THE Vanguard GROUP®

February 14, 2002

Jonathan Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Actively Managed Exchange-Traded Funds
File No. S7-20-01

Dear Mr. Katz:

The Vanguard Group, Inc. ("Vanguard") appreciates the opportunity to comment on the Securities and Exchange Commission's recent concept release on actively managed exchange-traded funds ("ETFs").[1] Vanguard is the sponsor and manager of more than one hundred mutual funds, with assets of approximately $575 billion held in over 15 million shareholder accounts. Vanguard is the world's largest provider of retail index funds and offers investors a balanced mix of actively and passively managed conventional mutual funds, as well as ETFs.[2]

As a general matter, Vanguard believes that the Commission should do all it can to accommodate new and innovative investment products that benefit investors. The Investment Company Act clearly affords the Commission that flexibility when it is consistent with the public interest and the protection of investors. In our view, there are several key issues associated with actively managed ETFs that must be resolved if these products are to be offered consistent with the protection of investors.

Transparency

The Commission's most difficult challenge, in our view, will be to determine what level of transparency is appropriate for actively managed ETF's. Transparency

[1] Investment Company Act Release No. 25258 (Nov. 8, 2001).

[2] Vanguard sponsors 72 actively managed funds with approximately $350 billion in assets and 32 passively managed (*i.e.*, index) funds with approximately $230 billion in assets. Currently, two Vanguard index funds, Vanguard Total Stock Market Index Fund and Vanguard Extended Market Index Fund, offer a class of exchange-traded shares, known as VIPER Shares. Vanguard plans to offer VIPER Shares for other funds in the future.

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refers to the amount of information available about the fund's portfolio holdings. Full transparency facilitates arbitrage and hedging by the exchange specialist and other market makers, keeping the bid-asked spread narrow and the market price of an ETF's shares well correlated with their net asset value (NAV).

Index ETFs are fully transparent. As a result, they generally have narrow spreads and close correlations between market price and NAV. Unfortunately, full transparency would be detrimental to actively managed ETFs because it would enable third parties to "front run" the fund. The Investment Company Institute has thoroughly documented how frequent disclosure of portfolio holdings can harm actively managed funds by increasing the potential for front running.[3] Limiting transparency reduces the potential for front running, but it also raises issues of its own, including wider bid-asked spreads and greater discrepancies between the market price and NAV of an ETF's shares.

The Commission's effort to resolve the transparency issue should be guided by the following principles:

- Equal treatment of all investors. Sponsors of actively managed ETFs should not be permitted to provide more information about portfolio holdings to the exchange specialist and market makers than they provide to other investors. Vanguard believes, as a matter of fundamental fairness, that all investors in a fund must be treated equally. Providing information only to a favored few is inconsistent with the foundation of our capital markets --full and fair disclosure to all investors.

- Disclosure to the ETF's investors. Investors in an actively managed ETF must receive adequate disclosure about the risks associated with the level of the ETF's transparency (and other risks unique to actively managed ETFs). For example, if the ETF is fully or substantially transparent, the risks of front running must be prominently disclosed. Conversely, if the ETF has limited transparency, the fund's disclosure documents should discuss the possibility that the spreads between the bid and asked prices and between the market price and NAV of the fund's exchange-traded shares may be higher than is typically the case for index ETFs.[4]

[3] *See* Letter from Craig Tyle, ICI General Counsel, to Paul Roye, Director of the Division of Investment Management, dated July 17, 2001, and Appendix B thereto.

[4] While these spreads may be higher for actively managed ETFs than for index ETFs, we do not believe that the discounts between market price and NAV will approach those seen in closed-end funds. Arbitrage opportunities and competition among market makers should keep the difference between market price and NAV to less than 2%, and considerably less than that on most days. Therefore, the Commission should be able to make the findings necessary to determine that shares issued by actively managed ETFs are "redeemable securities."

Tax efficiency and costs: index ETFs vs. actively managed ETFs

In its Concept Release, the Commission asked whether an actively managed ETF would possess the low expenses and tax efficiency associated with "existing" ETFs. We believe the answer is no. The low cost and tax efficiency of existing ETFs derive primarily from the fact that existing ETFs are index funds. There is no assurance that actively managed ETFs would be either low cost or tax efficient.

Actively managed ETFs could realize some savings from reduced account maintenance and shareholder recordkeeping costs, since such records would be maintained by the shareholders' brokerage firms. Thus, the potential exists for actively managed ETFs to be somewhat less costly than comparable conventional funds. Ultimately, the opportunity for investors to benefit from these cost savings would depend upon the willingness of the ETF sponsor to pass those cost savings along to shareholders.

The tax efficiency of existing ETFs is predominantly a function of the low portfolio turnover that is a hallmark of index funds. Given that the average portfolio turnover rate of actively managed stock funds is around 100%,[5] it is unlikely that most actively managed ETFs will be tax-efficient vehicles. To a much lesser extent, the tax efficiency of ETFs is a function of the in-kind redemption process, which allows a fund to push out low-cost-basis shares and thus avoid the realization of capital gains. In high turnover funds, this benefit is greatly reduced.

Prospectus delivery

The Concept Release solicited comment on whether actively managed ETFs should be granted the same exemption from the prospectus delivery requirements of the securities laws as many index ETFs have been granted. We see no reason to distinguish between actively managed and index ETFs with respect to prospectus delivery. ETF shares (whether index or actively managed) are bought and sold on the secondary market in precisely the same manner as closed-end fund shares. Closed-end fund shares are not subject to section 24(d) of the Investment Company Act, and thus are sold in the secondary market without prospectuses. To the best of our knowledge, neither the Commission nor industry observers have ever suggested that closed-end fund shareholders are ill-served by this regulatory structure. Moreover, as it does with index ETFs, the SEC should require actively managed ETFs to deliver a prospectus to any investor upon request.

In the past, the Commission has granted relief to ETFs from the prospectus delivery requirements based on the fact that secondary market purchasers of ETFs will receive appropriate disclosure in a document known as a Product Description. To the

[5] Over the past five years, the turnover rate of actively managed stock funds has averaged 97%. In 2000 and 2001, the figure exceeded 110%. Source: Morningstar.

extent that actively managed ETFs present features or risks different from those of index ETFs -- such as the increased risk that the market price of shares will vary materially from NAV – those differences can be disclosed in the Product Description. Disclosure in the Product Description also should reduce or eliminate any potential for confusion about the differences between actively managed ETFs and index ETFs or actively managed conventional funds.

Multi-class issues

The Commission has solicited comment on certain issues raised by an actively managed fund that has both an ETF class and a conventional class of shares.[6] The most pressing concern is that a fully (or substantially) transparent actively managed fund could be front-run by third parties. Any harm caused by such front running would hurt the fund's conventional shareholders to the same degree as its ETF shareholders. The only way to ameliorate this harm would be to reduce the transparency of the fund.

The Concept Release questioned whether significant redemptions of conventional shares would create undesirable tax consequences for ETF class shareholders. In light of the portfolio turnover rate of the average actively managed stock fund,[7] we believe that the answer, in most cases, would be no. Also, many funds select the highest cost lots when selling portfolio holdings, so redemptions of conventional shares may cause the fund to sell its holdings at a loss, which actually makes the fund more tax efficient, not less.

Finally, the Commission asked about the potential for investor confusion concerning the nature of the ETF share class. Vanguard has some experience with this issue, as our index funds are the only funds that issue both exchange-traded and conventional share classes. (Currently, all exchange-trades shares other than Vanguard's VIPER Shares are issued by stand-alone funds.) To date, Vanguard has not received any complaints from investors claiming to be confused about the difference between VIPER Shares and conventional fund shares. We believe that this is attributable primarily to two things. First, investors are now familiar with the concepts of both index ETFs and multi-class funds, so they are able to understand a fund that combines the two. Second, Vanguard has provided investors with a number of disclosure documents that, in clear and plain English, highlight the differences between the classes. We believe that, with

[6] We note that Vanguard has applied to the United States Patent and Trademark Office for a patent on this structure. The patent would cover, among other things, an investment company that offers one or more conventional classes of shares (purchased and redeemed at NAV) as well as one or more exchange-traded classes of shares (bought and sold on the open market at negotiated market prices). Assuming the patent issues, Vanguard could stand to gain if the Commission approves the issuance of actively managed ETFs and if some of those ETFs are structured as multi-class funds with both conventional and exchange-traded share classes. Notwithstanding Vanguard's possible patent rights, Vanguard believes that actively managed ETFs, multi-class or otherwise, raise serious investor protection issues. The Commission should not allow these vehicles to be publicly offered until those issues have been adequately addressed.

[7] *See* footnote 5 and accompanying text.

proper disclosure, investors similarly would be able to understand the differences between exchange-traded and conventional share classes issued by an actively managed fund.

Summary

Actively managed ETFs raise some troubling investor protection issues, especially on the subject of transparency. Full transparency allows an ETF to function most efficiently. It keeps costs down by promoting a narrow bid-asked spread and helps maintain a close correlation between the market price of an ETF's shares and the NAV of those shares. But full transparency also promotes front running, which can harm the ETF's shareholders, and potentially, other classes of shareholders as well. If these vehicles are to be offered, the Commission's challenge is to strike the appropriate balance between these two opposing interests. In striking that balance, the Commission should ensure, among other things, that all investors in the fund have equal access to information about the fund's portfolio holdings and receive adequate disclosure of the product's unique risks.

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Thank you for the opportunity to comment on the matter of actively managed ETFs. If you would like to discuss these comments further, please contact Barry Mendelson at 610-503-2398 or the undersigned at 610-503-4016.

Sincerely,

Heidi Stam
Principal
Securities Regulation

cc: Paul F. Roye, Director, Division of Investment Management
John J. Brennan, Chairman and CEO, The Vanguard Group, Inc.