchange-Traded Fund" in Form N-1A be modified to cover all ETFs, whether or not they are fully transparent.

B. Omission of information about how to create and redeem

We agree with the Commission's proposal to remove from the prospectus information about the creation and redemption process and associated fees. Retail investors will not be creating or redeeming, so this information potentially could confuse them. Furthermore, retail investors do not need to understand the creation/redemption process in order to make an informed investment choice. Finally, it is generally agreed that retail investors prefer streamlined disclosure of key information to a dissertation that includes "everything you ever wanted to know" about a fund.

C. Comparative index

The Commission is proposing to change the requirements regarding how index ETFs compare their performance to an index. Regardless of where the Commission ultimately comes out on this issue, Vanguard believes that whatever standard is applied to index ETFs should apply equally to all index funds. With respect to index performance comparisons, we see no basis for distinguishing between index ETFs and index funds generally.

Form N-1A currently requires all funds, whether index or actively-managed, to compare their performance to "an appropriate broad-based securities market index." Item 2(c)(2)(iii). The form also "encourages" funds to compare

their performance to "other more narrowly based indexes that reflect the market sectors in which the Fund invests." Instruction 6 to Item 22(b)(7); see also Instruction 2(b) to Item 2. The Commission is proposing to amend the prospectus and annual report requirements of Form N-1A to require an index-based ETF to compare its performance to its target index rather than a broad-based index. Because index funds are judged in part on their tracking ability, Vanguard agrees that a performance comparison to the target index is important and should be required for all index funds. However, we do not support dropping the requirement that index funds compare their performance to a broad-based index. To the extent such a comparison helps an investor make an informed investment decision, it is no less useful in the context of an index fund than an actively managed fund.

III. Proposed Rule 12d1-4

Proposed Rule 12d1-4 permits an investment company to acquire ETF shares in excess of certain limits specified in Section 12(d)(1)(A) if certain conditions are met. The conditions incorporated in the proposed rule are significantly less burdensome than the conditions imposed in exemptive orders previously issued to ETF applicants, and we generally support them, except as noted below. We applaud the Commission for its willingness to reconsider these conditions.

A. Conditions of Proposed Rule 12d1-4

One of the conditions of Proposed Rule 12d1-4 would prohibit an ETF (and certain related parties) from redeeming shares that were acquired by another fund in reliance on the rule. In the Proposing Release the Commission acknowledged that it would be difficult for an ETF to know whether a redemption order is submitted by a fund that relied on the rule, so the rule includes a safe harbor that permits the ETF to rely on a representation from the redeeming fund. The problem with this approach is that only Authorized Participants are eligible to redeem directly with an ETF. An ETF would have no way to know if the AP was redeeming as agent on behalf of a fund, let alone on behalf of a fund that relied on Proposed Rule 12d1-4 to acquire the shares. Accordingly, we recommend that this provision be deleted. No harm would come from the deletion because the rule would still prohibit the acquiring fund from redeeming shares it had acquired in reliance on the rule.

Another condition of Proposed Rule 12d1-4 would essentially prohibit the ETF from investing more than 10% of its assets in other investment companies as well as 3(c)(1) and 3(c)(7) companies. We are concerned that this condition could inadvertently trip up an ETF that normally does not invest more than 10% of its assets in other investment companies but may do so in rare circumstances. For example, although every Vanguard ETF ordinarily invests substantially less than 10% of assets in other ETFs, they all reserve the right to exceed that limit – temporarily – when doing so is in the fund's best interest.[6] We recommend that the rule as adopted include some accommodation for temporary holdings of other investment companies above the 10% threshold.

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[6] The following language (or something substantially similar) appears in the prospectus of each Vanguard ETF: "The Fund may temporarily depart from its normal investment policies and strategies when doing so is believed to be in the Fund's best interest, so long as the alternative is consistent with the Fund's investment objective. For instance, the Fund may invest beyond the normal limits in derivative or ETFs that are consistent with the Fund's objective when those instruments are more favorably priced or provide needed liquidity, as might be the case when the Fund receives large cash flows that it cannot prudently invest immediately."

B. Definition of "Exchange-traded fund" in Rule 12d1-4

Proposed Rule 12d1-4 contains a definition of "exchange-traded fund" that, like the definition in Form N-1A discussed above in Part II.A, is tied to the requirements of paragraph (e)(4) of Rule 6c-11. This definition will put non-transparent ETFs at a competitive disadvantage because such ETFs will not get the benefit of Rule 12d1-4. Non-transparent ETFs will have to procure a separate 12(d)(1) exemptive order from the Commission, causing them to incur additional time and expense. And those ETFs that have already received a 12(d)(1) exemptive order would have to continue abiding by burdensome conditions that proposed Rule 12d1-4 eliminates, or submit a new exemptive application.

To address this discrepancy in how different ETFs would be treated under Rule 12d-14, we recommend that the rule's definition of "exchange-traded fund" be modified to cover all ETFs, whether or not fully transparent.

C. Scope of Proposed Rule 12d1-4

As proposed, Rule 12d1-4 would permit an "investment company" to acquire ETF shares in excess of the limits specified in Section 12(d)(1). The rule's use of the term "investment company" rather than "registered investment company" means that the exemption should apply to 3(c)(1) and 3(c)(7) companies (hereafter, "private funds") and to foreign investment companies. However, in discussing the scope of the rule in the Proposing Release, the Commission appears to take the position that it would apply only to *registered* investment companies, stating: "Proposed rule 12d1-4 would permit open-end and closed-end management companies (including business development companies) and UITs that comply with the rule's conditions to invest in ETFs beyond the limits of section 12(d)(1)."[7] Informally, we have heard that the Commission staff believes the new rule would be limited to registered entities.

The discrepancy between the text of the proposed rule and the discussion in the Proposing Release needs to be clarified. We urge the Commission to retain the language of the rule as proposed and to state unequivocally in the adopting release that the rule will apply to all investment companies, registered or unregistered, including hedge funds and foreign funds. The Commission has provided no explanation as to why the rule should exempt only registered funds and we can think of no reason for the distinction. Proposed Rule 12d1-4 contains conditions designed to address the abuses that historically were associated with funds-of-funds arrangements and that led Congress to enact Section 12(d)(1), such as pyramiding and the threat of large-scale redemptions. Those conditions will effectively address such abuses whether the acquiring fund is a registered fund or an unregistered fund.

Unregistered investment companies, particularly private funds, invest frequently in ETFs, presumably because ETFs provide a simple and inexpensive way for such funds to gain liquid exposure to a defined market segment. Allowing unregistered funds to increase their ownership of ETFs will demonstrably benefit ETF shareholders. The ETF industry is very price competitive, and economies of scale from additional assets are likely to lead to lower expense ratios. The additional trading volume generated by unregistered funds is likely to lead to narrower spreads and, by generating more creations and redemptions that help to lower unrealized capital gains, greater tax efficiency. In light of these benefits, and the lack of any countervailing argument, we believe the public interest would be enhanced by permitting unregistered investment companies to acquire ETFs to the same extent as registered investment companies.

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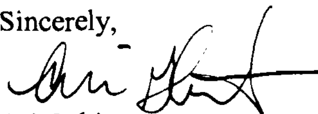
[7] Proposing Release, Part IV.C.1, at page 78.

We commend the Commission for addressing the need for specific ETF rules and disclosure and appreciate the opportunity to comment on the proposals. If you have any questions about Vanguard's comments or would like any additional information, please contact me at (610) 503-5663 or Barry Mendelson at (610) 503-2398.

Sincerely,



Ari Gabinet
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