THE Vanguard GROUP.

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May 10, 2004

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

RE: Mandatory Redemption Fees for Redeemable Fund Securities; File No. S7-11-04

Dear Mr. Katz:

The Vanguard Group[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposal to require mutual funds to impose short-term redemption fees.[2] Vanguard commends the Commission on its effort to act quickly to curtail the activities of short-term traders that may harm mutual fund investors. We support the Commission's proposal to require short-term redemption fees on most mutual funds and offer specific comments on the proposal. In our experience, redemption fees, together with fair value pricing and active transaction monitoring, are very effective in curtailing short-term trading that may harm funds and their shareholders.

We have the following primary comments regarding the Commission's proposal:

- Short-term redemption fees will only be effective to protect investors against the harms of time-zone arbitrage or other market-timing strategies if the fees are applied uniformly in each channel in which the fund is sold.
- While Vanguard has typically imposed much longer-term redemption fees, a five-day holding period would be an acceptable minimum given the Commission's stated objective of applying the fee to all types of funds and

[1] The Vanguard Group, Inc. ("Vanguard"), headquartered in Malvern, Pennsylvania, is the nation's second largest mutual fund firm. Vanguard serves 18 million shareholder accounts, and manages approximately $730 billion in U.S. mutual fund assets. Vanguard offers a wide array of mutual funds and other financial products and services to individual and institutional investors. In addition to serving our clients directly, we have multiple relationships with broker-dealers, banks, third party administrators, insurance companies and other fund intermediaries. We also provide defined contribution recordkeeping services to plan sponsors and offer more than 2,600 non-Vanguard funds through Vanguard Brokerage Services.

[2] SEC Release No. IC-26375A, 69 Fed. Reg. 11762 (March 11, 2004) ("Proposing Release").

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asset classes. However, we believe that a short-term redemption fee will be most effective at achieving the Commission's goals of curbing time-zone arbitrage and other short-term trading strategies if it is applied on a "last-in, first-out" or "LIFO" basis, rather than a "first-in, first-out" or "FIFO" basis.

- Redemption fees should not be mandatory for short-term bond funds of 2.5 years duration or less, and we strongly urge the Commission to exempt these funds from the final rule.[3] Many investors use short-term bond funds for cash management and other short-term financial needs, and due to the nature of these funds' investments, they are not readily susceptible to the harms of short-term trading. In addition, providing an exception for short-term bond funds is a far better way to address the Commission's concerns about investors' access to their money than is the proposed financial emergency exception.

- The proposal to include an exception for financial emergencies should be eliminated from the final rule. It would not only be impractical and costly to administer, but it would not achieve the Commission's stated objective of assisting smaller investors. To the contrary, the proposed exception could provide investors with the impression that it is appropriate to invest money that may be needed in the event of a financial emergency in stock and bond funds that are intended for longer-term investments. The Commission's concerns about small accounts should be addressed through investor education initiatives and prominent disclosure about redemption fees.

- The Commission should require intermediaries to provide fund companies with shareholder account information upon a fund's request, so that fund companies can research transaction activity and evaluate the intermediaries' application of redemption fees.

These recommendations and a number of additional comments are discussed in greater detail below.

I. Redemption fees should apply consistently in all investment channels.

The uniform application of short-term redemption fees across the fund industry will have substantial benefits for funds and investors, and is critical to achieving the Commission's goal of reducing the opportunity of short-term traders to exploit other fund investors. Without a uniform approach to short-term redemption fees across funds that charge the fees and across direct and intermediary channels, investors who perceive advantages to short-term trading will find ways to evade the fee to the detriment of long-

[3] We also agree that money market funds and exchange-traded funds should be exempt from the mandatory redemption fee.

term shareholders. As long as there are "fee-free" channels available for investment through intermediaries, investors who wish to trade rapidly to the detriment of other shareholders will find ways to do so.[4]

The Commission has recognized that many intermediaries are currently unable to deduct redemption fees or have found it impractical to develop the systems and procedures necessary to monitor and enforce multiple trading restrictions. Vanguard, as well as many other firms in the industry, has been working *with* intermediaries and also in its role *as* an intermediary to adopt procedures that will help achieve protections for investors comparable to that of redemption fees. While these efforts to implement effective controls over frequent trading have been somewhat successful on an ad hoc basis, we believe that the industry will never achieve complete success without the SEC's regulatory support. It is not necessary for the fee to be mandatory for all funds,[5] but any short-term redemption fee should be applied consistently to all shareholders in any fund that will be required to assess the fee. If the Commission mandates a consistent approach, intermediaries will be encouraged to develop the systems and procedures required to apply redemption fees to remain competitive.

Consistent rules for applying a short-term redemption fee are necessary to help funds and intermediaries make decisions about how best to commit the capital and human resources necessary to implement redemption fees in all channels. Absent a consistent methodology, fund companies and intermediaries could be forced to implement multiple methods for deducting redemption fees in order to offer multiple funds. Permitting multiple approaches to a minimum short-term fee would needlessly increase the cost and time necessary to achieve the Commission's goals.[6]

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[4] We recommend that the Commission clarify that redemption fees should be charged to the investors that make the investment decisions to purchase and sell shares, rather than to intermediaries that send client orders to funds. As proposed, there is some question regarding whether funds would be required to charge intermediaries for their redemptions. The Commission's intent is to ensure that those who transact through intermediaries pay the same redemption fees as those paid by investors who transact directly with the funds, and the final rule should ensure that fees are charged to the appropriate parties. With respect to 529 plans, individual account holders own municipal securities rather than fund shares, and therefore no redemption fees would apply to 529 plan accounts. We recommend that redemption fees not apply to state trusts that support 529 plans, because they act as intermediaries, rather than as investors who independently make investment decisions.

[5] We specifically recommend that short-term bond funds be excepted.

[6] Adopting a consistent short-term fee requirement should not prevent funds from extending the time period during which the fee would apply. These longer-term fees may be imposed on select funds depending on their investment objectives and strategies, cash flow and additional considerations. The mandatory redemption fee rule should not foreclose the ability of a fund to design longer-term redemption fees that are best suited to the fund's individual circumstances.

II. A LIFO methodology is the most effective methodology for a short-term redemption fee.

The proposed five-day holding period for triggering the short-term redemption fee is an acceptable minimum standard. While certain Vanguard funds have typically imposed redemption fees for longer periods, we agree that a very short-term fee is acceptable given the breadth of funds and asset classes that would be covered by the Commission's proposal. If coupled with a LIFO methodology, a five-day fee would be effective at accomplishing the Commission's goals of deterring market-timing and reimbursing long-term investors for the costs generated by short term traders. We are concerned, however, that a five-day, FIFO based fee will not achieve the Commission's objectives as effectively as a LIFO based fee. Using FIFO with a holding period as short as five days would be unlikely to deter short-term trading, because, as the Omnibus Taskforce recognized, shareholders intent on employing a timing strategy can maintain sufficient balances in their accounts to avoid a FIFO fee.[7] Attached as an Appendix is a chart illustrating how, with a five-day FIFO based fee, substantial sums could be traded in a short period of time without a redemption fee being applied, to the detriment of other fund shareholders. The chart also demonstrates that if the Commission is determined to proceed with a FIFO methodology, it should extend the holding period to at least 30 days to ensure that the redemption fees provide a deterrent to short-term trading.[8]

The Commission proposes a FIFO based fee in part because it believes a FIFO methodology would address concerns about the effect of the proposed fee on shareholders. The Commission has stated that with FIFO, "most transactions normally made by most investors would not be subject to the fee."[9] However, most transactions *normally* made by most investors are not within a five-day period, and therefore would not be affected by a redemption fee, whether it is applied on a LIFO *or* a FIFO basis.[10] A LIFO approach would also substantially simplify the transaction limits and procedures that would be needed to monitor activity that would not be subject to the redemption fee. We believe LIFO provides a simpler and more comprehensive solution, making it a more attractive safeguard for the vast majority of shareholders who generally understand the purpose of the fees and hold their fund investments for a longer term.

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[7] *See* Report of the Omnibus Account Task Force, January 2004, at p. 8.

[8] We note, however, that even a 30-day FIFO fee would not curtail time-zone arbitrage as effectively as a LIFO fee.

[9] Proposing Release, 60 Fed. Reg. at 11765.

[10] Certain transactions should be excepted from redemption fees whether the transactions are reflected on a fund or intermediary system as exchanges or as sales and purchases. These transactions would include non-discretionary transactions such as dividend reinvestments, payroll contributions into employee benefit plans, automatic investments, and scheduled rebalancing transactions. We also recommend that redemption fees not apply to distributions from retirement plans, because these transactions typically do not raise market-timing concerns. Many funds currently except these same transactions from FIFO based redemption fees.

Finally, some have suggested that the cost of switching to or building a LIFO methodology far exceeds that which would be necessary to develop a FIFO methodology. Regardless of the method adopted, a new mandatory redemption fee rule will cause funds, intermediaries, and retirement plan administrators to update their systems at considerable cost. The actual cost to a particular provider will depend on the availability and flexibility of existing systems to deduct redemption fees.

III. The proposed financial emergency exception will not accomplish the Commission's objectives and should not be included in the final rule.

The Commission has proposed requiring funds to forego assessing a redemption fee in the case of an unanticipated financial emergency if the amount of shares redeemed is $10,000 or less. The Commission states that the exception is designed to permit shareholders access to their investment when they need to meet unforeseen financial demands. We disagree strongly with the Commission's approach for the following reasons:

- Redemption fees do not prevent access to one's money. In the case of a five-day, 2% redemption fee, it is difficult to see how investors would be denied access to their funds. First, the fee would only apply to redemptions or exchanges within five days. It is hard to imagine what financial payment need would arise in a five-day period. Even in an emergency situation, few financial commitments must be paid for within five days. Further, the steps necessary to process an emergency exception would significantly extend the time in which the funds could be made available. Second, even if the fee is applied, the investor would receive 98% of his or her funds. This is no different from the penalty that is typically applied in the event of an early redemption of a bank certificate of deposit or certain other financial instruments.

- A financial hardship exemption sends the wrong message to investors about investing in mutual funds with longer-term investment strategies. The SEC and the fund industry should educate investors about the need to maintain a certain percentage of their assets in low-risk, liquid investments to meet short-term financial needs.[11] Money market and short-term bond funds are more appropriate for meeting short-term emergency needs than other types of

[11] *See, e.g.,* "How to Get a Financial Start, Build Your Foundations – Prepare for the unexpected," at http://flagship5.vanguard.com/web/planret/AdvicePTFinStartBuildYourFoundationII.html; "How to Manage Your Retirement, Step 1, Size up Your Situation –Keep Your Emergency Fund Funded," at http://flagship5.vanguard.com/web/planret/AdvicePTManageRetSizeUpYrSituation.html; "Saving, Speculating, and Investing," at http://flagship5.vanguard.com/web/planret/AdvicePTIBInvestingSavingSpeculatingInvesting.html.

mutual funds that are meant for long-term investors.[12] Concerns about investor awareness can be addressed by strong and prominent disclosure about the redemption fee. In addition, the effect on the fund and its remaining shareholders is the same as with other short-term redemptions, making it very difficult for funds to justify exceptions for some events but not others.[13]

- Implementing a financial emergency exemption would pose significant practical and operational problems that have not been fully considered. The cost of implementing and administering a financial emergency exemption could easily exceed the cost to investors of redemption fees paid in accordance with the proposed rule.[14] The Commission underestimates the operational infrastructure and staffing necessary to process financial hardship exemptions. Funds would have to review each request for a financial emergency exemption, follow up with investors by phone in many cases as needed to clarify the request, and determine how the redemption fee should be credited to the client. Fund companies would have no way to confirm the legitimacy of the requests for exceptions based on financial emergencies and long-term fund shareholders may be disadvantaged.

We believe the Commission's concern for smaller accounts would be best addressed by educating investors about the importance of maintaining low-risk, liquid investments for financial emergencies and disclosure about the fee.

IV. The Commission should require intermediaries to provide fund companies with shareholder account information when needed to follow-up on suspicious trading activity.

The Commission proposed three methods for funds to assure that appropriate redemption fees are charged to shareholders who purchase the funds through intermediaries. It is imperative that funds have the ability to monitor compliance with policies for the deduction of fees as well as transaction activity that might not be subject to the fee, but otherwise raise trading concerns. Given the myriad of intermediaries and the diversity of the processing systems and procedures they use, funds must have appropriate tools for monitoring trading activity.

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[12] This is why we strongly support an exception for short-term bond funds that are typically used for cash management and other short-term financial needs.

[13] The Commission recognized this in its release, noting that the costs imposed on long-term investors in funds by the cumulative effect of many smaller short-term traders may be greater than those imposed by a few large traders and that the proposal is designed to recoup these costs. Proposing Release, 60 Fed. Reg. at 11763.

[14] We believe that the cost of processing a single written request for an emergency exemption from a redemption fee would be substantial. Evaluating the request and contacting the shareholder would be a necessary part of each emergency exception. Based on our experience, we would expect that multiple client contacts, at significant cost, would be necessary to resolve a single request.

We agree that funds should be responsible for selecting the appropriate monitoring method, and that funds should have the flexibility to use different methods so that they can achieve the best results for shareholders while working with multiple intermediaries. This flexibility is essential due to different systems and account types used by intermediaries.

The Commission also proposed requiring intermediaries to provide funds with detailed transaction information on a weekly basis to assist funds with monitoring trading activity in accounts that are held on an omnibus basis. It is critically important that intermediaries provide this information to funds when necessary to research suspicious trading activity or evaluate the effectiveness of the intermediary's application of redemption fees. We are very concerned, however, that *required* weekly transmissions will create reams of data that will be costly and complex to reference and store and will quickly overwhelm fund company systems. We strongly recommend as an alternative that intermediaries provide this information upon the fund's request, so that fund companies can research transaction activity in particular funds or perform a specific evaluation of the intermediaries' application of redemption fees.

We appreciate the opportunity to comment. If you would like to discuss these comments further, or if you have any questions, please feel free to contact me, or Sarah Buescher, Senior Counsel.

Sincerely,

/S/ Heidi Stam
Principal
Securities Regulation

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
Robert E. Plaze, Associate Director
Division of Investment Management

John J. Brennan, Chairman and CEO
R. Gregory Barton, Managing Director and General Counsel
The Vanguard Group, Inc.

Appendix

					5 days				30 days			
Transaction Level Data					**LIFO**		**FIFO**		**LIFO**		**FIFO**	
Trade Date	Transaction Code Desc	NAV	Transaction Amt ($)	Transaction Amt (Shrs)	Number of Shares Eligible for Redemption Fee	**Redemption Fee**	Number of Shares Eligible for Redemption Fee	**Redemption Fee**	Number of Shares Eligible for Redemption Fee	**Redemption Fee**	Number of Shares Eligible for Redemption Fee	**Redemption Fee**
12/31/2002	Beginning Balance	81.15	$25,000.00	308.071								
1/15/2003	Purchase	84.75	$25,000.00	294.985								
1/21/2003	Redemption	81.93	($25,000.00)	-305.139	294.985	**$483.36**	0.000	**$0.00**	305.139	**$500.00**	305.139	**$500.00**
2/14/2003	Purchase	77.18	$25,000.00	323.918								
2/20/2003	Redemption	77.41	($25,000.00)	-322.956	322.956	**$500.00**	25.038	**$38.76**	322.956	**$500.00**	320.023	**$495.46**
3/14/2003	Purchase	77.16	$25,000.00	324.002								
3/19/2003	Redemption	80.94	($25,000.00)	-308.871	308.871	**$500.00**	9.990	**$16.17**	308.871	**$500.00**	308.871	**$500.00**
4/14/2003	Purchase	81.78	$25,000.00	305.698								
4/17/2003	Redemption	82.55	($25,000.00)	-302.847	302.847	**$500.00**	0.000	**$0.00**	302.847	**$500.00**	302.847	**$500.00**
5/14/2003	Purchase	86.89	$25,000.00	287.720								
5/20/2003	Redemption	85.1	($25,000.00)	-293.772	287.720	**$489.70**	0.000	**$0.00**	290.571	**$494.55**	282.607	**$481.00**
6/13/2003	Purchase	91.58	$25,000.00	272.985								
6/18/2003	Redemption	93.57	($25,000.00)	-267.180	267.180	**$500.00**	0.000	**$0.00**	267.180	**$500.00**	244.088	**$456.79**
7/15/2003	Purchase	92.47	$25,000.00	270.358								
7/18/2003	Redemption	91.82	($25,000.00)	-272.272	270.358	**$496.49**	0.000	**$0.00**	272.272	**$500.00**	228.640	**$419.87**
8/14/2003	Purchase	91.69	$25,000.00	272.658								
8/19/2003	Redemption	92.8	($25,000.00)	-269.397	269.397	**$500.00**	0.000	**$0.00**	269.397	**$500.00**	225.051	**$417.69**
9/15/2003	Purchase	94.06	$25,000.00	265.788								
9/18/2003	Redemption	96.36	($25,000.00)	-259.444	259.444	**$500.00**	0.000	**$0.00**	259.444	**$500.00**	214.137	**$412.68**
10/14/2003	Purchase	97	$25,000.00	257.732								
10/17/2003	Redemption	96.08	($25,000.00)	-260.200	257.732	**$495.26**	0.000	**$0.00**	260.200	**$500.00**	201.679	**$387.55**
11/14/2003	Purchase	97.25	$25,000.00	257.069								
11/19/2003	Redemption	96.53	($25,000.00)	-258.987	257.069	**$496.30**	0.000	**$0.00**	257.069	**$496.30**	194.878	**$376.23**
12/12/2003	Purchase	99.57	$25,000.00	251.080								
12/17/2003	Redemption	99.8	($25,000.00)	-250.501	250.501	**$500.00**	0.000	**$0.00**	250.501	**$500.00**	187.647	**$374.54**
					Total:	**$5,961.11**		**$54.94**		**$5,990.85**		**$5,321.82**