THE Vanguard GROUP

VIA ELECTRONIC MAIL

September 17, 2004

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW.
Washington, D.C. 20549-0609

RE: Proposed Rule Change by the NASD Relating to Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material File No. SR-NASD-2004-043

Dear Mr. Katz:

The Vanguard Group, Inc. ("Vanguard")[1] appreciates the opportunity to comment on the recent proposal by the National Association of Securities Dealers, Inc. ("NASD") to amend Rule 2210, the rule 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 in a "prominent text box."

Vanguard strongly supports NASD's objective to improve awareness of mutual fund expenses. 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 prominently disclose expense ratios and sales charges. However, the Proposal goes well beyond what is necessary to achieve this goal, and we cannot support it as currently drafted. We believe that the Proposal, when applied to many communications with the public subject to Rule 2210, will not improve investor awareness of fund expenses or otherwise fulfill its objectives. Indeed, in many circumstances, it will have the opposite effect.

[1] Vanguard, headquartered in Valley Forge, Pennsylvania, is the nation's second largest mutual fund firm. Vanguard serves 18 million shareholder accounts, and manages more than $750 billion in U.S. mutual fund assets. Vanguard offers 125 funds to U.S. investors and 40 additional funds in foreign markets.

[2] *Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material*, Exchange Act Release No. 50226 (Aug. 20, 2004) (hereinafter "Release").

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We detailed our objections to the proposal in our comment letter to the NASD dated January 22, 2004, a copy of which is attached. (see especially Part I on pp. 2-3). We will not repeat the arguments we made in January. However, we hope you will consider those arguments in addition to the ones made here.

In this letter, we want to emphasize three critical points:

- *The Proposal would result in less effective disclosure on mutual fund websites.* It fails to recognize the organizational and navigational advantages the worldwide web has over paper-based disclosure. It mandates rigid formatting requirements that unduly restrict the ability of mutual funds to present performance and expense information in the clearest possible manner. In particular, the Proposal would require so much information to be crammed on to one web screen that funds would have to clutter the screen, shrink the font size, or require readers to scroll horizontally beyond the right screen border, all of which violate fundamental rules about how to effectively present information on the web. These problems could be avoided by permitting certain information to appear "one click away" from each other.

- *Expense ratios quoted in fund advertisements should be based on pre-waiver expenses.* Whether or not the Proposal is adopted, NASD should make clear that expense ratios quoted in mutual fund advertisements must be calculated in accordance with the standards required under Item 3 of Form N-1A. In effect, this would require funds to show the fund's expense ratio without regard to fee waivers or expense reimbursements.

- *The implementation time period proposed in the Release is insufficient.* If the Proposal is adopted, funds will need a significant amount of lead time, perhaps as much as one year, in order to make, test, and implement the required changes. The short time period proposed in the Release seems to reflect a lack of awareness of the Proposal's impact on fund websites.

I. The Proposal would result in less effective web disclosure.

The worldwide web has revolutionized how mutual funds communicate with their shareholders and with prospective investors. For Vanguard, and we suspect for many other fund families, the web is now the predominant means of communication. Year-to-date, more than 75% of all client interactions with Vanguard occurred via the web.

From a regulatory perspective, the implications of web growth are enormous. The effect of a proposed regulation on web communication can no longer be an afterthought. Rather, it must be a primary consideration in crafting any regulatory initiative that affects how mutual funds communicate with the public. Vanguard is very concerned that the Proposal does not reflect sufficient consideration of how it would affect members' communications via the web.

A. Background: Vanguard's approach to web design

Vanguard's website has won several awards for its design and user-friendly features.[3] Vanguard information technology personnel regularly review articles, surveys, and other literature to keep apprised of state-of-the-art web design concepts. The company also conducts its own surveys and focus groups to find out what Vanguard shareholders like and don't like about our website. We have found two fundamental concepts of web design that are relevant to the Proposal:

- Fundamental Concept #1: *Do not put information on a page that extends beyond the right-hand side of the screen.*

A leading expert on internet usability, Jakob Nielsen,[4] has noted that users "hate" to scroll horizontally on a webpage.[5] Vanguard's own usability studies not only confirm this, but also show that some users simply will not scroll horizontally. Users find doing so "annoying."[6] Moreover, it simply is difficult to process two or more pieces of information (such as the fund's name and its performance) when the pieces are separated and cannot be viewed on the same screen.

- Fundamental Concept #2: *Limit the amount of information on a webpage.*

Steve Krug, another web usability expert,[7] has found that users scan web

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[3] *See, e.g.*, Forbes.com, www.forbes.com/bow/b2c/review.jhtml?id=701, Best of the Web list, Summer 2004 ("The king of fund families has a Web site to match."). kasina, LLC, a strategic consulting firm for the financial services industry, in 2003 named Vanguard's institutional investor website a Top 10 website for institutional asset management. Vanguard placed first in the "online services" category and second in the "web technology" category. *See* www.kasina.com/whitepapers/2003institutional/topinstitutional.html.

[4] Mr. Nielsen is known as "the guru of website usability" (New York Times, July 18, 1998), who "knows more about what makes a website work." (Chicago Tribune, March 6, 2000). He ranks sixth on the "Web's Top Ten Most Influential People" (ZDNet, 2003).

[5] Number 3 on the *Top Ten Web Design Mistakes of 2002*, Jakob Nielsen's Alertbox, www.useit.com/alertbox/20021223.html (Dec. 23, 2002).

[6] *Id.*

[7] Mr. Krug, head of the website consulting firm Advanced Common Sense, has done website usability consulting work for such companies as Apple, AOL, and Lexus. He is author of the renowned website usability book Don't Make Me Think: A Common Sense Approach to Web Usability (New Riders, 2000).

pages only for the information that they are looking for and disregard the rest.[8] His studies have shown that the typical user will not read a page that is filled with data. He advises his clients to create pages that incorporate *less* information per page to ensure that the page will be useful to the reader. Vanguard's experience confirms Mr. Krug's conclusions. In the past we have received specific comments from our shareholders objecting to clutter and small print size. Here is a sample of feedback we have received from our web users:

- "The pages are much too busy . . . . Strip out all of the unnecessary verbiage [a reference to legally required disclaimers] and present simple, pristine choices."
- "Reduce the clutter. It's hard to find things. . . . I shouldn't have to stare all over the page to figure out the simplest things."
- "Larger print. Some of us are older than 65, too much info in too fine print makes clutter and eye strain."
- "Simplify the screen. It is too cluttered and hard to understand."
- "Simplify!! Less clutter!"
- "Too much data on each page."

We have responded to these comments in the design of Vanguard.com.® Thus, each page is created so that all information fits within the four corners of the screen and does not extend beyond the right side of the screen. Each page maximizes the impact of the information presented by not overloading the reader with volumes of information. To ensure that users receive the maximum benefit from each screen, we have employed the one click away design. By giving the reader the option to click a prominent hyperlink for additional information, we have found that the reader will not only absorb and retain more of the content on that page, but will click for more information.

B. Member firms should have flexibility to present information in a manner designed to address NASD's concerns without specifically mandated web design requirements.

Given the nature of the web, it simply does not make sense to apply the same standards to web communications and print advertisements. A website should not be viewed as thousands of pieces of paper projected one at a time onto a screen. The web is a robust medium that permits content providers to organize vast amounts of information, and permits viewers to navigate through that information, in ways far different from – and far superior to – turning pages one at a time. At the same time, the web has

[8] According to Mr. Krug: "One of the very few well-documented facts about Web use is that people tend to spend very little time reading most web pages. Instead, we scan (or skim) them, looking for words or phrases that catch our eye. . . . On most pages, we're really only interested in a fraction of what's on the page. We're just looking for the bits that match our interests or the task at hand, and the rest of it is irrelevant. Scanning is how we find the relevant bits." <u>Don't Make Me Think: A Common Sense Approach to Web Usability</u>, *cited supra* note 7, at page 22.

limitations different from those associated with paper-based disclosure. In particular, a web screen is fixed in size and can accommodate only a limited amount of information. With paper, by contrast, disclosure can appear on the front and back of a page, or pages can be placed side-by-side, to increase the amount of data pieces disclosed in proximity to one another.

Unfortunately, the Proposal does not recognize either the robust nature of the web or its limitations. Instead, it mandates rigid formatting requirements that unduly restrict the ability of mutual funds to present performance and expense information in the clearest possible manner. The Proposal seems aimed at one very specific type of fund communication – advertising or sales literature (typically in print but also electronic, such as banner ads appearing on third party websites) that selectively promotes the performance of a single fund or handful of funds. For that type of communication, Vanguard strongly agrees that it is appropriate to require disclosure of expense ratio information with prominence at least equal to the prominence given to performance information. But the sheer variety of fund communications with the public militates against the application of rigid formatting requirements across the board.[9] And this is particularly true in the case of web design.

One major benefit of the web is that fund companies can make available to readers huge amounts of information in a user-friendly format. Clearly labeled tabs and hyperlinks help to organize the information and allow readers to navigate easily through what might otherwise be a bewildering and intimidating volume of information. The Proposal undermines these benefits. By requiring performance and expense ratio information to appear on the same web screen, the Proposal would limit a fund's ability to organize different categories of information under different links or tabs.[10] And by rejecting Vanguard's suggestion that standardized and nonstandardized performance information, or performance and expense ratio/sales charge information, appear one click away from each other, the Proposal discards the navigational flexibility of the web.

The Proposal likely will force Vanguard (and other fund companies) to violate the fundamental concepts of web design identified above in Part I.A. The Proposal would

[9] For example, while the idea of a prominent text box may make sense for a mutual fund ad that promotes performance, it does not make sense in the case of a web page that lists every fund in a fund family along with its performance. A box around the performance and expense information for dozens – and in some cases hundreds – of funds would not have the desired effect of highlighting fund expenses and fees. Moreover, the text box forces together certain unrelated pieces of information, such as expense ratios and performance, while separating related pieces of information that investors typically look for in conjunction with each other, such as performance and yield. Thus, while we applaud NASD for eliminating the original requirement that text boxes be used in "sales literature," we continue to object to the requirement in the current Proposal that all "advertisements," including websites, use text boxes.

[10] Vanguard's website gathers together all cost information (i.e., expense ratios and fees) about a fund under one link and all performance information about a fund under a different link based on feedback received from website users.

require disclosure on the same web screen of nonstandardized performance, standardized performance, expense ratio information, and sales charge information. Funds would have to disclose *on a single web screen*: 1-, 5-, and 10-year non-standardized returns (based on month-end figures as recently required by the Commission)[11]; 1-, 5-, and 10-year standardized returns (based on quarter-end figures); legends required by Rule 482; expense ratio information; and, if applicable, front-end and back-end sales load information. And because many funds, in response to shareholder wishes, provide 3-year returns (calculated to most recent month-end and quarter-end) and year-to-date returns, the screen would have to accommodate three more columns of information. Yet another column, for a fund's 7-day or 30-day yield, also would be likely to appear on the screen because investors want and expect to see yield information together with performance data.

It simply is not possible to incorporate all of this information on one screen without filling it with data (violating the clutter rule), shrinking the font size (reducing readability, especially for middle-aged and elderly users), and/or requiring users to scroll past the right side of the screen (violating the horizontal scroll rule). Given what is known about web users' behavior, the Proposal, as it applies to web disclosure, would not have the intended effect of raising awareness of expense ratio and sales charge information; indeed, it almost certainly would have the opposite effect. At a minimum, it would alienate a substantial percentage of web users and probably lead them to decrease their use of the web – the preferred source of information about Vanguard funds and other products and services.

C. The Proposal should permit standardized performance, non-standardized performance, and expense ratios/sales charges to appear one click away from one another, provided the links or tabs are prominent.

As originally proposed in December 2003, the NASD proposal to amend Rule 2210 included the following provision: "In a communication delivered through an electronic medium, the requirements of subparagraph (B) [*i.e.*, a "prominent text box" and a typeface for standardized performance, expense ratio, and sales charge information that is at least as large as that used for nonstandardized information] may be satisfied by presenting the information in a manner that is intended to draw attention to it."

Vanguard, in its January 2004 comment letter, suggested that NASD clarify that this standard would allow different types of information to appear one click away from each other, provided that the link or tab was prominent and clearly labeled. The Release

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[11] Vanguard's website provides fund performance current to the end of the most recent month in accordance with SEC Rule 482(b)(3)(i). That provision, adopted by the Commission in September 2003 with a compliance date of March 31, 2004, required funds to considerably redesign the performance areas of their websites. Month-end performance is nonstandardized performance for the eight month-ends that do not coincide with calendar quarter-ends.

accompanying the current Proposal rejected Vanguard's suggestion with no analysis. The NASD provided no rationale other than noting that the SEC had rejected a one click away standard for legends that must appear in proximity to performance information.[12] However, the SEC's rejection of the one click away standard for narrative disclosure directly related to accompanying performance is not analogous to, and does not provide support for, the NASD's rejection of the one click away standard in a wholly different context.

The proposed amendments to Rule 2210, as published in the Release, no longer permit electronic communications to satisfy the prominent text box and typeface requirements "by presenting the information in a manner that is intended to draw attention to it." As currently drafted, the Proposal would apply the same standard to electronic communications as it does for print advertisements. This means that *a single web page* would have to contain quotations of nonstandardized performance, quotations of performance, expense ratio information, and sales charge information. As noted earlier, this will inevitably result in clutter, small font size, and/or the need for horizontal scrolling.

Vanguard strongly urges that the amendments to Rule 2210, when adopted, provide a more flexible approach to compliance in the context of electronic communications. We particularly draw your attention to the facts and arguments set forth in Parts I.A and I.B of this letter, and ask that the Commission consider whether, in light thereof, the Proposal serves the best interests of investors. Those facts and arguments provide a compelling case for providing greater flexibility in the presentation of performance on fund websites (which typically include fund prospectuses and shareholder reports). We strongly believe that investors' interests would best be served if, with respect to electronic communications, NASD: (a) returns to the standard originally proposed, which would allow the required information to be presented "in a manner that is intended to draw attention to it"; and (b) acknowledges that information that is one click away is presented in a manner intended to draw attention to it.[13]

Applying the one click away standard not only satisfies NASD's stated objective of raising investor awareness of fees, but also preserves the navigational flexibility of the web discussed earlier in this letter. Indeed, in light of the fact that web users "scan" web pages only for specific information (see footnote 8), requiring fund companies to place additional information on the same page as nonstandardized performance arguably does not make it more likely that users will actually pay attention to that additional information.

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[12] Securities Act Release No. 8294 (Sept. 29, 2003) (adopting amendments to Rule 482).

[13] The one-click away standard should not apply to electronic communications (such as banner ads) that promote performance and appear on a third party's website. Accordingly, we would support a rule that differentiates between these ads and performance quotations on mutual fund websites.

II. Expense Ratios in Fund Advertisements Should be Calculated in Accordance with Item 3 of Form N-1A.

As originally proposed in December 2003, the amendments to Rule 2210 would have required mutual fund advertisements to include expense ratios, computed as of the most recent calendar quarter in accordance with Item 3 of Form N-1A, which governs disclosure of the expense ratio in the fee table of a fund's prospectus. Several commenters objected to this proposal and recommended that funds be permitted to use expense ratios calculated semi-annually in accordance with Item 9 of Form N-1A, which governs disclosure of the expense ratio in a fund's shareholder reports. In the Release, NASD noted that expenses calculated according to Item 9 reflect the effect of fee waivers and expense reimbursements (hereafter, "fee waivers"), while those calculated according to Item 3 do not. Because NASD believes that investors will be "better informed" with disclosure of expense ratios that do not reflect fee waivers, it amended the proposed rule change to require fee and expense disclosure derived from the fund's most recent prospectus, *i.e.*, calculated in accordance with Item 3.

There is good reason to calculate expense ratios differently for prospectuses and shareholder reports. Prospectuses are directed toward *prospective* investors – those considering a purchase of fund shares, which are intended to be long-term investments. Those investors should base their decision on an understanding of the long-term cost of owning the fund, not on a lower figure that is short-term in nature. By contrast, shareholder reports are designed to tell investors about how their fund did during the previous year or half-year. For those investors, it is appropriate to calculate expenses based on the actual cost of owning fund shares during the period covered by the report.

Because advertisements, like prospectuses, are directed toward prospective investors, quotations of expense ratios in fund advertisements should be calculated using the methodology in Item 3, not Item 9.[14] For this reason, whether or not the Proposal is adopted in its current form, Vanguard strongly believes that expense ratios that appear in fund ads – whether voluntarily or because disclosure is required – should reflect the fund's expenses without regard to fee waivers.

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

If the SEC approves the NASD Proposal substantially as proposed, Vanguard strongly urges that NASD members be given a reasonable time period for implementation. In our view, this should be 9-12 months, but in no event less than 6

[14] Instruction 3(e) to Item 3 permits a fund waiving fees to reflect its expense ratio net of fee waivers in a footnote to the table. Vanguard recommends that a similar standard be applied to fund advertisements.

months. The Proposal, if adopted, will require a major redesign of Vanguard's website as well as numerous pieces of printed sales literature. It would be difficult to accomplish that task in less than 6 months.

Each major change to Vanguard.com is planned six months to one year in advance. Vanguard develops and tests each change, focusing on client usability and navigation. Based on focus groups and other client feedback, our website is developed with a "User-Centered Design" process. This process takes into consideration the primary tasks and goals of users, including functions and information that they have told us is needed, as well as how they expect to see that information. The process is composed of 12 high-level steps and 85 underlying steps. Each step is important to ensure that Vanguard.com attains the high quality and user-friendliness for which it is known. In light of our shareholders' growing dependence on our website, and the risks entailed in shortening the process for redesigning, testing, and elevating website changes, we believe a 9-12 month lead-time is appropriate.

At any given time, Vanguard has several major website enhancements in the works. These enhancements, some of which are requested by shareholders, are designed to improve usability, education, and disclosure. A short lead time for implementing the Proposal (anything less than 6 months) would require a diversion of resources away from existing projects, increasing costs and inefficiency. This problem is exacerbated by the fact that the Proposal comes on the heels of a recently completed and extensive web redesign required to implement the Commission's amendment of Rule 482. Now, a scant few months later, a new regulatory initiative could again consume considerable information technology and other resources to address a similar issue.

Because the Proposal would require funds to revise performance materials that are updated on a quarterly basis, we recommend that NASD set a compliance date that not only provides adequate lead time for the necessary design changes of printed materials, but also coincides with a quarter-end period. For instance, the Proposal could require compliance with the new requirements for advertising and sales literature that includes performance data for periods ending June 30, 2005 and later.

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Improving awareness of mutual fund expenses and sales charges is an important goal. Regulatory solutions should focus on the heart of the problem: fund advertisements that promote the performance of hot funds and/or emphasize performance to the exclusion of other information that is equally, if not more, meaningful to an investment decision. Without a doubt, such ads should be reined in, and a requirement that such ads disclose expense ratio and sale charge information at least as prominently as the performance data would serve to protect and inform investors in a rational way. The Proposal, however, has ramifications far beyond ads that promote performance. For the reasons discussed above, those ramifications would do more damage than good.

Accordingly, Vanguard does not support the Proposal in its present form, and urges the SEC to modify it in accordance with the comments contained in this letter as well as our earlier comment letter to NASD.

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 Barry Mendelson at 610-503-2398.

Sincerely,

/s/ Heidi Stam

Heidi Stam
Principal, Securities Regulation

Enclosure (January 22, 2004 comment letter to NASD)

cc: Paul Roye, Director, Division of Investment Management
Susan Nash, Associate Director, Division of Investment Management

Thomas H. Selman, Vice President, NASD Regulation, Inc.

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

January 22, 2004

<u>**Via Federal Express**</u>
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).

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

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[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]

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[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
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