THE Vanguard GROUP.

January 22, 2004

Office of the Corporate Secretary
JAN 23
Notice To Members

Via Federal Express
Barbara Z. Sweeney
National Association of Securities Dealers
Office of the Corporate Secretary
1735 K Street, NW
Washington, D.C. 20006-1500

Re: *Proposed Amendments to Investment Company Advertising Rules: Notice to Members 03-77*

Dear Ms. Sweeney:

The Vanguard Group, Inc. ("Vanguard")[1] appreciates the opportunity to comment on the recent proposal by NASD to amend Rules 2210 and 2211, the rules governing member communications with the public (the "Proposal").[2] The Proposal is intended to raise investor awareness of the fees charged to purchase and own mutual funds, facilitate fund comparisons, and ensure prominent presentation of standardized performance. The Proposal, among other things, would require fund advertisements that include performance information: (1) to disclose the fund's standardized performance information, maximum sales charge, and annual expense ratio; and (2) to include these items of information in a "prominent text box." The fund's annual expense ratio would have to be calculated as of the most recent calendar quarter.

Vanguard strongly supports NASD's objective to improve awareness of mutual fund expenses. We have a long history of promoting investor-friendly disclosure of the fees and expenses associated with investing in mutual funds, and have supported regulatory efforts to do the same. Too many mutual fund advertisements focus on performance to the exclusion of other information that is equally, if not more, significant to an investment decision, including investment objectives, risks, and fees and expenses. For this reason, we strongly support requiring fund performance ads to disclose prominently expense ratios and sales charges.

We suggest that NASD modify parts of the Proposal to address certain practical considerations. While the notion of a standardized text box for expense information would work well in a typical magazine ad for a single fund, this aspect of the Proposal does not account for the variety of materials that is subject to regulation as "advertising"

---

[1] Headquartered in Valley Forge, Pennsylvania, Vanguard is the nation's second largest mutual fund firm, serving 17 million shareholder accounts and managing more than $675 billion in U.S. mutual fund assets. Vanguard offers 118 funds to U.S. investors and 20 additional funds in foreign markets.

[2] *Disclosure of Mutual Fund Expense Ratios in Performance Advertising*, NASD Notice to Members 03-77 (Dec. 9, 2003).

Post Office Box 2600 · Valley Forge, Pennsylvania 19482-2600
(610) 669-1000 · www.vanguard.com

under the federal securities laws. We therefore urge NASD to eliminate the text box requirement. In addition, we believe that the most efficient way to implement the new disclosure requirement is to draw expense ratios from the fund's most recent shareholder report, rather than requiring recalculation of this figure each calendar quarter.

Our specific recommendations are discussed below.

I. Member firms should have flexibility to present information in a manner designed to address NASD's concerns without the text box requirement.

Vanguard shares NASD's belief that mutual fund advertisements should be fair, balanced and not misleading. Mutual funds should not be permitted to promote performance, especially short-term performance, to the exclusion of other important information. To the extent the Proposal would provide investors with some of that additional information (specifically, expense ratio and sales charge information), we support it. However, the requirement that performance, expense ratio, and sales charge information appear in a "prominent text box" is largely incompatible with the way most performance information is presented to mutual fund investors. We are concerned that rigid formatting requirements will unduly restrict the ability of mutual funds to present expense information in the clearest possible manner and, by requiring redesign of investor communications, ultimately drive up the cost of providing basic fund information to shareholders.

NASD rules should ensure that mutual fund advertisements contain balanced information, and it is appropriate to require equal prominence for expenses and performance. However, it does not make sense to mandate a single method of presentation – the text box – for all material that may qualify as a fund advertisement under NASD and SEC rules. The sheer variety of fund sales literature simply does not lend itself to a one-size-fits-all approach. Although a text box approach might work well (and achieve NASD's objectives) for the prototypical ad that promotes performance, the universe of mutual fund sales material encompasses a great number of educational and informational pieces for which the text box is neither necessary nor appropriate. A common example would be a presentation of the standardized performance for all, or some subset, of the funds in a complex.[3] A box around the performance and expense information for dozens of funds would not have the desired effect of highlighting fund expenses and fees. Indeed, it likely would complicate the entire presentation and drive up the cost of production – outcomes that ill-serve investors. We believe the proposed text box is unworkable, cumbersome, and unnecessary for the great majority of materials that include fund performance.

For some sales materials, the text box requirement might actually have the opposite of its intended result, *i.e.*, it might de-emphasize expense ratio information. This would almost certainly happen, for example, with Vanguard's Fund Fact Sheets. Each

[3] *See, e.g.*, the "Vanguard Performance Profile," attached as Exhibit A, which is sent quarterly to all Vanguard shareholders, and the "Total Return Chart" attached as Exhibit B.

Fact Sheet is two pages (front and back of a single sheet) and provides a capsule overview of a single fund. *See* Exhibit C. As currently formatted, the Fact Sheet presents the fund's expense ratio at the top and performance information in a table at the bottom. If the Proposal is adopted, Vanguard would be required to show the expense ratio in a text box that incorporates the performance table at the bottom of the page. Vanguard would then have two choices: (a) present expense information twice, which is unnecessarily duplicative; or (more likely) (b) delete the expense ratio from the top of the page, making it less, rather than more, prominent.

In some instances, the text box requirement could have the unintended effect of reducing expense ratio information for investors. This might occur, for example, in the Vanguard booklet entitled "Facts on Funds," which contains thumbnail descriptions of each Vanguard fund, usually two to a page. *See* Exhibit D. Due to space limitations, each thumbnail presents performance information for the fund's largest share class only, but under a separate heading it presents expense ratio information for each share class. If expense ratio information were required to be integrated in a text box with the performance information, it is likely that expense ratio information would be limited to the share class for which performance is shown.

Because the use of a text box can lead to the negative outcomes described above, this requirement should be eliminated. In its place, we recommend a requirement that expense and sales charge information be presented in a type size at least as large as the performance information.[4] This approach would fulfill NASD's goal of improving investor awareness of the costs of buying and owning mutual funds and facilitating comparisons among funds, without restricting the ability of funds to present information in the manner they deem most effective.

II. Presentation of expense ratios calculated as of fiscal half years, rather than calendar quarters, would meet the goal of increased disclosure while balancing practical considerations.

The Proposal would require mutual fund advertisements to include expense ratios computed as of the most recent calendar quarter. Vanguard recommends that ads include expense ratios that are computed semi-annually, rather than quarterly, and that such computations be based on the fund's fiscal year rather than on a calendar year basis.

We do not believe there is a compelling reason to require quarterly updates to expense ratio information. In our experience, a fund's expense ratio varies little from

---

[4] We would not favor a requirement that expense and sales charge information be in close proximity to the performance information. We believe it is sufficient for the various items of information to be of equal prominence, as this will meet the objective of promoting investor awareness of that information. For an example of sales literature in which expense ratio information is of equal prominence with, but not in close proximity to, performance information, see the Fund Fact Sheet attached as Exhibit C. The fund's expense ratio appears at the top of the page, in a font size as large as the other information contained in the Fact Sheet. We believe this format fairly and adequately discloses a fund's expenses.

quarter to quarter[5] and, as a result, quarterly expense ratio information is not that useful to investors.[6] In our view, the benefit of providing investors with calendar quarter expense ratio information is outweighed by the costs of calculating and disseminating that figure multiple times per year. Currently, funds calculate their expense ratios twice a year: at the end of their fiscal year (for inclusion in the Annual Report to shareholders), and at the end of their fiscal half-year (for inclusion in the Semi-Annual Report to shareholders). If mutual fund ads are required to include calendar quarter expense information, funds will have to calculate and disseminate their expense ratios more frequently.[7] This would require an initial outlay of money to reprogram systems as well as ongoing personnel costs. Updating dissemination systems, including websites, automated telephone systems, and data sources, can be particularly expensive and time consuming. Given that expense ratios do not change significantly from quarter to quarter, these additional costs do not seem worthwhile in the interests of shareholders.

For the reasons stated above, Vanguard believes that the Proposal should be modified to require performance ads to disclose expense ratios calculated as of the fund's most recent fiscal year or half-year. This standard would fulfill NASD's goal of promoting investor awareness of fund expenses without imposing significant additional costs on mutual funds or depriving investors of important information.

III. Additional modifications to the proposed rule would afford member firms flexibility without compromising investor protection.

A. The Proposal should not cover institutional sales materials.

NASD recently amended its rules regarding communications with the public by creating a new category of communications -- institutional sales material -- that is subject to fewer content and filing standards than other communications with the public.[8] This development reflects NASD's recognition that institutional investors are more sophisticated than the general public.[9]

---

[5] In the case of a fund whose annual operating expenses have materially increased since the most recently calculated expense ratio, anti-fraud rules would prohibit the fund from advertising a "stale" expense ratio that management has reason to know is materially misleading. *See, e.g.*, Securities Act Rule 156. Such funds would be required to update their expense ratios in accordance with the standard set forth in Form N-1A, Item 3, Instruction 3(d)(ii)(A).

[6] We do not think it is problematic to use *fiscal* periods for expense ratios at the same time performance information is stated as of *calendar* quarter ends. While a meaningful comparison of fund performance depends on comparable time frames, a comparison of expense ratios will provide useful information even if the time frames are not exactly the same.

[7] Funds with a fiscal year-end that falls on a calendar quarter would have to do two additional calculations and related information dissemination per year. Funds with a fiscal-year end that does not fall on a calendar quarter would have to do four additional calculations and related information dissemination per year.

[8] *See SEC Approves Amendments to NASD Rules Governing Member Communications with the Public*, NASD Notice to Members 03-38 (July 7, 2003).

[9] In IM-2210-1, NASD states that "[d]ifferent levels of explanation or detail may be necessary depending on the audience to which a communication is directed."

Notwithstanding this recent amendment, NASD would require mutual funds to include in institutional sales material that contains performance information all of the disclosures (both as to content and form) required by the Proposal. We do not believe this requirement is necessary. There can be no doubt that institutional investors, given their level of sophistication, are well aware of the relationship between mutual fund costs and performance. Applying the Proposal to institutional sales material therefore is unnecessary to achieve the Proposal's goal of promoting investor awareness of fund costs. Accordingly, Vanguard recommends that NASD modify the Proposal to exclude institutional sales material.

B. NASD should clarify that the disclosure of expense ratios and sales charges in electronic communications may appear one click away.

For communications delivered through electronic media, the Proposal would allow funds to satisfy the text box and type size requirements by presenting the required information "in a manner that is intended to draw investor attention to it." Given the unique challenges and opportunities associated with disclosure through electronic media, Vanguard supports NASD's proposed standard because it provides appropriate flexibility. However, we believe that this aspect of the Proposal would benefit from additional clarification.

Due to the limited space available on web screens, we recommend revising the Proposal to clarify that, in electronic communications, expense ratio and sales charge information may appear one click away from performance data. This will allow websites to use a popular and reader-friendly format in which information for each fund is indexed by "tabs." Typically, one tab will lead to performance information while a different tab will lead to expense information.[10] This format organizes information logically, making it easy for investors to find the information that they are looking for. Moreover, the tabs present information in a manner intended to draw investor attention to costs. For this reason, we believe NASD should expressly clarify that expense ratio and sales charge information may appear one click away from performance data, provided that the link is clearly labeled as presenting expense/cost information.

IV. Member firms should have a reasonable compliance period to implement the Proposal.

Whether or not the Proposal is modified as suggested in this letter, Vanguard recommends that NASD provide a 180-day compliance period due to the complexity of conforming existing systems and materials with the Proposal's requirements. As discussed above, there are significant technological changes that will need to occur for compliance with this Proposal. Our internal phone, web and data source systems will have to undergo extensive redesign to accommodate additional information, such as the

[10] *See, e.g.*, the Fund Snapshot screens on Vanguard.com, one of which is attached as Exhibit E. One tab links to a screen that contains price and performance information; another tab links to a different screen that contains cost information. The cost screen includes disclosure about the fund's expense ratio and, if applicable, purchase fees, redemption fees, and other related costs.

period-ending date of expense ratio information. Procedures and systems will need to be changed to store and distribute more frequently calculated expense ratio data. In our experience, the average time to redesign, test, implement, and elevate both the telephone and Internet systems, as well as reformat and redesign a large number of investor communications, is approximately six months.

For Vanguard and other fund companies that have brokerage affiliates that sell funds of other families, there will be additional steps necessary to comply with a calendar quarter updating requirement for expense ratios. We obtain performance and expense ratio information about non-Vanguard funds from third party vendors and make that information available on our website. However, most vendors of fund data currently provide fiscal year-end expense ratios only. Therefore, we would not be able to provide more recent expense information (whether quarterly or semi-annually) for non-Vanguard funds unless and until those vendors change their current practice.

* * *

We believe this Proposal, with the modifications suggested, will improve performance advertising disclosure to the benefit of mutual fund investors. We appreciate this opportunity to comment. If you would like to discuss these comments further, or if you have any questions, please feel free to contact me at 610-503-4016, or Lisa L.B. Matson, at 610-669-5284.

Sincerely,

Heidi Stam
Principal
Securities Regulation

cc: Angela C. Goelzer, Counsel
Investment Company Regulation, Regulatory Policy and Oversight
NASD

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