October 18, 2004

Jonathan G. Katz
Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549-0609

Re: Mandatory Redemption Fees for Redeemable Fund Securities
<u>File No. S7-11-04</u>

Dear Mr. Katz:

The Vanguard Group would like to supplement its comments dated May 10, 2004, on the Securities and Exchange Commission's proposal to require mutual funds to impose short-term redemption fees. Our comments will focus on an important issue that was addressed in several other comment letters submitted on the Commission's proposal: how the rule should apply to transactions processed on behalf of participating employees in 401(k) and other participant-directed retirement plans.

Our comments recommend that the Commission's final rule permit mutual funds to apply redemption fees (whether mandatory or voluntary) in the context of retirement plans only to participant-directed investment exchanges if funds choose to do so, and not to other routine transactions such as plan contributions, participant loans, hardship withdrawals, and termination distributions where there is little opportunity for participating employees to profit unfairly at the expense of other investors.

1. Background

Many comments on the redemption fee rule proposal were filed by organizations that represent employers who sponsor retirement plans and service providers who provide recordkeeping and related services for these plans. The majority of these comments requested that, in the context of a participant-directed retirement plan, the Commission adopt a uniform rule providing that redemption fees only apply to participant-directed investment exchanges, and not to other transactions commonly occurring in retirement plans, such as plan contributions, participant loans, hardship withdrawals, and termination distributions.

The rationale for this position is that only participant-directed investment exchanges provide the opportunity for abusive short-term trading or market timing by participating employees. In the case of other retirement plan transactions such as plan loans, hardship withdrawals, and termination distributions, participating employees are strictly limited by tax law requirements and retirement plan rules in their ability to direct these transactions. Thus, these transactions generally occur infrequently at the individual participant level, and it would be impracticable (if not impermissible) for participants to take excessive numbers of loans or fully taxable hardship withdrawals or distributions for short-term trading or market timing purposes. Similarly, in the case of participant contributions and loan repayments, these transactions are invariably made by regular payroll deduction, where participants have little or no opportunity to control the timing or frequency.

Other comments have suggested that the Commission adopt an opposite uniform rule requiring that redemption fees be applied to all participant-level transactions occurring in retirement plans that result in purchases and sales of mutual fund shares. Under this approach, redemption fees would attach to all underlying retirement plan transactions, including regular payroll deduction contributions, participant loans, hardship withdrawals, and termination distributions, regardless of whether these transactions present any opportunities for short-term trading or market timing by participating employees.

2. Objectives of Proposed Rule

The Commission's Proposing Release explains that the proposed redemption fee rule is designed to reduce the opportunity of short-term traders to exploit other investors in the mutual fund by (1) requiring them to reimburse the fund for the approximate redemption-related costs incurred by the fund as a result of their trades, and (2) discouraging short-term trading of mutual fund shares by reducing the profitability of the trades. According to the Proposing Release, excessive trading can not only disrupt the management of the fund's portfolio and raise the fund's transaction costs, it can also significantly disadvantage long-term investors by diluting the value of their shares (the Release cites one study estimating that hundreds of millions of dollars of dilution costs were caused by market timing in international funds over a 26-month period).

3. Vanguard Recommendations

We appreciate the Commission's efforts to approach the redemption fee issue from the broad perspective of reducing the ability of short-term traders to unfairly disadvantage other mutual fund investors. In that vein, we recommend that the Commission's final rule permit funds to apply redemption fees (whether mandatory or voluntary) in the context of retirement plans only to participant-directed investment exchanges if funds choose to do so, and not to other routine transactions such as plan contributions, participant loans, hardship withdrawals, and termination distributions. Since the primary objective of the redemption fee rule is to reduce the opportunity of short-term traders to profit unfairly at the expense of other investors, funds should be allowed to exempt those routine retirement plan transactions from redemption fees when they present little or no opportunity for exploiting other investors.

If the Commission should be persuaded that uniformity in this area is needed, we believe that a uniform rule limiting the application of redemption fees to participant-directed investment exchanges would be far more consistent with the overall purposes of the rule, and fairer to all fund investors, than a uniform rule requiring the application of redemption fees to any and all transactions regardless of whether they offer opportunities for short-term trading or market timing. Although we question the need for Commission-imposed uniformity, we agree with the comments submitted by employer organizations and retirement plan providers that routine retirement plan transactions should be exempt from redemption fees when they present little risk of abusive or unfair activity.

We appreciate the opportunity to submit comments on this important issue. If you have any questions, please do not hesitate to contact the undersigned.

Sincerely,

/s/ R. Gregory Barton

R. Gregory Barton
Managing Director and General Counsel

cc: The Honorable William H. Donaldson, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel S. Campos, Commissioner
The Honorable Cynthia A. Glassman, Commissioner
The Honorable Harvey J. Goldschmid, Commissioner

Paul F. Roye, Director
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