Vanguard

June 1, 2005

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

RE: Mutual Fund Redemption Fees; File No. S7-11-04

Dear Mr. Katz:

The Vanguard Group[1] appreciates the opportunity to comment on the implementation of Rule 22c-2 under the Investment Company Act of 1940, and the need for standardization of redemption fees.[2] We support the Commission's adoption of a rule that facilitates the ability of funds to charge redemption fees. In our experience, redemption fees, together with fair value pricing and transaction monitoring, are very effective in curtailing short-term trading that may harm funds and their shareholders.

We acknowledge the Commission's considerable effort to evaluate the issues posed by this rule, given the diverse and strong views that a variety of market participants have expressed on the subject. We note, too, that as commenters and the Commission have learned more about these issues and how the new rule would work, views have changed, making this rulemaking effort a moving target, and certainly more difficult than most. Importantly, however, there is complete accord with respect to protecting fund shareholders from the potential ill effects of short-term trading strategies, including market timing. Although we believe the adopted rule requires modification, we believe it can still achieve its objective, given the Commission's willingness to solicit and consider additional comments. We are grateful for the Commission's approach in that regard.

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[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 $820 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 non-Vanguard funds in these plans through the Vanguard Brokerage Services division of Vanguard Marketing Corporation.

[2] *Mutual Fund Redemption Fees,* Investment Company Act Release No. 26782, 70 Fed. Reg. 13328 (March 18, 2005) ("Adopting Release").

As more fully explained below, we are very concerned that the contractual requirements of the rule are unworkable from a practical standpoint and will create significant unintended and detrimental consequences for fund shareholders. These provisions were never formally proposed, so there was no opportunity to review or analyze the operation of the rule in its current form. As a result, we believe that in adopting the rule, the Commission did not have adequate information about the impact of requiring funds to contract with intermediaries.

Vanguard greatly appreciates the opportunity to identify these issues now so that they can be resolved fully prior to the compliance date of the rule. In that regard, we urge the Commission to act quickly to suspend the compliance date or take other action that will allow fund companies to stop the implementation process as soon as possible, so that we do not expend valuable resources identifying and contracting with intermediaries only to find later that this requirement has been revised. Given the scope of the implementation effort required for this rule, we have already begun working towards the October 2006 compliance date and are currently devoting substantial resources to this effort. Indeed, our initial implementation efforts have given us the information needed to formulate the comments expressed below.

The Commission also requested additional comment on whether voluntarily imposed redemption fees should be subject to mandatory standards. We reiterate our previous comments that standardization is not appropriate or necessary in the context of a voluntary fee. Standardization under these circumstances may create significant disincentives to the adoption of redemption fees that might otherwise benefit a fund.

I. The requirement to enter into written agreements with intermediaries is unworkable and should be eliminated or modified.

Rule 22c-2 requires every fund to enter into a written agreement with *each* of its intermediaries by October 16, 2006. Under the contract, the intermediary must agree to (1) supply the fund with transaction level data to assist the fund in monitoring trading activity, and (2) execute instructions from the fund to restrict or prohibit purchases by shareholders who have violated the fund's trading policies.

A. *The definition of financial intermediary is so broad that it would require mutual funds to enter into written agreements with thousands of account owners and other parties*.

Rule 22c-2(c)(1) defines "financial intermediary" as "[a]ny broker, dealer, bank, *or other entity* that holds securities of record issued by the fund, *in nominee name"* (italics supplied). This definition differs significantly from the definition of financial intermediary that was originally proposed by the Commission.[3] Although we appreciate

[3] The proposed rule defined financial intermediary to include record holders as defined in Rule 14a-1(i) under the Securities Exchange Act of 1934 and insurance companies that sponsor separate accounts.

the Commission's effort to change the definition in response to comments, this new definition is extremely broad and unclear. Under this definition *any entity* could qualify as a financial intermediary. As a result, fund companies must review all accounts that are not registered to an individual to determine whether the accounts would require a contract under the rule. For example, Vanguard has more than 1.3 million such accounts.

Under Rule 22c-2(a)(2), contracts must require financial intermediaries to provide funds, upon request, with information about the identity and transactions of shareholders (or, for retirement plans, plan participants) investing in the funds.[4] In many cases, however, the financial intermediary who has the account relationship with the fund does not have the underlying shareholder or participant transaction data, making it impossible for the intermediary to agree to the contractual provisions required by the rule. For example, a financial intermediary who has an account directly with the fund may in turn have arrangements with multiple other parties who may themselves act in an intermediary capacity. Usually, only the intermediary with the direct relationship to the individual has the transaction data for that specific individual. In the 401(k) and retirement plan context, the plan trustee is the owner of the funds held by the plan, and in many cases a separate entity appointed by the sponsoring employer serves as plan recordkeeper and maintains separate accounts for the participating employees and the plans. In this scenario, neither the fund company, nor the plan trustee, who is the fund's account owner, maintains participant records.

Although the rule is unclear on this point, requiring funds to seek out underlying intermediaries or recordkeepers that have transaction data but no direct relationship with the fund company would be a virtually impossible task. The effort itself would be extremely burdensome, exponentially compounding the cost, resources, and time required to comply with this rule. And in the end, we are not certain that most funds could meet the rule's requirements.

Given the significant burdens on funds that result from the contract requirement, we have evaluated whether the contract requirement is necessary to address the Commission's concerns about short-term trading. We have concluded that there is no benefit to funds or shareholders from requiring funds to seek out and contract with all intermediaries that they may be able to identify. Rather, the Commission should only require funds to obtain such contracts when the fund determines it is necessary to address short-term trading concerns.[5] And, when contracts are pursued, they should require intermediaries to provide, at the fund's request, *only* the client transaction data that the intermediaries have on their own records. In some cases that may be individual

[4] Rule 22c-2(c)(4) defines "shareholder" to include participants in participant-directed employee benefit plans. It is the plans, however, that are the legal shareholders of the fund. The Commission should clarify that the definition of shareholder in Rule 22c-2 does not apply in other contexts.
[5] Vanguard supports the comment letter of the Investment Company Institute dated May 9, 2005. The ICI recommends the use of contracts only when the fund determines a contract is necessary to address short-term trading concerns.

shareholder or participant data, and in other cases the data may be at a more consolidated level.

Funds should have the option to address trading activity in omnibus accounts through means other than by requesting underlying data through contractual relationships. For example, funds could apply their trading and redemption fee policies directly to these accounts at the omnibus level. Importantly, a fund can still protect its shareholders from harmful trading activity in omnibus accounts if it receives information at a more consolidated level. In these cases the fund can request that its direct client stop accepting purchases from the offending party, thereby protecting the interests of the fund and its shareholders.

We also note that omnibus account monitoring, while not foolproof, is an effective way to determine whether a fund is experiencing harmful trading activity. In light of the events of the past year and a half, we think it is fair to say that monitoring capabilities are improving and are being implemented more widely throughout the industry. We believe that resources are much better spent improving monitoring capabilities than contracting with thousands of intermediaries, which may or may not yield helpful results. We note, too, that the Commission has taken numerous steps to address market timing concerns. For example, the new compliance rule and required improvements to disclosure about market timing and fair value pricing practices have already had an impact.[6] These efforts, together with increased monitoring by funds, should address many of the Commission's concerns.

B. The rule raises important public policy issues that should be reevaluated by the Commission.

1. The rule should not impair the ability of intermediaries to use omnibus accounts, which facilitate investment in mutual funds and benefit all shareholders by increasing scale and lowering costs.

Mutual funds are an extremely attractive investment vehicle for a wide variety of investors because they offer professionally managed, low-cost, diversified investments. Consolidation of investors and accounts for purposes of investing in funds makes funds accessible to all kinds of investors in all types of situations. Omnibus arrangements facilitate broad investment in mutual funds by many investors through a variety of channels, just as they do for other, less regulated types of investments. These channels

[6] *Compliance Programs of Investment Companies and Investment Advisers,* Investment Company Act Release No. 26299, Advisers Act Release No. 2204, 68 Fed. Reg. 74714 (Dec. 24, 2003) (Requires funds and investment advisers to adopt and implement policies and procedures reasonably designed to prevent violation of the federal securities laws, including procedures reasonably designed to ensure compliance with the fund's disclosed policies regarding market timing); *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings,* Investment Company Act Release No. 26418, 69 Fed. Reg. 22300 (Apr. 23, 2004) (Requires funds to describe the risks associated with frequent trading in fund shares and any associated policies and procedures adopted by the board).

have developed to meet the needs of an ever-expanding and diverse client base and their existence allows funds to facilitate investment, reduce costs, and generate economies of scale for the benefit of all shareholders.

The Commission should be wary of encumbering these channels so as to establish a different regime for the use of omnibus accounts for mutual funds as opposed to other investments (such as collective trusts, separate accounts, wrap programs, or brokerage accounts), making mutual funds a less desirable investment option for some types of investors, particularly retirement plans. We urge the Commission not to take any action that would create disincentives for retirement plans or other omnibus investors to use mutual funds as their investment vehicle of choice. We believe a better approach is to improve methods of monitoring omnibus activity to address concerns about harmful trading. As noted above, we believe many of these steps are already underway.[7]

2. As adopted, the rule imposes considerable barriers and disincentives for fund companies to serve as investment providers to small business retirement plans.

Small business retirement plans may be disproportionately affected by the rule. Fund companies provide mutual fund investments to hundreds of thousands of small business retirement plans, often at the omnibus level. These plans serve small firms, professional associations, and retail businesses, but do not always have contractual relationships with the fund company. Rather, these relationships are established through the account opening process in the name of the plan itself. The fund company often does not provide separate recordkeeping services for these plans and therefore has no plan participant transaction data. In fact, given the nature of these clients and the economics of these plans, they are unlikely to engage recordkeepers at all. Rather, an employee of the plan sponsor is often responsible for providing participants with information about their plan investments.

Requiring funds to enter into agreements with small business plans under these circumstances may create unintended consequences. It may discourage small business employers from engaging mutual fund providers to provide investments for their employees' retirement plans. In addition, the revenues generated by these plans may not support the cost of entering into agreements and obtaining records from these plans, causing some fund companies to curtail their service to this segment or raise fees for these plans. In our view, this would be an unfortunate result. By adopting the more flexible approach we recommend, funds could treat the plan, rather than the plan's participants, as the shareholder for purposes of Rule 22c-2 and still protect the funds against harmful trading activity.

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[7] *See supra* note 6 and accompanying text.

We urge the Commission to consider alternatives to the contractual requirements of Rule 22c-2. If, despite the concerns we have listed above, the Commission is determined to maintain the contract requirement in some form, there are modifications that would improve the rule. One option would be to significantly limit the universe of intermediaries with whom contracts may be required. As a last resort, we urge the Commission to limit required contractual arrangements to accounts opened *after* the compliance date so that the account opening process can be used as a means to identify financial intermediaries. This approach would at least avoid the untenable position funds face under the rule as adopted, which requires them to investigate the status of millions of mutual fund accounts and then enter into contracts with potentially thousands of intermediaries, who are under no obligation to do so.

II. Requiring standardized terms for redemption fees will not serve investors well and therefore standards should not be imposed without compelling evidence that they would benefit investors.

The Commission has requested additional comment on whether voluntarily imposed redemption fees should be subject to mandatory standards. We have commented previously, and continue to believe strongly, that mandatory redemption fee standards are not appropriate or necessary in the context of a voluntary fee. We believe that standardization under these circumstances would create significant disincentives to the adoption of redemption fees that might otherwise benefit a fund.

Given the diverse and strongly held views on how redemption fees should be used and applied,[8] we see little benefit from the Commission's dictating particular standards. Some commenters have favored standardization and others have opposed it. We note that the Commission faced the same dilemma with respect to whether redemption fees should be mandatory or voluntary. Once the Commission determined to make the fees voluntary, it appropriately assigned the decision of whether to impose a redemption fee to the fund's board of trustees. Under the circumstances, we believe the Commission should take the same approach with respect to the application of redemption fees, including waivers and exceptions.

In meeting their responsibilities under Rule 22c-2, fund boards will likely consider multiple factors in deciding whether to impose a redemption fee. Because the Commission has appropriately looked to the fund board to determine *when* it is appropriate to impose redemption fees, the board should also be entrusted to determine *how* those fees should apply for the benefit of the fund and its shareholders. These decisions go hand-in-hand and the Commission should not force funds to separate them. Allowing the board to determine how the redemption fee will apply will ensure that funds will be able to implement redemption fees in the most effective manner particular to their circumstances. These circumstances include numerous factors such as investment

[8] As the Commission notes in the Adopting Release at note 60 and note 61, some funds view redemption fees as a deterrent to market timing while others have used redemption fees to recapture trading costs associated with short-term transactions in the fund.

objectives and strategies, cash flow, characteristics of the investor base, the effectiveness of the fund's transaction monitoring systems, and the fund's tolerance for frequent trading activity, among many others, all of which can vary widely. For these reasons, the board is in the best position to make a determination of how the fees should apply in a particular case.

Vanguard strongly urges the Commission to allow funds to set the parameters for their own redemption fees and disclose how those fees will apply. Assuming appropriate disclosure, funds should be permitted to vary the application of redemption fees and trading policies when necessary to meet the overall objectives of the fee, which, the Commission has recognized, also tend to vary.[9] Funds should be able to accept an intermediary's redemption fee and monitoring procedures even though they would differ in some manner from the fund's internal policy. If the basic methodologies followed by an intermediary are similar to the fund's, fund shareholders will not be harmed by allowing for certain variations, provided there is clear disclosure to all investors who purchase through that intermediary. As financial intermediaries and funds work together to resolve these issues, we are confident that certain common standards will emerge, thereby reducing variations over time.

We emphasize that the recent focus on harmful market timing and the steps the Commission has taken to address this problem will help ensure that funds and intermediaries take action to reduce or eliminate harmful trading activity; redemption fees need not be the sole solution, and indeed, as a practical matter they never will be. Affording funds appropriate flexibility to address the issues through multiple and varied solutions makes the most sense and is likely to be the most effective and practical means to address the Commission's concerns. And, of course, this approach does not foreclose the Commission's continued study and assessment of trading activity in funds and the effectiveness of other measures the Commission has adopted to deal with these concerns.[10] Vanguard will actively support those efforts, as it has in the past, well into the future.

If, despite Vanguard's foregoing concerns and recommendations, the Commission determines to proceed with standardization, we urge the Commission to take Vanguard's views of appropriate standards into account. We have discussed Vanguard's position regarding certain standards at length in previous letters and will not repeat those comments here.[11] To summarize our position, consistent with our view that redemption fees are a valuable deterrent to market timing and other abusive short-term trading activity, Vanguard strongly supports limiting redemption fees in the retirement plan context to participant directed exchange activity. In addition, Vanguard strongly opposes mandatory *de minimis* and financial hardship exceptions.

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[9] *See supra* note 8.
[10] *See supra* note 6.
[11] Comment Letters of The Vanguard Group, Inc. dated May 10, 2004, and Oct. 18, 2004.

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Vanguard appreciates the Commission's efforts to help funds more effectively enforce market timing and redemption fee policies with respect to omnibus accounts. We acknowledge the complexity and difficulty of these efforts and urge the Commission to continue its dialogue with funds to address issues as they arise on an ongoing basis. Vanguard and its personnel are available to support these constructive efforts in every possible way. If you would like to discuss these comments further, or if you have any questions, please do not hesitate to contact me or Sarah Buescher, Senior Counsel, in Vanguard's Legal Department.

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

Meyer Eisenberg, Acting Director
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