ADMINISTRATIVE PROCEEDING
FILE NO. 3-5281

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

THE VANGUARD GROUP, INC., et al. :

SUPPLEMENTAL INITIAL DECISION

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Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: Fred C. Aldridge, Jr. and Philip J. Fina, of Stradley, Ronon, Stevens & Young, for applicants.

Gerald Osheroff, Arthur J. Brown, Alan C. Porter and W. Randolph Thompson, for the Commission's Division of Investment Management.

Fred Lowenschuss and William D. Parry, of Fred Lowenschuss Associates, for Joseph Silberman.

Richard M. Phillips, of Hill, Christopher and Phillips, P.C., and James L. Walters, for Wellington Management Company.

William J. Kennedy, Allan S. Mostoff, Paul G. Haaga, Jr. and F. Hastings Griffin, Jr., of Dechert Price & Rhoads, for the independent directors of the Vanguard Funds.

BEFORE: Max O. Regensteiner, Administrative Law Judge

In an initial decision filed on December 1, 1978, I denied an application by The Vanguard Group of Investment Companies ("the Funds" or "the Group") and The Vanguard Group, Inc. ("Vanguard"), their jointly owned subsidiary, for authorization of proposed internalized distribution arrangements. That determination was based on my finding that the allocation of distribution expenditures among the Funds on an asset-related basis did not meet the fairness standards inherent in Section 17(d) of, and Rule 17d-1 under, the Investment Company Act. Pursuant to an interim exemption granted by the Commission, pending final determination with respect to the application, applicants had internalized distribution in October 1977, using an asset allocation method, and have been operating on that basis ever since.

The initial decision suggested that applicants be given an opportunity to amend the application to overcome the defects found in the asset-related allocation method. Applicants thereafter moved for permission to amend the application by putting forward a different allocation formula. They also requested the opportunity to present evidence in support of the revised proposal. The Commission granted these requests. It remanded the proceedings to me for the taking of additional evidence with respect to that proposal and for the submission of a supplemental initial decision.[1/]

1/ The Commission had previously granted applicants' request to postpone the date for the filing of petitions for review of the initial decision until 15 days after service of a supplemental initial decision.

Accordingly, supplemental hearings were held, during which the new formula and the Funds' operations under internalized distribution were examined in considerable depth. Thereafter, supplemental proposed findings and/or briefs were submitted by the parties and by the participants other than Wellington Management Company ("WMC").2/

Recent Developments in the Vanguard Complex

Reference is made to my earlier decision for a description of the background, evolution, composition and management of the Vanguard complex, as developed in the record of the earlier hearings. For the most part, the matters discussed there will not be repeated here. At the supplemental hearings, evidence was presented regarding a number of recent developments and the functioning of the internal distribution system, which had been in its infancy at the time of the original hearings.3/

My earlier decision stated that the Vanguard Group then consisted of 14 funds. Actually, the number had been

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2/ WMC's counsel had stated prior to the supplemental hearings that WMC would not participate if the hearings were limited to issues pertaining to the revised allocation formula. I indicated that they would be so limited. Although WMC's counsel attended the hearings, he did not participate therein.

3/ Certain of these matters had been reported by applicants in submissions made following the original hearings.

reduced to 13 shortly before issuance of that decision by the merger of Trustees' Equity Fund into Windsor Fund. That number has remained constant. However, earlier this year Allstate Enterprises Stock Fund, an "outside" Fund with net assets of $131 million at December 31, 1978, was merged into W.L. Morgan Growth Fund, one of the Vanguard Funds.

As noted in my prior decision (p. 5), the composition of the boards of directors (or trustees) of the Funds and Vanguard has changed since the time of the earlier hearings. The principal change is that since August 1978, Robert W. Doran, WMC's president, no longer serves as a Fund director. The Fund and Vanguard boards now consist of John L. Bogle, president and chief executive officer of the Funds and Vanguard, and seven independent directors.

The year 1978, the first full year of internalized distribution, saw a significant increase in complex-wide sales of new shares. Such sales (excluding exchanges and reinvested income) totalled $269.6 million, as compared to $122.6 million in 1977; representing the largest sales total since 1967. Redemptions also increased, from $265.4 million to $302.4 million. Three Funds, Warwick Municipal Bond Fund, Windsor, a large common stock fund stressing capital appreciation, and Whitehall Money Market Trust, accounted for the bulk of the sales increase. Warwick, the newest of the Vanguard Funds, alone had sales of over

$86 million. As discussed below, however, sales of Warwick and Whitehall shares have certain distinctive characteristics. Wellington Fund's sales continued at a minimal level in 1978, totalling $1.3 million. At year-end 1978, the Vanguard Group's net assets were $1.9 billion, as compared to $1.8 billion a year earlier. In order of magnitude, the individual Funds' net assets were (in millions of dollars): Wellington, 640; Windsor, 599; Ivest Fund, 152; Wellesley Income Fund, 123; W.L. Morgan, 82; First Index Investment Trust, 66; Gemini Fund, 60; Warwick, 55; Whitehall, 53; Westminster Bond Fund, 47; Qualified Dividend Portfolio II (QDP II), 19; QDP I, 13; and Explorer Fund, 10.

Figures for the first quarter of 1979 show a further substantial sales increase for the Vanguard Group, compared to the same period in 1978. The increase was attributable principally to Whitehall and Warwick. For the full year 1979, applicants project sales of about $350 million, including a total of $205 million for Whitehall and Warwick.

Distribution expenditures of a marketing and promotional nature ("marketing expenses") for the Group were $966,000 for the 12 months ended September 30, 1978, the first year of internal distribution, and $960,000 for calendar year 1978.[4/]

4/ The above figures and figures subsequently referred to as marketing expenses do not, except where otherwise indicated, include distribution expenses of an administrative nature. These expenses, which were also assumed by the Group when distribution was internalized, are no longer accounted for separately and, like other administrative expenses, are allocated among the Funds essentially on an asset-related basis.

These amounts were slightly below the budgeted figures. Somewhat higher marketing expenses, in the amount of $1,286,000, are budgeted for 1979. Based on projected average 1979 net assets of about $2.1 billion, this would represent a ratio of marketing expenses to assets of .062%, as compared to a ratio of .052% for the previous year. Both in the past and as projected for 1979, the major portion of the Group's marketing expenditures are and will be used for the promotion of Warwick, Whitehall and Windsor. Wellington accounts for only an insignificant portion.

Effective August 1, 1978, new investment advisory fee schedules went into effect for seven Funds. Based on December 31, 1977 assets, the new schedules provided for reduced fees for Wellington (in the amount of about $450,000), Ivest ($50,000), Wellesley ($78,000), Westminster ($37,000) and Whitehall($5,000), or a total of about $620,000. The new schedules for Windsor and Gemini, on the other hand, resulted in moderate increases. Based on year-end 1978 assets, the reduction for Wellington, with significantly lower assets, was somewhat higher($465,000); that for Whitehall, which had significantly higher assets, was substantially greater ($52,000).5/ In connection with

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5/ The reductions for the other three Funds were not significantly changed.

the Morgan-Allstate merger, WMC agreed to enter into a new advisory agreement with Morgan providing for a reduction in the advisory fee rate.

The Revised Allocation Formula

After the Division, in its original brief, had urged that the relative asset method of allocating distribution expenses was unfair and had proposed in its stead a formula basing only half of the allocation on assets and the other half on relative sales volume, applicants, while continuing to maintain that the asset-based formula met the standards of the Investment Company Act, began intense consideration of alternatives. They deemed the Division's proposal unworkable, concluding, among other things, that it would result in unacceptably high expenses for new or growing funds. Many alternative formulae developed by the Vanguard staff were considered by the Funds' directors. Following issuance of my decision, applicants decided upon the Vanguard Modified Formula ("VMF") for allocating marketing expenses. It is the VMF for which approval is now sought.

The VMF provides that marketing expenses will be allocated among the Funds (other than Gemini which is a closed-end company) on a quarterly basis in the following manner:

1. 50% on the basis of relative average month-end assets during the preceding quarter; and

2. 50% on the basis of relative sales during the preceding 24 months, [6/] provided, however, that no Fund's aggregate quarterly contribution, expressed as a percentage of its assets, may exceed 125% of the average expenses for the Group, expressed as a percentage of the Group's total assets. Where a Fund's marketing expense allocation reaches the "cap," any excess is to be allocated on an "iterative" basis among Funds which have not reached the cap. First Index's contributions would still be subject to the limitation described in the earlier decision (at p. 12).

Applicants propose that approval of the amended application be conditioned on (1) an annual review and evaluation of the joint distribution arrangements by the independent directors on behalf of each Fund, in substantially the same manner and under substantially the same conditions as Section 15(c) of the Act imposes for the review and evaluation of investment advisory agreements,[7/] and (2) the filing of annual distribution reports containing specified data.[8/] Presumably, applicants' consent to a

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6/ The issuance of shares pursuant to a "reorganization," as defined in Section 2(a)(33) of the Investment Company Act, would be excluded from the sales computation.

7/ This represents essentially a condition urged by the Division in its original brief and found appropriate in my earlier decision.

8/ The reporting requirement would terminate in the event of certain Commission actions. See p. 14 of my earlier decision.

condition limiting annual marketing expenses to .20% of average month-end assets is still operative, although that condition was proposed in the context of a formula which, unlike the one now under consideration, assessed a uniform percentage of assets against each Fund.

Summary of Parties' Contentions

Applicants, with the support of the independent directors, urge that the distribution arrangements as revised by the VMF will provide a reasonable correlation between distribution assessments and benefits received and are therefore within the range of fairness, as well as being commercially feasible. Particular concerns with respect to Wellington's participation in the joint distribution arrangements are claimed to be reasonably satisfied by the VMF.

While acknowledging that the amended proposal is in some respects an improvement over the earlier one, Silberman urges that it would not obviate the objections which he raised to the original proposal, particularly the conflict of interest inherent in the Vanguard management structure. He further asserts that under the VMF, Wellington would still receive little or no return or more likely even a negative return on its contribution to marketing expenses. Further, he argues that the proposal would be unfair to a majority of the Funds (characterized by him as the "self-

sustaining" Funds) which would be required, for the foreseeable future, to contribute substantially more to the promotion of the other Funds (Warwick, Whitehall and QDP I and II, which he characterizes as the "parasite" Funds) than they can expect to recover in the form of expense savings.

The Division recommends that the amended application be granted, subject to the condition that Gemini be made a participant in the marketing expense allocation arrangements. While concluding that the benefits of the distribution arrangements do not lend themselves to precise quantification, it takes the position that, considering the total package of tangible and qualitative benefits, the VMF reasonably correlates costs with likely benefits. Applicants, in turn, have no objection to Gemini's inclusion in the allocation arrangements.

Findings and Discussion

In discussing the requirements of Rule 17d-1 in my earlier decision, I stated that "in any complex multi-party arrangement such as the one proposed here, absolute equality may be unattainable." (p. 40). I also referred in that decision to "the complexities involved in allocating distribution expenditures fairly among a group of funds with widely disparate characteristics in terms of size and saleability." (p. 69) Having had the benefit of further

evidence and argument as well as further reflection, I now find that those "complexities" are even more far-reaching than I indicated, and that I understated the unattainability of absolute equality.

As discussed more fully below, there are innumerable and constantly shifting variables in the statistics pertaining to the 13 Funds and their interrelationships. The analysis of costs and benefits necessarily involves assumptions and projections of various kinds. Moreover, there are intangible factors which are not quantifiable. The Division now states that in its view the requirements of Section 17(d) and Rule 17d-1 are met if each Fund's participation in the distribution arrangements falls within a reasonable range of fairness. That formulation seems consistent with the one adopted in my earlier decision; it may be the most stringent one that can be applied here.

Objectives and Impact of VMF

According to the amended application, the VMF was designed to (and does) satisfy two major objectives:

1. Unlike the asset-based formula, the VMF would allocate marketing expenses in a manner reflecting significantly the fact that a Fund benefits to a greater degree from the sale of its own shares than from the sale of shares of other Funds in the Group.

2. The allocation must be fair to each Fund and

must be commercially feasible. In particular, applicants state, any method which significantly increased the expense ratios of smaller and growing Funds, or income-oriented Funds, would not be commercially feasible.

In order to meet these objectives, applicants focused on various criteria which any revised formula should satisfy. These included (a) basing the marketing expense allocation significantly on sales; (b) reducing the allocation to large Funds such as Wellington which have no significant current sales; (c) maintaining the Funds' competitively advantageous expense ratios; (d) providing for reasonable predictability of the impact of marketing expenses on each Fund's expense ratio; (e) preserving the Group's ability to organize and market new funds; and (f) preserving for each Fund the savings from prior cost reductions. In addition, it was deemed important that the formula be durable, so as to obviate the need for further applications as a result of changing conditions, and reasonably simple to disclose. Applicants believe that the VMF meets the objectives and satisfies the above criteria.

With respect to the impact of the proposed VMF as compared to that of the existing asset-related formula, applicants point out that under the VMF larger Funds with significant current sales relative to the Group's sales (such as Windsor and Warwick) or small Funds with significant current sales relative to their assets (such as Explorer and the QDP's) would bear an increased portion of the marketing expenses. On the other hand, the VMF would reduce the marketing expenses of those Funds (Wellington, Ivest, Morgan and Wellesley) whose current sales are small relative to their assets and to Group sales. Tables I and II below, which are applicants' exhibits S-11A and 11B,[9] compare existing allocations with what they would have been under the VMF if calculated at December 31, 1978 (Table I) and as projected for year-end 1979 (Table II). In addition to showing the shifts as indicated above, they also show that the major current impact of changing to the VMF would be to shift marketing expenses from Wellington to Windsor. Under the VMF, Wellington's marketing expense would be reduced by 26-28% from current levels and would be the smallest percentage of assets of any of the Funds.

9/ Exhibits offered during the supplemental hearings were given the prefix "S."

TABLE I

	Millions		Allocation of Marketing Costs				
	Assets on 12/31/78	Sales Volume 24 mos. to 12/31/78	Present Formula Dollars	Present Formula Percent	Proposed Formula Dollars	Proposed Formula Percent	Proposed Formula vs. Present
Wellington	$639.5	$ 3.0	$330,295	.052%	$235,852	.037%	$(94,443)
Windsor	598.8	116.9	309,274	.052	386,593	.065	77,319
Ivest	151.8	8.4	78,403	.052	69,173	.046	(9,230)
Morgan	81.6	5.9	42,146	.052	39,559	.048	(2,587)
Wellesley	122.6	8.1	63,322	.052	58,124	.047	(5,198)
Westminster	47.0	10.8	24,275	.052	30,344	.065	6,069
Explorer	10.4	4.8	5,371	.052	6,714	.065	1,343
Whitehall	53.1	74.6	27,426	.052	34,282	.065	6,856
QDP I	13.4	15.1	6,921	.052	8,651	.065	1,730
QDP II	19.2	21.7	9,917	.052	12,396	.065	2,479
First Index[a/]	66.2	26.7	34,192	.052	42,740	.065	8,548
Warwick	55.1	94.9	28,459	.052	35,573	.065	7,114
Total	$1,858.7	$390.9	$960,000	.052%	$960,000	.052%	-0-

a/ Although First Index did not bear its portion of marketing expenses in 1978, applicants included it in the table, in anticipation of its becoming a full participant in the joint distribution arrangements.

TABLE II

	Millions		Present Formula		Proposed Formula		Proposed Formula
	1979 Year-End Assets	24 mos. Sales Volume b/	Dollars	Percent	Dollars	Percent	vs. Present
Wellington	$567.0	$ 4.0	$370,133	.065%	$273,894	.048%	$ (96,239)
Windsor	599.0	120.0	391,022	.065	449,979	.075	58,957
Ivest	128.0	12.0	83,557	.065	77,228	.060	(6,329)
Morgan a/	194.0	16.0	126,642	.065	114,013	.059	(12,629)
Wellesley	114.0	12.0	74,418	.065	70,602	.062	(3,816)
Westminster	50.0	24.0	32,640	.065	40,799	.082	8,159
Explorer	12.0	10.0	7,834	.065	9,792	.082	1,958
Whitehall	98.0	200.0	63,974	.065	79,967	.082	15,993
QDP I	19.0	16.0	12,403	.065	15,504	.082	3,101
QDP II	24.0	24.0	15,667	.065	19,584	.082	3,917
First Index	70.0	24.0	45,695	.065	57,119	.082	11,424
Warwick	95.0	210.0	62,015	.065	77,519	.082	15,504
Total	$1,970.0	$672.0	$1,286,000	.065%	$1,286.000	.065%	-0-

a/ Includes Morgan-Allstate Merger at $120 million.

b/ Represents double the projected 1979 volume.

Based on 1978 figures, its allocation, in terms of asset percentage, would be 71% of the Group average and 57% of the maximum allocation level. Comparable percentages for 1979 would be 74 and 59, respectively.

The tables show the very significant impact of the "cap" in the VMF. Thus, Table I shows that average marketing expenses for the Group, expressed as a percentage of total assets, were .052%. Had the VMF been in effect, no Fund's allocation could have exceeded 125% of that percentage, or .065%. Eight of the 12 Funds included in the Table[10/] would have reached the cap. Table II shows seven Funds reaching the cap of .082% under the assumptions reflected in that Table. No evidence was presented as to what the figures would be without the cap. By my calculations, the 1978 (rounded) allocations on a straight 50% assets - 50% sales formula would have been as follows (compared with what they would have been under the present formula and under the VMF):

10/ Gemini is not included in the tables because it does not presently participate in the payment of marketing expenses and would continue to be excluded under the proposed VMF. The inclusion of Gemini (which as of year-end 1978 had $60 million in net assets and of course had no sales) among the participants in the VMF, as proposed by the Division, would have an insignificant impact on the figures in the tables.

	Present Formula	50-50 Formula	VMF
Wellington	$330,295	$167,040	$235,852
Windsor	309,274	297,600	386,593
Ivest	78,403	48,000	69,173
Morgan	42,146	26,400	39,559
Wellesley	63,322	38,400	58,124
Westminster	24,275	28,800	30,344
Explorer	5,371	8,640	6,714
Whitehall	27,426	105,600	34,282
QDP I	6,921	22,560	8,651
QDP II	9,917	31,200	12,396
First Index	34,192	67,200	42,740
Warwick	28,459	134,400	35,573

The contrast is striking, most notably so with respect to Whitehall and Warwick. Instead of the modest increases from the asset formula which would result for those funds from application of the VMF, under a 50-50 formula marketing expense would be almost quadrupled for Whitehall and almost quintupled for Warwick. The above chart also indicates that, on the basis of 1978 figures, the substantial increase for Windsor under the VMF is due not to its significant sales, as suggested by applicants, but to the cap.[10a/] Thus, while it is true that the VMF is significantly sales-related, the impact of that relationship is greatly diluted by the cap. It seems likely that marketing expenses of the above magnitude would result in unacceptable expense ratios for Funds such as Warwick and Whitehall whose yield is of critical competitive importance. The cap is designed to avoid that result and generally to maintain expense ratios at competitively advantageous levels, considering also that it is impossible

10a/ Based on the figures in Table I, Windsor's percentage of Group assets exceeded its percentage of Group sales. Under such a configuration, an asset-based allocation of course results in a higher assessment than one based 50% on assets and 50% on sales. Table II reflects an even greater disparity between Windsor's assets and sales percentages.

to anticipate the future sales experience of the various Funds and their relationships in terms of sales. At the same time, it is evident that as a result of the cap, the reduction in Wellington's allocation is far less than it would be without the cap.

For reasons also related to expense ratios, applicants deem the cap necessary to preservation of their ability to organize and market new funds. In addition, as previously noted, one of the criteria for a new formula was that it could not eliminate each Fund's "savings" resulting from internalization, in terms of the differential between advisory fee adjustments and distribution costs. Shareholders' approval of internalized distribution had been obtained in 1977 on the representation that there would be net savings. Understandably, applicants believe that a revised expense allocation method which completely eliminated those savings for some Funds would not be palatable to those Funds and their shareholders.

Benefits from Participation in Distribution Arrangements

I turn now from consideration of the proposed new method for allocating marketing expenses to the other side of the coin, the relative benefits to the Funds from internalized distribution. The earlier decision discussed benefits, both tangible and intangible, at

considerable length. But additional evidence has now been adduced, much of it bringing the Funds' operational experience up to date, and new analytical approaches to the measurement of benefits have been introduced.

Applicants contend that implementation of the internalized distribution arrangements provides several quantifiable elements of expense reductions or savings directly attributable to or substantially related to the adoption of those arrangements. These may be logically condensed into three categories of asserted savings. The first consists of savings attributable to the extent to which advisory fee reductions in 1977 and further reductions in 1978 (or increases in the case of two Funds) exceed distribution costs which the Funds would have borne under the VMF. The second relates to savings, in terms of economies of scale, resulting from the Morgan-Allstate merger. And the third category is economies of scale resulting from share sales.

Serious questions have been raised, however, regarding (1) attribution of the first two savings categories to the internalized distribution arrangements, and (2) the methodology of computing economies of scale attributable to share sales.

The Division, relying in part on findings in my earlier decision, contends that attribution of the full

amount of expense reductions resulting from the advisory fee adjustments to internalization of distribution is unwarranted, although it does not dispute the existence of some relationship between the two.

In my earlier decision, I found that the internalization of distribution "in some measure" enhanced the Funds' independence from and their bargaining power vis-a-vis their investment adviser (p. 47). But I also concluded that attribution of the 1977 fee reductions and net expense savings entirely to such internalization was unwarranted (p. 50). In reaching that conclusion, I found, among other things, that the cost of operating a no-load distribution system was much less than that of operating a load system and that reduced fees could have been obtained by switching to a no-load system even without internalization. (p. 50). I also referred to the fact that the Funds had been in a strong bargaining position vis-a-vis WMC since at least 1975 and could have obtained advisory fee reductions aside from any change in the distribution system. (Ibid)

Applicants now indicate their disagreement with my findings concerning the respective costs of different distribution systems. They urge that there is nothing

inherent in a no-load system that makes it cheaper to operate, since such a system can entail significant media advertising expenditures, and that it was internalization and the resulting more cost-effective structure, including the directors' determination to reduce distribution expenditures, which made it possible to obtain both advisory fee reductions and net expense savings. However, Bogle's testimony was in fact to the effect that a no-load system is less expensive to operate. 11/ While theoretically expenditures in such a system are substantially in the control of the distributor, the record shows that upon Bogle's recommendation, the independent directors concluded that a substantial no-load distribution system could be operated at a cost significantly less than that of the then existing system. 12/

Moreover, it should be noted that WMC's willingness to reduce its advisory fees by an amount roughly equal to net distribution expenses that it would no longer have to bear, thus leaving its net income essentially intact, can hardly be viewed as a reflection of the Funds' enhanced bargaining power.

11/ See Tr. 308, 842-44, 877-78. See also applicants' exhibit 11-15, p. 17.

12/ The Vanguard staff advised the directors that expenditures at the level of the initial proposed $1.3 million distribution budget "would make Vanguard a major factor in the no-load field at the outset." (Appl. Exh. 11-15, p. 7).

Unlike the 1977 advisory fee revisions, those in 1978 (which, however, affected only seven of the Funds) were not linked with any structural changes and, at least potentially, should afford considerable insight into the Funds' bargaining position. Bogle described the circumstances leading to the 1978 revisions as follows: In late 1977, he advised the board that the "pure" advisory fees which the Funds then had could be compared to "pure" fees paid by various institutional investors. He reviewed "posted" fee rates of "pure" advisers (i.e., advisers which did not or could not engage in distribution activities), discussed fee rates with a few and actually solicited a bid for advisory services to Wellington. Bogle concluded that the fee schedules of some of the Funds were higher than those available from pure advisers. Armed with that information, and pursuant to the board's directions, he engaged in intense negotiations with WMC. The latter deemed proposed reductions too large and also sought fee increases for Windsor and Gemini. Those Funds have the same portfolio manager and apparently had good investment performance. As noted, fee reductions for Wellington, Ivest, Wellesley, Westminster and Whitehall and fee increases for Windsor and Gemini were agreed upon. Those increases were far smaller than the reductions which had been made in 1977.

According to Bogle, the new fee schedules, at least for Wellington and Whitehall, were structured to provide for further reductions in the light of anticipated asset growth or reduction. For example, in the case of Wellington, where redemptions were expected to continue to exceed sales by a wide margin, the fee schedule was designed to produce increased savings on a declining asset base.13/

Bogle further testified that during the past few years mutual fund advisory fee rates have been generally increasing, and that the five Funds were able to secure the 1978 fee reductions, in important measure, because "we" were able to evaluate advisory fees solely for the provision of investment advise and "unbundled" from functions such as administration and distribution; "that is to say that our independence from the adviser was a critical item if not the overriding element." (Tr. 3903).

The Division contends that there is nothing in the record to contradict the finding in my earlier decision (at p. 50, n. 51) that it was not clear that the 1978 fee reductions could be achieved only because distribution had been internalized. It further argues that the fee

13/ As has been noted, Wellington's advisory fee reductions, in relation to the previous fee schedule, increased by about $15,000 on the basis of year-end 1978, as compared to the higher year-end 1977, net assets.

increases for Windsor and Gemini demonstrate that factors other than increased bargaining power achieved through internalization must have significantly influenced the negotiations.

The earlier finding referred to by the Division, however, has little, if any, significance in the present context. The 1978 advisory fee revisions were negotiated subsequent to the original hearings. Information concerning them was included in applicants' reply brief. Although I accepted that information as part of the record, I ruled that because there had been no opportunity for cross-examination or rebuttal, I would draw no inferences from it unless only a single inference could be drawn. The pertinent information regarding the 1978 revisions has now been put into evidence in the normal fashion and Bogle, subject to cross-examination, has testified concerning them.

The evidence presented concerning the circumstances surrounding the fee adjustments -- limited essentially to Bogle's testimony as summarized above -- lacks the specificity and detail that would have been desirable. For example, the record does not indicate the nature of the "pure" advisory fees that were considered or the bid that was received. It does not indicate whether and in what manner those items or the greater freedom to change advisers resulting from internalized distribution were brought

to bear on the negotiations with WMC. Testimony from a WMC representative involved in the negotiations might have shed much light on the factors that were considered. Nevertheless, the record warrants a finding that the enhanced bargaining power resulting from the Funds' internalized structure, and their ability because of that structure to negotiate with WMC in terms of "pure" advisory fees,using as benchmarks the posted fees of "pure" advisers, had a significant impact on the 1978 fee reductions. That finding is not vitiated by the fact that in the case of two Funds with special characteristics, fees were increased.

However, I fail to understand the logic in applicants' presentation (see applicants' exhibit S-24) comparing the various Funds' percentages of the Group's savings resulting from advisory fee reductions net of distribution expenses which would be assessed under the VMF. Unlike the costs shared by the Funds through Vanguard, advisory fees are not shared by the Funds or allocated among them. Rather, they are evaluated separately for each Fund and are the subject of distinct contractual relationships.

The fact remains that, with the exception of First Index which has no investment adviser and Warwick which began its existence in anticipation of internalized distribution, each Fund has achieved a position of increased independence vis-a-vis its adviser. Moreover, due in

some measure to internalized distribution, the combination of reduced advisory fees (for all Funds except First Index and Warwick) and distribution costs (either under the present asset allocation system or under the VMF) at a level below such reductions provides annual cost savings. As applicants point out, the savings margin is sufficiently large to permit future savings, though of course in smaller amounts, even if marketing expenses were to rise substantially.

Silberman contends that even if Wellington's most recent fee reduction was attributable in part to its enhanced bargaining position vis-a-vis WMC, it does not follow that the same result could not have been achieved under a marketing structure not requiring Wellington to pay "huge amounts to subsidize the advertising and promotion of other funds." (Brief, p. 4). He asserts that Wellington requires little in the way of distribution services and, either on its own or together with other "self-sustaining" Funds, could provide those services. Thereby, he urges, Wellington would achieve the same independence and bargaining power, and yet pay only its own distribution expenses.

It is true that Wellington might be in a better position under a different structure. But the issue before me is whether each Fund's participation in the proposed arrangements falls within a reasonable range of fairness, not whether a different structure might be more beneficial to one or more of the Funds.

The Morgan-Allstate merger, recently consummated, has produced and will produce savings to the Group, as a result of the substantial increase in assets to absorb only modestly higher shared expenses. Because Allstate had a disproportionately large number of shareholder accounts (i.e., the average account size was relatively small), and because the allocation of shareholder account maintenance expenses (equivalent to the transfer agency costs) among the Funds is based (with minor exceptions) on the respective number of accounts, Funds such as Ivest that have relatively small average shareholder accounts derive a higher percentage savings than those with larger average accounts. As a percentage of their year-end 1978 assets, the Funds' estimated annual savings range from .001 for First Index to 0.42 for Ivest.[14/] Wellington's

14/ These figures, derived from applicants' exhibit S-23, were predicated on Allstate assets of $140 million, whereas its assets at the time of the merger had apparently been reduced to about $121 million. But it does not appear that the savings percentages would be materially affected.

percentage of .021, or about $134,000, is slightly above the Group average.

While Bogle acknowledged that Vanguard's promotional efforts had at best a modest impact upon the securing of Allstate as a Morgan merger partner, Allstate's proxy statement soliciting approval of the merger indicates that the Vanguard Group's internalized distribution had some influence on the selection of Morgan by Allstate's management. Yet it would be "stretching things" unduly to find on the basis of that material alone that the savings from the merger are attributable, or even substantially related, to the internalization of distribution.[15/]

Turning now to the benefits which the Funds experience and will experience in the form of economies of scale resulting from the sale of Fund shares, such economies are essentially of two kinds: As to those relatively fixed expenses which are shared among the Funds either on an asset-related basis (comprising most of the "administration" costs such as executive salaries and marketing expenses as presently allocated) or on the basis of number of shareholder accounts (shareholder account maintenance

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15/ I agree with applicants that consideration of the consequences of the merger provides an instructive illustration of the benefits to the Group created by the infusion of assets into any Fund in the Group.

expenses), sales of shares of any of the Funds will cause those expenses to be redistributed over a larger asset and account base and, if material in amount, will almost invariably reduce expense ratios for all the Funds.16/ Secondly, where a Fund's own shares are sold, it will be subject to a reduced effective advisory fee rate once its assets reach or have reached at least the first "breakpoint" in its fee schedule, and its "unique" relatively fixed expenses, including such items as taxes and custodian, legal and audit fees, will be spread over a larger asset base.

At the supplemental hearings, applicants presented tables designed to show first-year savings from economies of scale resulting from share sales. The first of these, received in evidence as exhibit S-18, analyzes the first-year savings generated as a result of actual 1978 sales through the shifting of expenses to the new asset base thus

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16/ It is possible that a Fund whose sales are in the form of many small accounts could be subject to an increased assessment for shareholder account maintenance expenses in relation to its assets.

Moreover, First Index and Warwick do not share the shareholder account maintenance expenses with the other Funds. Instead, they assess a fixed per-account charge directly to their shareholders on a periodic basis.

acquired. Exhibit S-20 analyzes first-year savings to be achieved from projected 1979 sales. Applicants offered additional tables (exhibits S-19, S-19-1 and S-21) which, taking as departure points the first-year savings as computed in S-18 and S-20, were designed to show aggregate returns and the annual rate of return on marketing expenditures over a 15-year period. Because these tables were admittedly very imprecise and reflected questionable assumptions, particularly as to redemption rate figures which were a critical factor in the computations, I declined to receive them in evidence. As a result, the supplemental record does not include longer-term rate of return figures.

In the table which is exhibit S-18, each Fund's expense ratio (aside from marketing expenses) was first calculated based on actual 1978 year-end assets. This is Part I of the table. In Part II, the expense ratio was calculated on the basis of those assets less 1978 sales volume.[17/] The difference in expense ratio, representing

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17/ However, in the case of Whitehall and Warwick, where deduction of 1978 sales volume from year-end assets would have yielded a negative asset figure, the reduction was by the net change in assets during 1978. The "recycling" of money in and out of these Funds is discussed below.

the reduction resulting from 1978 sales, was then applied to the adjusted net assets to arrive at one year's savings resulting from those sales.[18/]

The expense figures used in the table are in part actual figures, in part estimates and in part what was denoted at the hearings as "snapshots in time." For example, in Part I the Group total for shared expenses and other expenses, as well as the individual Funds' other (non-shared) expenses, represent actual 1978 expenses. On the other hand, the table allocates the shared expenses among the Funds essentially on the basis of relative assets and number of shareholder accounts at year-end 1978. Those expenses are thus presented as if assets and number of accounts had been relatively the same throughout the year as they were at year's end. Advisory fees are shown in amounts that would have been paid if each Fund's assets had been the same as year-end assets throughout the year. Part II of the table reflects various estimates and assumptions as to what the expenses would have been given the assumed lower asset figures. For example, it assumes that the Group's total shared expenses

18/ In Part II of exhibit S-18, in the line entitled "Percentage of Change in Expense Ratio," it appears that the figure for Warwick should be 53 instead of 5.3.

(again excluding marketing expenses) would have been the same even if assets had been some $213 million less. Bogle's testimony indicates that that assumption, obviously a major one in the construction of the table, is not unreasonable.

Exhibit S-20, designed to show first-year expense savings from projected 1979 sales, employs basically the same methodology as S-18, except that, being prospective in nature, it reflects projected sales and redemptions and budgeted expenses for 1979.

Table III below, derived from exhibits S-18 (as slightly modified in Bogle's testimony) and S-20, shows, on an individual Fund basis, the first-year savings from share sales, marketing expense as it would have been (or would be) if allocated under the VMF and the percentage relationship between the two:

TABLE III

Fund	First-Year Savings ('000s)		Marketing Expense Under VMF ('000s)		% Recovered First Year	
	1978	1979	1978	1979	1978	1979
Wellington	$102	$141	$271	$274	38	51
Windsor	173	172	375	450	46	38
Ivest	48	59	81	77	59	76
Explorer	5	11	7	10	71	110
Warwick	54	41	34	78	158	52
Morgan	21	27	45	114	46	23
Wellesley	27	35	65	71	41	49
Westminster	14	25	29	41	48	60
Gemini	5	7	0 a/	0 a/	-	-
QDP I	0 b/	0 b/	8	15	0	0
QDP II	6	14	12	19	50	73
Whitehall	41	47	33	80	124	58
First Index	15	17	0 c/	57	-	29
	511	596	960	1,286		

a/ As noted, the VMF as proposed would not include Gemini.

b/ QDP I's expense ratio is guaranteed by WMC. As a result, no expense savings result from sales.

c/ During 1978, First Index was still amortizing its organizational expenses and did not share in the joint distribution expenses.

As applicants point out, the above figures show that Wellington and Warwick, which are at the extreme ends of the percentage recovery spectrum in 1978, are very close to each other in 1979, as a consequence of Wellington's increase from 38% to 51% and Warwick's decrease from 158% to 52%. They further point out that Whitehall's pattern is close to Warwick's and that Windsor decreases from 46% to 38%. Applicants attribute these fluctuations to the following operative factors:

1. As the assets of a large Fund such as Wellington decrease because of redemptions and the absence of significant current sales and become a smaller percentage of total Group assets,[19/] its share of marketing expenses will decrease more rapidly than its economies of scale. Therefore, its percentage return on investment will increase substantially as long as the Group, through sales, maintains or increases its assets.

2. As a large Fund such as Windsor has the same or an increased percentage of total Group assets as a result

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19/ Wellington's projected sales for 1979 are $2 million and its projected net assets at the end of 1979 are $567 million, compared to actual net assets of $640 million at the end of 1978. Total Group assets were $1,919 million at the end of 1978 and are projected at $1,910 million at the end of 1979.

of the sale of its shares, [20/] its share of marketing expenses will increase more rapidly than its economies of scale. Therefore, its percentage return on investment will decrease.

3. As a small and growing Fund such as Warwick or Whitehall with a very substantial portion of Group sales increases in asset size and in its percentage of total Group assets,[21/] its share of marketing expenses will increase much more rapidly than its economies of scale. Therefore, its rate of return will quickly fall into line with rates of return experienced by larger Funds.

Based on the figures in Table III, applicants advance the conclusion that the first year returns on marketing investments are substantial and in addition are reasonably proportionate for each of the Funds with the exception of the initial returns to new or small Funds such as Warwick and Whitehall during their initial period of rapid asset growth when they derive economies of scale at the maximum possible rate. Comparison of the 1978 and 1979 figures, applicants note, shows that the percentage recovery disparity between the well established Funds and the rapidly growing Funds ends quickly.

20/ Windsor's 1978 sales were $73.3 million; its projected 1979 sales are $60 million. Its assets of $599 million as of December 31, 1978 are also its projected year-end 1979 assets.

21/ Warwick's assets are projected to increase from $55 million in 1978 to $95 million in 1979, its sales from $86 million to $105 million. Whitehall's assets are projected to increase from $53 million to $98 million, its sales from $49 million to $100 million.

The Division states that because of conceptual and factual problems with assumptions reflected in S-18 and S-20, similar to those which it previously expressed with respect to the cost-benefit analyses presented by applicants during the original hearings, it does not accept the first-year savings figures. Not all the problems that were raised earlier are pertinent to the calculations in S-18 and 20. The only one specifically noted in the Division's supplemental brief is the treatment of shared expenses as fixed. Bogle acknowledged that in fact there is no such thing as "fixed costs." But I accept his testimony that those expenses are relatively constant over the short run in relation to sales and, as noted above, I find that it was not unreasonable to show them as unchanged in each of the two tables.

Another of the Division's objections to applicants' earlier cost-benefit analyses was that they implied a causal relationship between marketing expenditures and sales, when in fact certain types of sales, such as those to existing shareholders, may in large part not be attributable to such expenditures. Such a relationship is also implied in exhibits S-18 and 20 and Table III. Silberman disputes the existence of a proportional relationship between marketing expenditures and sales.

Bogle testified that "in the long run" there is almost a 100% correlation between marketing expenditures and sales.

(Tr. 3824) He explained that even a reinvesting shareholder presumably became a shareholder in the first instance as a consequence of the marketing effort. It seems clear that a substantial portion of the Funds' sales to existing shareholders, which account for a substantial part of total sales, and some portion of other sales cannot be attributed directly to marketing expenditures. Over the short term, sales of that nature would likely continue even without a sales effort. But in the long term, at least an indirect relationship exists between marketing effort and almost all sales.

While it disagrees with applicants' "savings" calculations as reflected in Table III, the Division deems the relative first-year "recovery" figures there presented a persuasive analytical basis for finding the joint distribution arrangements now proposed to be fair. The Division notes that the range of recovery rates for both 1978 and 1979 is broad, ranging from 38% to 158% in 1978 and from 23% to 110% in 1979. Like applicants, it further notes, however, that the two Funds that lie at the extremes in 1978 -- Wellington and Warwick -- have almost identical recovery percentages on the basis of 1979 figures. At the same time, it points out, the two Funds projected to be at the extremes of the range using 1979 figures fall in the middle of the range using 1978 figures. The Division attributes this

"somewhat unexpected phenomenon" in part to the "self-adjusting nature of the system." (Br. p. 42) As it perceives that system, a Fund with disproportionately high sales in one year will assume an increasing share of expenses because of its higher relative net assets, and *vice versa*. Further, the Division takes the position that qualitative benefits flowing from internalization of distribution, in particular increased independence, should be viewed as accruing equally to each of the Funds and serve to reduce quantitative disparities in the recovery percentages.

Silberman, however, urges that the Division was misled in its reliance on the first-year recovery figures derived from exhibits S-18 and 20. He asserts that those figures result from a fundamental distortion in the exhibits, due principally to their "snapshot in time" approach whereby expense ratios and marketing allocations are determined at an instant in time at the end of the year and then annualized backwards. Silberman asserts that by making the allocations "after the fact," applicants understated the amounts which would have been paid by funds such as Wellington with declining net assets and overstated amounts that would have been paid by growing funds such as Warwick. The result, he asserts, is overstatement of Wellington's and understatement of Warwick's first-year recovery. In this

connection, Silberman's supplemental reply brief includes, as one of numerous tables, a table K-1 which represents a reconstruction of S-20 designed to determine 1979 savings on the basis of figures averaged out over the course of the year. There has been no opportunity for the parties and other participants to comment on the methodology of that table. And I am not in a position to appraise the validity of the figures used. Interestingly, however, the table not only shows a larger marketing expenditure for Wellington than S-20 and a smaller one for Warwick (and Whitehall), but it shows first-year recovery percentages for Wellington, Warwick and Whitehall of 24, 35 and 45, respectively, <u>all</u> of them smaller than those reflected on S-20. And the differences between those figures are of course much smaller than the differences based on 1978 figures as reflected in S-18.[22/] While Silberman's objections to the methodology of S-18 and S-20 appear to have some merit, I am not satisfied that those tables, which are at best imprecise, are materially distorted. And his own table appears to support the conclusion that the differences in first year recovery percentages between Funds such as Wellington, on the one hand, and Warwick and Whitehall, on the other, narrow rather quickly.

22/ Silberman did not reconstruct S-18 on the same basis as S-20.

Silberman presents a further approach to the fairness analysis, a dichotomy between "self-sustaining" and "parasite" funds. As previously indicated, he defines those characterizations in terms of a comparison between (1) the annual amount spent on each Fund's promotion and (2) the amount of its contribution to marketing expenses and (at least in part of his discussion) its contribution to other shared expenses. On the basis of this analysis and 1978 figures, Silberman states that four Funds -- Warwick, Whitehall and the QDPs -- fall into the "parasite" category, in that in each case the amount in category (1) exceeds that in category (2). Of the four Funds, it is Warwick and Whitehall which he sees as presenting the most serious "parasite" problem.[23/] The amount spent on the marketing of those Funds in 1978 was about 6-1/2 times the amount they would have contributed to marketing expenses under the VMF and almost twice their contributions to all shared expenses. Accordingly, Silberman states, the "self-sustaining" Funds are paying far more to subsidize the "parasite" Funds than the benefits being conferred thereby. He further asserts that this subsidization is likely to continue indefinitely, particularly in view of the conflict of

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23/ Indeed, under Silberman's own analysis in his Table F, the QDPs are not "parasite" funds if their total contributions to shared expenses are taken into account.

interest position of the common officers and directors.

In a sense, Silberman's analysis raises the basic question of the propriety of a joint distribution arrangement and whether it is ever appropriate for one Fund in a complex to finance the distribution of shares of another Fund in the same complex. I answered that question in the affirmative in my earlier decision (p. 62). Of course, the arrangement must be found to be fair. The Silberman analysis, which is a kind of simplified one-year return on investment analysis, does not take into account continuing savings after the first year. And, in my judgment, it does not aid as much in the determination of fairness, even on a one-year basis, as the more refined analysis reflected in S-18 and S-20. Moreover, on the basis of applicants' projections for 1979 and taking into account non-distribution shared expenses, Whitehall would in fact be "self-sustaining" that year, within Silberman's definition, and Warwick would be close to it.

To this point, the discussion of economies of scale has been essentially in terms of one-year savings resulting from sales of shares. Savings, of course, almost invariably continue beyond the first year as the new assets continue to absorb a portion of the expenses. The level of savings in subsequent years decreases year by year, however, with the rate of decrease depending on the rate at which the asset base resulting from the sales is diminished.

Normally, redemption rates of the various Funds would provide the basis for determining the durability of sales and the "decay" of savings attendant upon the resulting assets.[24/] However, Warwick and Whitehall, which have assumed vastly more important positions in the complex, in terms of sales and assets, since the original hearings present special considerations and problems. In their sales literature, both Funds stress the ease with which shareholders can withdraw money, including withdrawals by check. And in fact their shareholders withdraw and reinvest with a frequency uncommon to investors in other funds. Computed on the conventional basis (average assets divided by redemptions), both Whitehall and Warwick had 1978 redemption rates in excess of 100%. Yet their net assets increased during the year from $20 million to $53 million (Whitehall) and from $10 million to $50 million (Warwick). Further large asset increases are projected for 1979. Bogle was of the view that because of the "recycling" of money in and out of these two Funds, it made no sense to view redemptions in the conventional

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24/ But since savings result in part from a Fund's own sales and in part from other Funds' sales, and since redemption rates may vary considerably over time, the projection of future savings with any degree of precision is at best an uncertain enterprise. Applicants have acknowledged this throughout the proceedings.

manner. Accordingly, in long-term rate of return computations offered by applicants (S-19 and S-21), a 60% redemption rate was used for Whitehall and a 50% rate for Warwick. Bogle acknowledged that these figures were unsupported by any data and were based solely on business judgment. Because, among other things, there was no substantiation for those percentages and because a Group redemption rate used in computing the rate of return was not sales-weighted (which, however, would have given far greater impact to the uncertain Warwick and Whitehall figures), I rejected the proposed exhibits. The result is that the supplemental record contains no long-term cost-benefit analyses comparable to those admitted in the earlier hearings.

Both applicants and Silberman have constructed longer-term cost-benefit or rate of return analyses and presented them as tables in their briefs. The various tables, especially the ones prepared by Silberman, reflect a wide variety of assumptions. Many of those assumptions are untested. All the tables suffer from the infirmity that there are simply no reliable data concerning the durability of assets produced by sales of Warwick and Whitehall shares. Thus, I do not feel warranted in accepting any of the longer-term return on investment figures even as a rough indication of benefits from share sales.

I do not agree with Silberman that applicants' failure to provide reliable cost-benefit analyses at the supplemental hearings means that they failed to meet their burden of proving the fairness of the proposed arrangements. There are many different considerations that enter into the ultimate fairness determination. Moreover, both Whitehall and Warwick are of recent origin, particularly the latter. Even had applicants compiled and presented detailed historical data as to the durability of their assets, such data would not have provided reliable guides for the future.

Conclusions

The evidence presented at the supplemental hearings demonstrated more clearly than had been previously apparent the difficulty, if not impossibility, of measuring with precision the benefits obtained and obtainable by the various Funds as a result of the joint arrangement and of correlating costs and benefits. Nevertheless, the record as a whole warrants the conclusion that the proposed revised arrangements (putting aside for the moment the question of Gemini's participation) fall within a reasonable range of fairness.

Unlike the original asset-based allocation formula, the VMF would significantly reflect the fact that substantial

benefits of the joint distribution arrangement accrue only to a Fund that sells its own shares. Consequently, costs and benefits would be brought more closely into line. Of course, the cap in the VMF has the effect of limiting the impact of sales differentials among the Funds. The Division notes that since each Fund has its own special characteristics, tangible benefits -- which in the Division's analysis are limited essentially to economies of scale -- are not generated uniformly. It suggests that the cap can be viewed as quantifying the judgment that, when both tangible and qualitative benefits to each Fund are considered, no Fund can reasonably be expected to derive total benefits worth more than 125% of the average benefits to the Group. This theoretical formulation, however, is lacking in statistical support. In my view, the cap can be justified on the bases put forward by applicants, in particular the need to preserve competitively favorable expense ratios for fast-selling yield-oriented Funds such as Whitehall and Warwick whose net assets are still relatively small, and to preserve the ability to organize new funds that would benefit the Group.

As discussed above, it appears that in terms of economies of scale, each Fund is deriving and will derive substantial first-year returns. Warwick and Whitehall are presently deriving substantially greater benefits from their marketing

expenditures than Wellington, at the other end of the spectrum. But as the former two Funds reach greater asset size, their returns on investment will decrease quite rapidly. And their growth will benefit the other Funds. Wellington in particular will increasingly benefit, in terms of maintenance of its presently favorable expense ratio, as it continues to decline in size. Of course, expenditures by the other Funds to promote Warwick and Whitehall and the effect of those expenditures in terms of sales results and durability of assets so produced will need to be subjected to periodic searching review by the directors to determine whether such expenditures continue to be beneficial not only to those Funds, but the others as well.

Finally, it is significant that under existing circumstances each of the Funds (except for First Index and Warwick) has more than offset its proposed distribution expenditures under the VMF with advisory fee reductions, which at least in significant part were attributable to the internalization of distribution. This cost savings is particularly noteworthy in Wellington's case.

The Division urges that approval of the amended application be conditioned on the full participation of Gemini in the funding of marketing expenses. Gemini, as a closed-end company, cannot experience benefits realized by the

other Funds from the sale of their own shares. But it can benefit from economies of scale resulting from sales of the other Funds' shares. And its payments under the VMF would be substantially limited to its proportional part of the 50% of marketing expenses that is based on relative assets.[25/]

Applicants agree that Gemini does benefit from the internalized distribution arrangements and should participate in the marketing expense allocations. Gemini's proposed exclusion from those allocations apparently resulted from a misapprehension regarding the Division position.[26/] Applicants request, however, that any condition requiring Gemini's participation not become effective until after the Gemini shareholders' regular annual meeting next spring, in order to avoid subjecting Gemini to the expense of a special meeting, which would probably exceed the amount of its contribution to marketing expenses during the intervening period.

25/ Because of the cap, Gemini would be subject to a somewhat higher assessment than one based solely on assets.

26/ The Division had opposed Gemini's participation in marketing expense allocations under the original asset-based allocation system. As a result, applicants had amended their application so as to exclude Gemini from participation. In putting forward its subsequent 50% assets - 50% sales formula, however, the Division proposed Gemini's full participation.

It appears appropriate to impose the condition proposed by the Division but on the deferred basis requested by applicants.

Silberman urges that the final order in this proceeding should be made retroactive to October 1, 1977, the date when internal distribution began, so as to recompense Wellington for excess amounts contributed under the unfair asset allocation method. Applicants, the independent directors and the Division oppose imposition of such a condition. Aside from the fact that the Commission has not found the asset allocation method to be unfair, the Commission's temporary exemption order authorizing applicants to proceed with internal distribution under that method is, at least for me, dispositive with respect to the period covered by that order.

Order

On the basis of the above findings and conclusions 27/ and those in the earlier initial decision,

IT IS ORDERED that the amended application pursuant to Section 17(d) of the Investment Company Act and Rule 17d-1 thereunder and the requested exemptions pursuant to Sections 6(c) and 17(b) of the Act are hereby granted.

27/ All supplemental proposed findings and conclusions and contentions have been considered. They are accepted to the extent they are consistent with this decision and necessary to a determination of the issues presented.

The foregoing order is subject to the following conditions:

1. Beginning on the day after its next annual shareholders' meeting, Gemini Fund shall become a participant in the marketing expense allocation based on the Vanguard Modified Formula;

2. No Vanguard Fund may incur annual marketing expenses in excess of .20% of its average month-end net assets;

3. At least annually, the independent directors shall review and evaluate the joint distribution arrangements on behalf of each Fund, in substantially the same manner and under substantially the same conditions as are imposed for review and evaluation of investment advisory agreements under Section 15(c) of the Act;

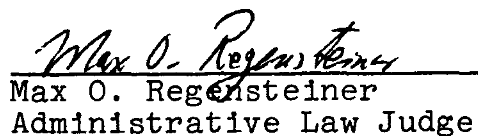
4. The Funds shall continue to file annual distribution reports with the Commission. Each such report filed after the effective date of this decision shall include the Group's total marketing expenses and those incurred by each Fund during the year reported on; sales of each Fund's shares and direct marketing expenditures on its behalf during such year; each Fund's net assets at the beginning and at the end of the year; and the proposed budget of marketing expenses for the next year;

5. No Vanguard Fund shall refer to itself as "no-load"; and

6. The above order is subject prospectively to preemption by any Commission decision on the general subject of mutual fund distribution and the above conditions are subject to termination or relaxation consistent with any rules that may be adopted hereafter by the Commission, all as specified in amendments 4 and 5 to the application.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to that rule, this supplemental initial decision together with the initial decision shall become the final decision of the Commission as to each party or participant which has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the supplemental decision upon it, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review the initial decisions as to it. If a party or participant timely files a petition for review, or the Commission takes action to review as to a party or participant, the initial decisions shall not become final with respect to that party or participant.



Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
October 4, 1979