ADMINISTRATIVE PROCEEDING
FILE NO. 3-5281

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

THE VANGUARD GROUP, INC., et al. :

INITIAL DECISION

Washington, D.C.
November 29, 1978

Max O. Regensteiner
Administrative Law Judge

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APPEARANCES: Fred C. Aldridge, Jr. and Philip J. Fina, of Stradley, Ronon, Stevens & Young, and Raymond J. Klapinsky, for applicants.

Gerald Osheroff, Arthur J. Brown, Alan C. Porter and W. Randolph Thompson, for the Commission's Division of Investment Management.

Fred Lowenschuss and William D. Parry, of Fred Lowenschuss Associates, for Joseph Silberman.

Richard M. Phillips, Patricia H. Wittie and Cherif Sedky, of Hill, Christopher and Phillips, P.C., and James L. Walters, for Wellington Management Company.

William J. Kennedy, Allan S. Mostoff, Paul G. Haaga, Jr. and F. Hastings Griffin, Jr., of Dechert Price & Rhoads, for the independent directors of the Vanguard Funds.

BEFORE: Max O. Regensteiner, Administrative Law Judge

By application originally filed in February 1977 and amended thereafter, the registered investment companies which comprise the Vanguard Group of Investment Companies (referred to hereafter as "the Vanguard Funds" or simply "the Funds"), and The Vanguard Group, Inc. ("Vanguard"), their jointly owned subsidiary which provides management and administrative services to them at cost, seek Commission authorization, under the Investment Company Act of 1940 ("the Act"), of proposed internalized distribution arrangements.

Pursuant to a request filed by Joseph Silberman, a shareholder of Wellington Fund (one of the Vanguard Funds), the Commission ordered a hearing to be held on the application. At the same time, it issued an "order of temporary exemption" which, on an interim basis pending final determination, granted the approval and exemptions sought by applicants, subject to certain conditions.[1/] Thereafter, I accorded leave to be heard to the "independent directors" of the Vanguard Funds and to Wellington Management Company ("WMC"), investment adviser of most of those Funds, as well as to Silberman. Within the scope of their respective interests, these "participants" took part in the very extensive hearings. Thereafter, the parties (applicants and the Commission's Division of Investment Management)

1/ Investment Company Act Release No. 9927 (September 13, 1977), 13 SEC Docket 92.

and participants submitted proposed findings and/or briefs.

I. Description of Applicants and Background of Application

Introduction

Prior to May 1975, the Vanguard Funds, like most mutual funds, were externally managed. WMC was investment adviser and manager for each of the Funds then in existence. It was also principal underwriter for those of the Funds which continuously offered their shares to the public. On May 1, 1975, the Funds "internalized" their corporate management and administrative (but not investment management) functions through Vanguard. And in October 1977, following the Commission's interim authorization, the distribution function was also internalized.

The Vanguard Complex

The senior member of the Vanguard complex (known as The Wellington Group until Vanguard became operative in May 1975) is Wellington Fund, formed in 1928 by WMC's predecessor. Wellington, a balanced fund (i.e., one whose portfolio includes common and preferred stocks and bonds), grew into one of the giants of the industry. By 1965, its net assets exceeded $2 billion. From that high water mark, net assets declined more or less steadily; by the end of 1977 they amounted to only about $700 million. In 1958, WMC organized a second fund, Windsor Fund (originally

Wellington Equity Fund), a common stock fund stressing capital appreciation. From time to time, additional funds, with a variety of investment objectives, were added to the group, until the number totalled 15 as of the end of 1977, with aggregate net assets of about $1.8 billion.

In addition to the above-named companies, the complex comprised Ivest Fund, Explorer Fund, Trustees' Equity Fund, Wellesley Income Fund, W.L. Morgan Growth Fund, Westminster Bond Fund, Whitehall Money Market Trust, Qualified Dividend Portfolio ("QDP"), QDP II, First Index Investment Trust, Warwick Municipal Bond Fund, Exeter Fund and Gemini Fund. Pursuant to Commission authorization,[2/] Exeter was merged into First Index in April 1978, leaving a total of 14 funds at the present time. Except for Gemini, a closed-end company, these are open-end funds which continuously offer their shares to the public. Until February 9, 1977, shares of nine of the Funds were sold with a sales load. On that date, those Funds switched to a no-load basis.

WMC is the investment adviser of each of the Funds except for First Index, which has no investment adviser, and Warwick Municipal Bond Fund, the newest of the Vanguard

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2/ Investment Company Act Release No. 10210 (April 18, 1978), 14 SEC Docket 855.

Funds, for which Citibank, N.A. serves as adviser. Prior to October 1977, WMC was also the principal underwriter for each of the continuously offered Funds. And prior to the May 1975 internalization, WMC provided most corporate management and administrative services to the Funds.

At the time the instant application was filed in February 1977, the Vanguard Funds, with minor exceptions, had the identical 11 directors.[3/] Of these, 9 were not "interested person(s)" of the Funds, as that term is defined in Section 2(a)(19) of the Act. In other words, they had no affiliation with WMC, the investment adviser and principal underwriter, were not officers of the Funds, and had none of the other relationships to the Funds encompassed within the "interested person" definition. It is these directors, and additional or replacement directors in the same category, who are referred to herein as the "independent directors." The other two directors were Robert W. Doran, president and chief executive officer of WMC, and John C. Bogle, chairman of the board, president and chief executive officer of each of the Funds and of Vanguard. Of the 11 directors, all but Doran comprised the board of Vanguard. Doran had served on Vanguard's board from its organization in September 1974

3/ Daniel S. Gregory was not a director of Explorer Fund (because of possible conflict of its business with that of the company of which he is chief executive) or a trustee (equivalent of director) of First Index (because he was "uncomfortable" with that Fund's underlying concept). Robert W. Doran, president of WMC, was not a trustee of First Index, which, as noted, has no investment adviser. He was also not a director of the recently organized Warwick Municipal Bond Fund which uses a different investment adviser. Gregory and Doran determined not to stand for re-election in 1978.

until April 1976.

Subsequent to February 1977, another independent director was added to the boards; two independent directors died; and Doran and one independent director decided not to stand for re-election in 1978.[4/] As a result, the Fund and Vanguard boards now consist of Bogle and seven independent directors.

All of the Vanguard Funds have the same officers, headed by Bogle; the same persons constitute most of Vanguard's principal officers. Since May 1, 1975, none of them has had any affiliation with WMC.

The 1975 Internalization

The 1975 internalization was the outgrowth of certain events that transpired around the beginning of 1974. At that time, as previously noted, the Vanguard Funds were managed by WMC. Their officers were officers or employees of WMC. Bogle, the Funds' president and chief executive officer, also occupied those positions with WMC. The Funds did have approximately 40 employees who were not also WMC's employees and who were engaged principally in fund accounting. But those persons were under the supervision and control of the executives, who were affiliated with WMC.

4/ By my order of September 7, 1978, certain post-hearing occurrences and data were incorporated in the record of this proceeding. These matters were first reported in a letter from Bogle to the Division and were subsequently recited in applicants' reply brief.

Long-standing disagreements among WMC's top management officials came to a head on January 23, 1974, when Bogle was removed as president and chief executive officer of WMC and was succeeded by Doran. Shortly before that date, Bogle had submitted to the Funds' independent directors a proposal that the Funds acquire WMC, which he characterized as a proposal for "mutualization." The proposal, which was similar to one Bogle had first advanced some years earlier, contemplated that WMC would become a wholly-owned subsidiary of the Funds and would serve as investment adviser and distributor for them.

On January 24, 1974, the Funds' boards determined that Bogle should continue as board chairman and president of the Funds and directed him to conduct a study (which came to be known as the Future Structure Study) "of the means by which the Fund(s) might best obtain advisory, management and underwriting services in the future." WMC agreed that during the pendency of the Study it would continue to pay Bogle's salary, and it agreed to cooperate in the Study. The independent directors retained Richard B. Smith, a former SEC commissioner, to serve as their special counsel during the conduct of the Study. Following an exhaustive study of a variety of options -- among them internalization of distribution together with internalization of administration, or both administration and

investment management -- the Fund boards concluded in July 1974 to internalize the Funds' "corporate administrative affairs" and to continue to contract with WMC for investment advisory and distribution services. The new advisory contracts were to provide for advisory fee reductions in excess of the expenses to be assumed. As part of their determinations, the boards adopted the principle that upon implementation of the restructuring, no Fund officers would be employed by, affiliated with or have an economic interest in any external adviser or distributor.

To implement the internalization decision, the Funds filed an application with the Commission in October 1974 for necessary exemptions from and approval under the provisions of the Act. Following issuance of an order granting the application,[5/] the Funds' shareholders approved the entry of each of the Funds into a Funds Service Agreement ("the Agreement") and into a new investment advisory agreement with WMC containing significantly reduced fee schedules. On May 1, 1975, the Funds internalized their corporate management and administrative functions through Vanguard, a service company wholly owned by the Funds in proportion to their relative net assets. Under the terms of the Agreement, the Funds' aggregate cash investment in Vanguard

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5/ Investment Company Act Release No. 8676, 6 SEC Docket 352 (February 18, 1975).

is limited to $500,000 and the cash investment of each Fund to 0.05% of its net assets. The amounts invested are adjusted periodically on the basis of changes in relative net assets.

Developments After May 1, 1975

Further significant developments occurred in the period between May 1, 1975 and February 1977, when the Funds decided to internalize distribution. Among other things, three new investment companies were organized by WMC and joined the Fund Group. Unlike the existing open-end companies, the shares of these companies were offered to the public without a sales charge. First Index, another new company, was sponsored by Vanguard itself. In June 1976, Vanguard became the transfer agent for the Vanguard Funds (except Gemini). And at the 1976 meetings of the Funds' shareholders, pursuant to a determination which the boards had made at the conclusion of the Future Structure Study, one of two directors affiliated with WMC did not stand for re-election.

Internalization of Distribution - Background

Prior to February 1977, WMC distributed the shares of those Funds that were sold with a sales charge principally through retail broker-dealers. These retailers received the bulk of the sales charge, and WMC received the balance. Until the early 1970's, WMC's portion was sufficient to cover its

distribution expenditures, but in the subsequent years that was no longer the case.

Among areas which were to be further explored following conclusion of the Future Structure Study and the restructuring decisions made by the Funds' boards at that time were "a clear definition of sales related activities for the separate pricing of such services under the distribution contract" and "analysis of the future mode of Fund share distribution and level of sales charges." The "separate pricing" there referred to meant the "unbundling" or division of the traditional investment advisory fee into one asset charge for investment advisory services and a separate asset charge for distribution services. In a July 1976 memorandum, Bogle strongly recommended the concept to his fellow-directors, stating that it appeared to afford a wide range of advantages, among them improved evaluation of advisory and distribution fees and costs, enhanced ability to negotiate the terms and provisions for obtaining each service, and improved disclosure to Fund shareholders.

The directors subsequently received and discussed further memoranda on the subject, both from Bogle and from WMC, which argued strongly against separate pricing. During the October 1976 board meeting, 6/ the evaluation of separate pricing was expanded

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6/ The singular form is used because the Funds' board meetings were (and are) generally conducted as a single meeting.

to the broader question of the manner in which the Funds' shares could best be distributed. Over the course of the next few months, much additional material was submitted to the directors by Bogle and his Vanguard staff and by WMC, and the issues were discussed at length by the boards. On February 8, 1977, the boards, with four directors (including Doran, WMC's representative) opposed, approved by a combined vote resolutions that shares of all the continuously offered Funds immediately be offered on a no-load basis, and that, subject to SEC and shareholder approval, all distribution and marketing activities of the Funds be internalized through Vanguard or a wholly-owned subsidiary. The boards also approved proposed new advisory fee schedules providing for reduced fees. The no-load decision was implemented the following day; pending implementation of the internalization decision, WMC continued as principal underwriter of the continuously offered Funds.

II. The Application

The Proposed Internalized Distribution Arrangements

The internalization of distribution and related steps were to be effectuated as follows: Subject to shareholder approval and to obtaining necessary Commission authorization, (1) the Funds Service Agreement was to be amended to provide for the Funds' sharing of distribution expenses by allocating those expenses, with certain exceptions noted below, among the Funds based on their relative net assets; (2) Vanguard was to organize a subsidiary, Vanguard Marketing Corporation ("Marketing"), which would become principal underwriter for the continuously

offered Funds; and (3) the Funds were to enter into new investment advisory agreements with WMC providing for aggregate fee reductions in the amount of $2,131,000 (based on January 1, 1977 assets). Based on Marketing's initial proposed annual distribution budget of $1,300,000, the Funds' initial annual net expense reduction was thus estimated as approximately $800,000. The distribution budget consisted of administrative expenses related to distribution of about $315,000, and expenditures of approximately $985,000 of a marketing and promotional nature. The latter figure represented roughly 5/100th of 1% of the Funds' aggregate net assets. Applicants represented that it was their present expectation that in the future annual marketing and promotional expenditures would not exceed twice that percentage, or 1/10th of 1% of aggregate net assets. They consented to the Commission's imposition of a condition setting a ceiling of 2/10th of 1% (Amendment 4 to Application).

As amended, the Service Agreement was to provide expressly that the distribution expenses to be borne by the Funds may include the expenses incurred from time to time in forming one or more new investment companies which are to become members of the Vanguard Group, as well as the expenses of offering shares of those companies to the public. The application seeks Commission authorization for the creation of new companies and their admission to the Vanguard Group without the need

for further exemptive orders or for approval by shareholders of the existing Funds. No new Fund will be organized, however, without the approval of two-thirds of Vanguard's independent directors, and not more than $50,000 will be spent on the organization of any new Fund.

Special provision was made for First Index, Exeter and Gemini. First Index, which is an index-matching fund without an investment adviser, was organized by Vanguard in December 1975. It made an underwritten public offering in August 1976 and itself bore organizational and offering expenses of about $79,000. These expenses were capitalized and are being amortized over a period not to exceed five years. The Funds' boards determined that until such expenses have been fully amortized, First Index will not bear any expenses related to distribution of the Funds' shares. However, it will begin to bear such expenses not later than the earlier of August 1981 (the end of the current five-year amortization period) or the date on which amortization is actually completed if an accelerated schedule is adopted. Further, First Index is to share in distribution expenses to the extent the amount being amortized is less than the Fund would be required to contribute under the net asset-based formula applicable to other Funds.

Gemini, a closed-end company, was to share only in distribution expenses of an administrative nature and not those of

a marketing and promotional nature.[7/]

The Relief Requested

The primary relief applicants seek is an order pursuant to Section 17(d) of the Act and Rule 17d-1 thereunder, permitting the proposed joint internalized distribution arrangements. As discussed more fully below, those provisions require that transactions involving "joint participation" between an investment company and its affiliated persons (in this case the other investment companies in the complex as well as Vanguard and Marketing) be first scrutinized by the Commission "for the purpose of limiting or preventing participation by such registered. . . company on a basis different from or less advantageous than such other participant."[8/]

Applicants also request an order pursuant to Section 6(c), the Act's general exemptive provision, (1) exempting the independent directors from Section 2(a)(19)'s definition of "interested person" to the extent that status arises solely because of their relationship to Marketing; and (2) exempting the proposed distribution arrangements, to the extent necessary, from the provisions of Sections 2(a)(35) and 22(c) of the Act

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7/ The same provision was made for Exeter, an "exchange fund" which did not offer shares to the general public. As noted above, Exeter has since gone out of existence.

8/ The quotation is from the statute.

and Rules 2a-4 and 22c-1 thereunder, which deal with the price at which shares of open-end companies may be sold to or redeemed from investors.

Finally, applicants seek an order, pursuant to Section 17(b) of the Act, exempting from Section 17(a) the issuance by Vanguard and the purchase by the Funds (including any newly organized Funds) of securities of Vanguard and periodic transfers of Vanguard securities among the Funds in order to maintain ownership of Vanguard proportional to their assets.

Applicants consent to the imposition of certain conditions. One, already noted, would impose a ceiling of 2/10ths of 1% of average month-end net assets on the Funds' distribution expenses of a marketing and promotional nature, provided that if the Commission adopted a rule permitting greater expenditures the Funds could conform their expenditures to its provisions. A second condition provides for the filing of annual reports regarding past and projected marketing and promotional expenditures. That condition would terminate in the event the Commission adopted a rule or interpretive release of general applicability which by its terms would permit the Funds' proposed financing of distribution activities without a reporting requirement. Finally, orders permitting the proposed distribution arrangements would be subject to preemption by and conformance with any Commission decision on the general subject of mutual fund distribution.

The Interim Order

Coincident with ordering a hearing on the application, the Commission deemed it appropriate, "in view of the cost savings that Applicants have represented will inure to the benefit of the Vanguard Funds during the first year of operation of the Vanguard distribution proposal," to grant applicants an "interim and temporary" order of exemption, pending final determination of the application and any review thereof, on the basis of the information in the application.[9/] The order was made subject to the condition that annual marketing and promotional expenses not exceed 1/10th of 1% of the Funds' average month-end assets over a calendar year and to the "preemption" and reporting conditions referred to above. The Commission imposed the further condition that upon implementation of internalized distribution, none of the Vanguard Funds refer to itself as "no-load" until such time as the Commission, by action of general applicability to registered investment companies, defined on what basis mutual funds bearing distribution expenses out of fund assets may refer to themselves as "no-load." In this connection, one of the issues specified for consideration at the hearing was whether it is appropriate for the Funds to characterize themselves as "no-load" and whether any final order granting the requested exemptions should include conditions prohibiting

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9/ Investment Company Act Release No. 9927 (September 13, 1977), 13 SEC Docket 92.

such characterization or subjecting the Funds to other disclosure requirements if such a phrase is used.

Implementation of Internalized Distribution

On October 1, 1977, following shareholder approval of the internalization of distribution and (in the case of the Funds advised by WMC) of new investment advisory agreements with WMC providing for reduced advisory fees, the continuously offered Funds entered into principal underwriting agreements with Marketing; the Funds other than First Index and Warwick entered into new advisory contracts with WMC; and all Funds entered into the amended Service Agreement providing for the sharing of distribution expenses. Marketing, whose board consists of the same persons as Vanguard's board (the Funds' president and the independent directors), commenced operations with an initial annual budget of about $1.3 million.

III. Issues Presented; Contentions; Findings and Discussion

The Issues

The issues specified in the order for hearing are as follows:

(1) whether the proposed internalization of the distribution function of the Vanguard Funds is necessary or appropriate in the public interest and consistent with the protection of

investors and the purposes fairly intended by the policy and provisions of the Act;

(2) whether the participation of each of the Vanguard Funds in the proposed internalization of the distribution of their shares through the use of Marketing is consistent with the provisions, policies and purposes of the Act and whether such participation is on a basis different from or less advantageous than that of other participants.

(3) whether it is appropriate for expenses that may be incurred by Marketing in forming one or more new investment companies to be paid out of assets of any or all of the Vanguard Funds;

(4) whether it is appropriate for expenses incurred in distributing the shares of one fund in the Vanguard complex to be paid out of assets of any or all of the funds in the Vanguard complex;

(5) whether it is appropriate for the Vanguard Funds to internalize their distribution services without internalizing their investment advisory services;

(6) whether it is appropriate for the Vanguard Funds to characterize themselves as "no-load", and whether any final order of the Commission granting the requested exemptions should include conditions prohibiting such characterization or subjecting the Vanguard Funds to other disclosure requirements if such a phrase is used.

Outline of Parties' and Participants' Contentions[10/]

Applicants, supported by the independent directors, urge that the requested relief be granted, subject only to the conditions proposed in the application. In their view, the internalized distribution arrangements are the latest step in a "highly successful program" initiated by the independent directors in 1974 with a view to providing the Funds and their shareholders with complete independence from all persons serving them, actual cost savings and the best structural position to obtain for each Fund in the future the best available services at the lowest reasonable cost. Those arrangements, they contend, are fair to each of the Funds and in all respects meet the applicable standards. The independent directors, in addition to endorsing those views, urge that, consistent with judicial and Commission pronouncements calling for the assumption of increased responsibility by truly independent fund directors, great weight be given their informed and reasonable business judgment.

Silberman urges denial of the application. He stresses, among other things, conflicts assertedly arising from the facts that the Funds, Vanguard and Marketing have virtually identical

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10/ Contentions regarding issues 5 and 6 and my findings and conclusions concerning them are presented toward the end of this decision.

officers and directors and that Wellington Fund has no independent representation, and he argues that Wellington would participate in the distribution arrangements on a less advantageous basis than the other Funds.[11/] He further takes the position that if any form of internalized joint distribution system is to be permitted, certain minimum conditions and safeguards should be imposed -- among them a requirement that at least 75% of each participating Fund's board of directors consist of persons not affiliated with the investment adviser, principal underwriter or the other participating Funds.

The Division takes the position that, while the direct bearing of distribution costs by the Vanguard Funds is not inconsistent with the Act's provisions and policies, the participation of some Funds in the distribution arrangements, particularly Wellington Fund, can reasonably be expected to be on a significantly less advantageous basis than that of others. Accordingly, it does not support the application in its present form. It would, however, support the application if conditioned to modify the allocation method so as to provide for what it deems to be a more appropriate relationship between amounts contributed for distribution and benefits reasonably expectable, and if certain additional conditions were imposed. Applicants,

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11/ I cannot accept Silberman's position that he represents not only his own interests as a shareholder of Wellington Fund, but the Fund and all of its shareholders. That position is predicated on the fact that Wellington "would otherwise have no independent representation," since its officers, directors and counsel also represent Vanguard and the other Funds and are therefore assertedly in a conflict of interest position. However, the Fund and its other shareholders have not designated Silberman as their representative.

in turn, urge that the proposed conditions not be imposed. And the independent directors assert that the Division's proposed allocation formula is unworkable. They suggest possible alternatives.

Finally, WMC, consistent with its declared reason for participating in the proceedings, namely, to assure development of a complete record as to matters pertaining to it, takes no position on the merits of the application. It makes certain brief observations some of which will be noted in the course of this decision.

May a Registered Investment Company Bear Distribution Expenses?

There appears to be agreement that the general question whether it is permissible under the Act for an investment company to assume and bear directly the cost of distributing its shares is at least implicitly in issue here. Applicants and the Division take the position that, at least in the context of the Vanguard Funds' internalized structure, it is permissible to use fund assets for that purpose. Silberman disagrees.

By way of preliminary comment, it should be noted that it was a fact of life in the Vanguard situation (and apparently in the industry by and large) that the amount retained by the underwriter out of the sales load has in recent years been wholly inadequate to cover distribution expenses. As a result, WMC, like other adviser-underwriters whose principal source

of revenue is investment advisory fees paid by mutual fund clients, necessarily had to draw on that resource for distribution expenditures.[12/] WMC figures for a recent year dramatically illustrate that point. In 1975, WMC had a pre-tax profit of over $4 million on advisory services provided to the Funds, representing a 63% profit margin. On the other hand, it incurred a pre-tax loss of over $2 million on its distribution services (excluding increased advisory fees resulting from sales created by those services). It seems more realistic to characterize this type of arrangement as an indirect use of fund assets to pay distribution expenses than to continue with the euphemistic explanation, which has been generally put forward, that the adviser is simply using part of its advisory fee profits to support its distribution effort.[13/]

12/ This was and is of course true a fortiori in the case of adviser-underwriters of no-load funds.

13/ However, in October 1976 the Commission, in ordering public hearings concerning the appropriateness of mutual funds' bearing distribution expenses (Investment Company Act Release No. 9470 (October 4, 1976), 10 SEC Docket 680), listed among issues for consideration the following:

> "Where a portion of the management fee paid by a mutual fund is used to help pay expenses associated with the sale of shares, is this the practical equivalent of the fund bearing selling expenses? If so, should such a use of the management fee be permitted? Under what circumstances? As a practical matter is such a use of the management fee distinguishable from a situation where a fund underwriter is affiliated with the adviser, and consistently operates at a loss? . . . .

As noted below, these and the other issues raised by the Commission in 1976 are still under consideration.

Returning now to the permissibility of the direct bearing of distribution expenses by an investment company,[14/] it is clear, first of all, that the Act contains no express prohibition. The provision most directly in point is Section 12(b). That Section makes it unlawful for a registered open-end company (other than one complying with the provisions of Section 10(d)) to act as distributor of its securities, except through an underwriter, in contravention of such rules as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. Section 12(b) is not self-operative. And the Commission has not adopted or even proposed the adoption of rules under it.[15/]

Silberman nevertheless contends that the use of fund assets to subsidize distribution of fund shares has long been condemned by the Commission and the courts. However, the fact that the Commission set the instant application down for hearing and granted it on an interim basis is itself inconsistent with the idea that it has closed the door on such use. Moreover, analysis of the statements and authorities cited, and others, indicates that they do not support the broad conclusion urged

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14/ Questions which may arise under Section 22 of the Act are discussed at page 72 infra.

15/ Just recently, however, the Commission issued a release requesting comments on the use of fund assets to pay distribution expenses, with a view to the possible promulgation of proposed rules under Section 12(b). Investment Company Act Release No. 10252 (May 23, 1978), 14 SEC Docket 1203, discussed more fully below. In the same release, the Commission stated that it was of the view that, to the extent a fund made payments to promote the distribution of its shares, it would be acting as a distributor of those shares.

by Silberman.

It is undeniable that this area has been a matter of serious concern to the Commission, as reflected in pronouncements going back at least to the 1960's. The main basis for its concern has been the obvious benefits to an external adviser from the sale of additional shares and the more questionable benefits to fund shareholders.[16/] A good starting point for considering the Commission's more recent pronouncements is the 1972 "Statement on the Future Structure of the Securities Markets." In a segment dealing with the various regulatory problems related to the use by investment company managers of fund portfolio brokerage (a fund asset) to reward dealers for sales of fund shares, the Commission said, among other things:

> "[T]he cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment and not, even in part, by the existing shareholders of the fund who often derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon the existing shareholders of the fund may violate principles of fairness which are at least implicit in the Investment Company Act."

While this statement can be read as an outright condemnation of the financing of distribution out of fund assets, it did not deal with the situation (though impliedly conceding that it could exist) where existing shareholders in fact derive substantial benefit.

16/ In a recent article, the author noted that the Commission's reluctance to authorize use of fund assets to subsidize sales of fund shares is to be viewed in light of the normal situation of external adviser control paired with asset-related compensation. "The benefit to the adviser. . . is easy to see; much less clear is . . . benefits flowing to fund shareholders. . . ." Freeman, The Use of Mutual Fund Assets to Pay Marketing Costs, 9 Loy. Chi. L.J. 533, 536 (1978).

Indicative of the fact that the Commission did not consider that there was an absolute bar under the Act against use of fund assets to pay distribution expenses is the order it issued in Broad Street Investing Corp. shortly after its Future Structure pronouncement. As discussed more fully below, that order, issued pursuant to Section 17(d) and Rule 17d-1, permitted joint arrangements whereby an investment company complex sought to bear directly a portion of the cost of internally distributing the shares of its member companies. 17/

In October 1976, the Commission announced public hearings on the appropriateness of arrangements whereby mutual funds would, directly or indirectly, bear expenses related to the distribution of their shares, with a view to enabling the Commission to provide guidance to the industry regarding the propriety of using fund assets to finance distribution expenses. 18/ By way of background, the Commission stated that it and its staff generally had questioned the propriety of such a practice, although in certain unusual circumstances (citing the Broad Street situation as an example) no objection had been raised. The Commission listed a number of issues, in two broad categories, for consideration. One category comprised legal issues, e.g., (1) whether it was legal under any circumstances for a mutual

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17/ Investment Company Act Release No. 7114 (April 4, 1972).

18/ Investment Company Act Release No. 9470 (October 4, 1976), 10 SEC Docket 680.

fund to bear distribution expenses and (2) the nature and extent of the Commission's authority in the matter. The second category consisted of policy issues, among them whether it could be demonstrated that sales of additional shares benefited shareholders under some or all circumstances.[19/]

In August 1977, the Commission issued a further announcement on the subject.[20/] Stating that it had not completed its consideration of the relevant issues and was not yet prepared to suggest whether, and if so under what circumstances, mutual funds should be permitted to bear distribution expenses, the Commission said that it therefore had "no reason at this time" to change its previous position that it was "generally improper" under the Act for mutual funds to use their assets, directly or indirectly, to finance distribution of their shares. At least pending completion of its review, no new arrangements involving use of fund assets to finance distribution would be sanctioned without the most careful scrutiny.

Most recently, the Commission issued an advance notice of proposed rulemaking under Section 12(b) of the Act, requesting public comment with respect to the question of whether there might be conditions under which funds could be permitted to use their assets to finance distribution expenses.[21/]

19/ Certain of the other policy issues raised also parallel issues presented or matters raised in this proceeding. Among them were: whether financing of distribution by charges against fund assets would be inequitable with respect to existing shareholders who had already paid an initial sales load; and whether use of part of the management fee to pay distribution expenses was the practical equivalent of the fund bearing selling expenses.

20/ Investment Company Act Release No. 9915 (August 31, 1977),12 SEC Docket 1657.

21/ Investment Company Act Release No. 10252 (May 23, 1978), 14 SEC Docket 1203.

After adverting to the varying views expressed during and in connection with the distribution hearings, including the view that net redemptions which the mutual fund industry was experiencing were harmful to shareholders, the Commission stated that it deemed it useful to explore further whether permitting mutual fund assets to be used to finance distribution could, under some circumstances, benefit investors, and at the same time to solicit comments about a variety of possible conditions upon such use of assets designed to safeguard investor interests. The Commission indicated that any such conditions should be designed to accomplish three objectives:

> "(1) to minimize any conflict of interest on the part of a fund's investment adviser or officers with respect to recommendations that fund assets be used to promote distribution, by limiting the degree to which the advisory fee is affected by sales; (2) to help ensure that fund assets are used to finance distribution only when, after appropriate consideration, the disinterested directors of the fund and the fund's shareholders determine that such use of fund assets would be in the interest of the fund, and (3) to help ensure that all shareholders are treated fairly. . ."

The Commission went on to describe the types of conditions it was considering.[22/]

It seems fair to say that the Commission's recent statements suggest a not inhospitable attitude toward the use of fund assets to finance the distribution of fund shares, under appropriate safeguards, in circumstances where investors are likely to be

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22/ The Commission emphasized that nothing in its release should be construed as suggesting that it had reached any conclusions with respect to the merits of the instant application.

the primary beneficiaries.

Silberman also reads too much into the decision of the Court of Appeals in Moses v. Burgin.[23] In that case, the investment adviser of a mutual fund, its affiliate(which was the fund's principal underwriter) and two fund directors affiliated with the adviser were held to have engaged in "gross misconduct," within the meaning of Section 36 of the Act as it then read,[24] because they failed to disclose to the fund's unaffiliated directors the possibility of recapture of brokerage paid on portfolio transactions, which was directed instead (by "customer-directed give-ups") to broker-dealers who sold the fund's shares.

The court rejected the defendants' argument that even if recapture was available to the fund, the directors still had the right to choose between it and directing give-ups to stimulate sales since they deemed sales to be beneficial to the fund's shareholders. In holding that the directors had no such choice, the Court relied on the language of the fund's charter requiring it to receive full asset value upon sale of its shares. It reasoned that the purpose of this provision

> "Was to prevent the value of the existing shareholders' interest in the assets from being diminished by the addition of further participants. If Fund receives the asset value of new shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for

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23/ 445 F.2d 369 (C.A. 1), cert. denied 404 U.S. 994 (1971).

24/ When the suit was brought, Section 36 prohibited "gross misconduct or gross abuse of trust." In 1970, Congress strengthened this language to prohibit "any act or practice constituting a breach of fiduciary duty involving personal misconduct."

> itself, then the net income Fund receives from the process of selling a share is less than asset value. The existing shareholders have contributed — by paying more than otherwise necessary on Fund's portfolio transactions — to the cost of the sale, which was supposed to have been borne by the new member alone." 25/

The Court went on to say that it was not holding that the lower court was not justified in finding that the promotion of sales of fund shares was beneficial to existing shareholders, as well as being beneficial to the adviser and underwriter. "It is merely that, by the terms of the charter, Fund cannot use free money, or credit, to pay brokers for sales. Sales are Crosby's [the underwriter's] business." 26/

Silberman argues that implicit in the last quoted sentence is a recognition that sales are not the business of a mutual fund itself. But no such generalized conclusion is warranted. As pointed out in the recent Second Circuit decision in Tannenbaum v. Zeller, 27/ the statement was made in the context of the particular fund's charter provision.

Tannenbaum, like Moses, was a shareholder derivative action based on the use of portfolio brokerage to reward broker-dealers who sold fund shares rather than its recapture for the fund's direct benefit. The Court construed Moses' holding that the directors had no choice if recapture was freely available as being based solely on interpretation of that fund's charter

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25/ 445 F.2d at 374.

26/ Ibid.

27/ 552 F.2d 402 (C.A. 2, 1977).

and not on fiduciary obligations imposed by Section 36 of the Act.[28/] It pointed out that the violation of that Section found in Moses resulted from management's failure to disclose sufficiently to the independent directors the possibilities of recapture, and not from the breach of an absolute duty to recapture imposed by the Act. The Court held, among other things, that the decision to forego recapture did not violate the fiduciary obligations of the adviser or the directors under Section 36 of the Act

> "if the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors." 29/

At least from the perspective of the Vanguard complex as a whole, it appears, partly on the basis of findings made below regarding directorial independence and benefits to shareholders from internalized distribution, that the Tannenbaum tests are met here.

The Role of the Independent Directors; Conflict of Interest

A central theme running through the presentations of applicants and the independent directors is the true independence of those directors and the consequences that should flow from that status.[30/] The independent directors point to judicial

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28/ The Court, relying on an earlier Second Circuit decision, rejected Moses' "charter reasoning."

29/ Id. at 418-19. This tripartite test had been proposed in the Commission's amicus curiae brief.

30/ The theme is closely related to that of the Funds' independence from external service providers, a subject which is discussed below.

pronouncements calling on fund directors to exercise greater independence and assume more responsibility and to statements by Commission members and officials calling for a greater role by independent fund directors in the governance of fund business affairs, to be accompanied by a lessening of Commission regulation. Reference is also made to the holding in Tannenbaum giving great weight to the reasonable determinations of independent fund directors who are in possession of all relevant information. It is urged that, consistent with these pronouncements, the independent directors of the Vanguard Funds, who have demonstrated their independence, should be permitted to make the reasonable business judgments reflected in the proposed distribution arrangements.

The Act, in Section 10(a), requires that at least 40% of an investment company's board of directors be independent. At all times here relevant, the Vanguard Funds have far exceeded that requirement by having a substantial majority of independent directors.[31/] During the period when internalized distribution was under consideration and then approved by the Funds' boards, 9 of the 11 directors were independent and a tenth (Bogle) was independent of the adviser. And, as has been

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31/ This statement does not take into account the consequences of the directors' affiliation with Marketing. Applicants' request for an exemption with respect to that affiliation is considered below.

noted, the Fund boards now consist of Bogle and seven independent directors. Four of the independent directors testified at the hearings, two of them at Silberman's behest.[32/] Each impressed me as a person of substance, highly intelligent and sophisticated about the mutual fund business. I have no reason to doubt that in those qualities these four are representative of the independent director group as a whole. The testimony of these men reinforced the documentary indications in the record that the independent directors approach their responsibilities thoroughly, seriously and conscientiously. For at least a number of years, the independent directors have had a degree of independence from the Funds' investment adviser which appears to be rare in the industry. One indicator of that independence is the fact that for some years now the independent directors have had the sole responsibility for selecting new independent directors. Its best manifestation, of course, is the fact that the several internalization decisions made by the boards were contrary to the strongly urged views of WMC.

It is clear, however, that for many years Bogle has been the most powerful force in the Funds' management. Bogle has spent his entire working career in the investment company field and is regarded as an innovator and leader in the investment company community. In 1969-1970, he served as Chairman of the Investment

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32/ Those two had voted against the resolutions to change to a no-load internalized distribution system. One of them is no longer a director of of the Funds.

Company Institute's board of governors. In addition to his obviously great intelligence and ability, Bogle's attributes also include a forceful personality. Perhaps understandably, the independent directors' brief overstates the directors' role in the structural changes which the Vanguard Group has undergone since 1974 and in doing so glosses over Bogle's role as the major moving force behind those changes and the fact of his very strong influence on the Funds' affairs.[33/] The record does show, nevertheless, that the independent directors have played a very active and influential role; indeed, on occasion they caused decisions to be made which differed from Bogle's proposals. For example, in the 1974-1975 period, Bogle's proposed "mutualization," tantamount to complete internalization, ended up as a far more modest internalization, due in large measure to the influence of special counsel retained by the independent directors. In 1976, it was one of the independent directors who was largely responsible for expanding the focus of the ongoing study from "separate pricing" to a broad examination of what distribution system would be best for the Funds. The important audit, compensation and nominating committees are composed exclusively of independent directors.

Of course, regardless of the extent of the directors' independence, the pending proposal must pass muster under the

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33/ But Silberman's charge that the whole internalization process since 1974 must be seen as a scheme by Bogle to regain the power and authority he wielded when he was at the helm of WMC involves a psychological analysis which I am not prepared to adopt. Moreover, it necessarily entails a portrayal of the independent directors as Bogle's "puppets," which is wholly unwarranted.

standards of Section 17(d) and Rule 17d-1. But in view of the directors' loyalty solely to the Funds and their shareholders and the thoroughness of their deliberations their determinations are entitled to considerable weight.[34/]

Silberman and to some extent the Division, however, focus on a different set of relationships of the directors, namely, that they and the officers serve all of the Funds in the complex (as well as Vanguard and Marketing). Silberman, noting that in determining upon the distribution arrangements and in implementing them, Wellington Fund, which is to pay the largest portion of the distribution expenditures, had and has no independent representation, urges that those directors and officers are in a position of conflict of interest which requires that their determinations as to benefits to each Fund must be independently and objectively scrutinized.

That, of course, is precisely the object of these proceedings. But the claim of a conflict of interest permeating the distribution arrangements on a continuing basis raises a serious issue meriting serious consideration. Silberman's contention appears to rest principally on the nature of the Vanguard structure rather than on any assertion that the officers and directors or any of them have a personal interest in

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34/ In the Tannenbaum case, the Commission's amicus brief, which suggested, in substantially the form adopted by the Court, the standards regarding the scope of directors' discretion regarding matters such as the recapture of brokerage commissions, stated that in some situations, as for example transactions falling within Section 17, the Act provides that the board will have no discretion (p. 29). I take this statement to mean simply that where the Act expressly prohibits a transaction absent Commission approval, the final say rests with the Commission and not the directors.

favoring one Fund over another.[35] In substance, the argument is similar to the Division's argument that applicants' proposal creates a conflict of interest because the common directors of a complex of funds may perceive greater allegiance to the complex than to any particular fund, with the result that they might act in the interest of the complex or of a majority of the funds, rather than in the interest of a particular fund or a minority of the funds, when such interests conflict. While the Act does not preclude common boards of directors,[36] this type of conflict is potentially particularly serious in the joint distribution context where the directors and officers have to decide on a continuing basis whether to continue to assess contributions on an asset-related basis, how much to spend on distribution and how to spend the amounts contributed by the complex's constituent funds.[37] The sheer number of Funds in the complex,

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35/ Silberman does point out, however, that most of the directors who own any of the Funds' shares own substantially more shares in Funds other than Wellington Fund than in Wellington, and that those shareholdings therefore present further elements of conflict. Neither applicants nor the independent directors have seen fit to respond to this argument which is by no means frivolous. However, in view of my findings as to the potential conflict of interest based on interlocking directors and officers, it does not seem necessary to give further consideration to this secondary line of argument.

36/ See Report 91-1382 of House Committee on Interstate and Foreign Commerce (1970), p. 15: . . . a director of one investment company would not ordinarily be deemed an interested person of that company by reason of being a director of another investment company with the same adviser."

37/ This is not to suggest that serious conflicts could not arise in other contexts. See Glaser, A Study of Mutual Fund Complexes, 119 Pa. L. Rev. 205 (1970); Comment, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich. L. Rev. 696 (1972). The latter article, stating that it is unlikely that an independent director can serve two or more related funds without conflicts arising and that it is unfair to the shareholders of either

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each with different characteristics, makes it very difficult for the directors and officers to avoid thinking in complex-wide terms on matters of this nature. The fact that, generally speaking, the board meetings for all the Funds are conducted as one common meeting -- really a practical necessity in view of the common directors -- naturally tends to promote such thinking.

The independent directors' response to Silberman's arguments lends support to the impression that the complex-wide approach is influential. In rejecting the possibility of eliminating interlocking directorates, they question the practicality of having separate directors for each Fund. 38/ But they place greatest emphasis on the argument that a "compartmentalizing" of directorships would preclude the directors of each Fund "from understanding the role of that Fund in the Vanguard Fund complex and harmonizing its operations with those of the other Funds for the good of all." Independent Directors' Brief, p. 26) Statements to similar effect are made elsewhere in their brief. As will be discussed below, each Fund in the complex derives certain benefits, both tangible and intangible, from its membership in the complex.

37/ (Continued)
fund to permit the directors to balance the competing interests of shareholders (p. 715), proposes that different funds within a complex be required to have different independent directors (p. 724).

38/ The Division also dismisses as impractical the possibility of each Vanguard Fund having a few directors (the Division uses the example of three) who do not serve on the board of any other Vanguard Fund.

But in those instances where the interests of different Funds participating in a joint arrangement may differ, the shareholders of each Fund are entitled to have its directors determine on a continuing basis whether the arrangement is of benefit to that Fund. Any other approach would run counter to the directors' fiduciary obligations under Section 36 of the Act and would be inconsistent with the policy expressed in Section 1(b)(2) of the Act that (as here pertinent) an investment company should be operated in the interest of its shareholders and not in the interest of other investment companies.

The independent directors contend that conflict of interest questions are irrelevant in the context of a Section 17 application, because that Section permits the Commission to grant exemptive relief notwithstanding any conflict, if the applicable standards are satisfied. As a general proposition, the contention has merit. In the instant context, however, the conflict question is relevant because of the continuing nature of the arrangement and the continuing decisions that the directors will be required to make relating to distribution matters.

I leave for later consideration the questions whether the potential conflict is sufficiently mitigated by the nature of the distribution arrangements, and whether conditions proposed by the Division and by Silberman to deal with it are adequate and/or necessary.

The Standards of Section 17(d) and Rule 17d-1

Section 17(d) of the Act and Rule 17d-1 thereunder, which have been briefly summarized above, provide the principal regulatory framework for resolution of the issues presented. As pertinent, they prohibit an "affiliated person" (as defined in Section 2(a)(3)) of a registered investment company (or an affiliated person of such a person), acting as principal, from participating in or effecting any transaction in connection with any joint enterprise or arrangement in which such company is a participant, unless an application regarding such enterprise or arrangement has been granted by the Commission. Implementing the statutory authorization to the Commission to prescribe rules "for the purpose of limiting or preventing participation by such registered . . . company on a basis different from or less advantageous" than that of the "affiliate participant," the Rule specifies that in passing on an application, the Commission will consider whether the participation of the registered company as proposed is "consistent with the provisions, policies and purposes of the Act and the extent to which such participation is on a basis different from or less advantageous than that of other participants." In the Vanguard complex, each of the Funds is an affiliate of every other Fund and of Vanguard.[39/]

39/ There is no dispute about these affiliations. Hence it is unnecessary to discuss the various lines of reasoning leading to the findings of affiliation.

There is no need to dwell at length on consistency of the distribution arrangements with the "provisions, policies and purposes" of the Act. The pertinent provisions of the Act, other than Section 17(d) itself, are discussed elsewhere in this decision. The "policies and purposes" of the Act, according to Section 1(b), are to mitigate and as far as feasible eliminate the undesirable conditions enumerated in the various subsections of that Section. It appears to me that only two of those subsections, (1) and (2), are relevant here. While applicants also refer to subsections (4) and (5), these deal, respectively, with undue concentration or inequitable methods of control of investment companies (in other words, capital structure) and with improper accounting practices or inadequate independent scrutiny of accounting practices.

Section 1(b)(1) deals with inadequate and inaccurate disclosure to investment company shareholders and prospective shareholders. The separate disclosure of distribution and advisory expenditures which internalization of distribution makes possible, as contrasted with the undisclosed use of an unspecified portion of the advisory fee for distribution expenditures,[40/] is certainly consistent with the full disclosure philosophy reflected in the Act.

40/ Cf. Freeman, The Use of Mutual Fund Assets to Pay Marketing Costs, 9 Loy. Chi. L.J. 533, 559 et seq. (1978).

Section 1(b)(2), as here pertinent, is directed to the situation of investment companies being operated in the interest of affiliated persons or of other investment companies rather than in the interest of their shareholders. As is evident, Section 17 of the Act, including Section 17(d), represents a principal Congressional response to this type of abuse. Whether the proposed internalized distribution arrangements meet Section 17(d) standards remains to be seen. There is merit, however, in applicants' contention that the added degree of independence from external entities which (as further discussed below) internalized distribution brings with it is consistent with the policy that a fund should be managed with an eye single to the interest of its shareholders.

In an effort to define the standards against which a joint arrangement is to be tested, applicants and the Division devote many pages to discussion of the legislative history of Section 17(d) and Rule 17d-1 and of court and Commission decisions pertaining to those provisions. Those authorities, however, furnish little light beyond what is evident from the terms of the Section and Rule. 41/ It seems clear that Rule 17d-1, which calls for

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41/ The focus of the decisions has been on whether a particular transaction came within the scope of Section 17(d). Applicants' reliance on Christiana Securities Company, Investment Company Act Release No. 8615 (December 13, 1974), 5 SEC Docket 745 [citations on appeal omitted] is misplaced since the Commission's opinion discussed only the standards of Section 17(b) and not those of Section 17(d). The only reference to the latter provision and to Rule 17d-1 is in a footnote, in which the Commission noted that relief under those provisions was also requested; indicated that it was doubtful they were even applicable; and held that if they were, their standards were satisfied. It may be noted that the problem in Christiana

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consideration of "the extent to which" an investment company's participation is on a basis different from or less advantageous than that of other participants, does not require absolute equality of participation. Indeed, in any complex multi-party arrangement such as the one proposed here, absolute equality may be unattainable. What the Rule does require, as applicants and the Division in substance agree, is that an investment company not participate in a joint enterprise with its affiliates on a basis which is unfair in relation to that of the affiliates, or in which the affiliates take undue advantage of the investment company.

Fairness of Distribution Arrangements

The proposal under consideration contemplates that the sums deemed necessary and appropriate for distribution expenditures (in other words, the distribution budget) will be allocated among the Funds in the complex on the basis of their relative net assets and will be spent in the manner deemed most productive by management. Operations are in fact now being conducted on this basis, pursuant to the Commission's interim order. Under this system, there is no correlation between amounts contributed by a particular Fund, on the one hand, and amounts expended for distribution of its shares or the extent of sales of its shares, on the other. This appears in its most glaring form as applied to Wellington Fund. Wellington is by far the

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41/ (Continued)
was that the proposed transaction provided far greater benefits to the investment company than to the non-investment company affiliate. Thus, while there was a serious Section 17(b) problem, there was obviously none under Section 17(d).

largest of the Vanguard Funds and thus would bear the single largest portion of distribution expenditures. However, like balanced funds generally, it has for some years been out of vogue compared to other investment vehicles and its shares have not been as saleable as those of other Vanguard Funds. In January 1977, the Vanguard staff estimated that Wellington, which on the basis of its then relative net assets would pay more than 40% of distribution expenditures, would account for only about 1.8% of projected sales during the first year under a no-load distribution system.[42/] During the first 3 months in which the internalized distribution system was actually in operation, nothing was spent in advertising Wellington shares with the exception of one newspaper advertisement and one direct mailing to a group of corporate directors, both of which related to all continuously offered Funds in the Vanguard Group.[43/] Expenditures were concentrated on the new Warwick Municipal Bond Fund which was considered (and was) a very marketable product.

While recognizing that through economies of scale, each Fund can benefit from sales of shares of other Vanguard Funds,

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42/ According to recently submitted figures covering the nine months since internalized distribution began, Wellington's sales amounted to less than 1% of complex sales. Based on the quarter-end average, Wellington accounted for 38% of complex net assets.

43/ More attention is devoted in this decision to Wellington Fund than to any other single Vanguard Fund. This is attributable in part to the fact that a Wellington shareholder is a participant in the proceedings and also to its peculiar characteristics as noted above which mean that it poses the most critical test of the fairness of the proposed arrangements. It is self-evident, however, that those arrangements must be found to be fair (or at least not unfair) to each of the Funds.

the Division contends that the proposed arrangement is unfair to Wellington Fund and potentially to other Funds and thus fails to meet Rule 17d-1 standards, a conclusion which Silberman strongly endorses. The Division proposes another system of allocation of distribution expenditures which would in its view be in closer proportion to the benefits derived from such expenditures.

In opposing imposition of the Division's proposed allocation method -- discussed in detail below -- applicants, in addition to defending the fairness of the asset allocation method, urge that the independent directors should not be restricted from making such changes in the allocation method and other aspects of the distribution system as are appropriate in the light of experience with the system. Similarly, in a supplemental brief filed in response to the Division's allocation proposal, the independent directors object to the imposition of any "rigid formula" by the Commission, which would limit the discretion and flexibility the directors now have to respond to changing conditions. They urge that if any conditions are to be imposed, such conditions should be only in the nature of general principles rather than a specific formula.

I find these arguments puzzling. While it is true that the Funds Service Agreement provides for an asset-allocation method "except as otherwise expressly determined" by Vanguard's board of directors, the application was presented, and the

case was tried, on the theory, and only on the theory, that the allocation would be based on relative net assets. That was also the way in which the proposed internalized distribution was presented in proxy statements seeking shareholder approval. Should the requested relief be granted, it would not extend to any other allocation method. Hence there is no basis for the pleas that the directors' flexibility not be circumscribed.

Citing the Commission's actions in 1972 and 1976 with respect to the Broad Street complex, applicants point out that the Commission has previously found that an asset-related method for paying distribution expenses satisfies the standards of Section 17(d) and Rule 17d-1. In 1972, the Broad Street complex consisted of five investment companies, including a large closed-end company. Fund management and advisory services were internalized. Shares of the open-end companies were sold with a traditional sales load. Commission approval was sought of a joint arrangement under which the net cost of operation of the internal wholesale distributor of shares of the open-end companies would be borne directly by all the investment companies in the complex. The open-end companies were to share distribution costs on the basis of their total net assets, the closed-end company on the basis of 60% of its net assets. Annual contributions were to be limited to .05% of average net assets for the open-end companies, .03% for the closed-end company.

Without ordering a hearing, the Commission issued an order pursuant to Section 17(d) and Rule 17d-1 permitting the proposed arrangement.[44/] In 1976, the Division (pursuant to delegated authority) issued an order that in substance permitted the complex to add a new fund to its internalized joint arrangements.[45/]

I agree with applicants that the bases on which the Division seeks to distinguish the Broad Street situation from the Vanguard proposal are mostly insubstantial. For example, while it is true that the Broad Street Group was fully internalized, so that no external organization could benefit from asset growth, whereas in the Vanguard situation the external investment advisers will so benefit, this distinction is of little consequence since determinations as to distribution expenditures are to be made by directors wholly independent of the advisers. On the other hand, the Broad Street orders, which were issued without benefit of an evidentiary record, were based on representations regarding the benefits to be obtained by each fund in a particular set of circumstances, including rather low expenditure ceilings. Moreover, the Commission's recent pronouncements, which have been noted earlier in this decision,

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44/ Broad Street Investing Corporation, Investment Company Act Release No. 7114 (April 4, 1972).

45/ Broad Street Investing Corporation, Investment Company Act Release No. 9513 (November 8, 1976).

indicate that the whole question of use of fund assets to finance share distribution is under re-examination.

Turning now to applicants' detailed presentation in support of the proposed distribution arrangements, they urge that those arrangements must be viewed as a fundamental structural change, part of a program begun in 1974, producing for each of the Vanguard Funds a package of interdependent, continuing benefits, many of them qualitative, consisting principally of: (1) complete independence to select an investment adviser and to negotiate an appropriate advisory fee; (2) significant immediate savings and potential future savings; (3) a more effective share distribution system; and (4) participation in economies of scale. Viewed from this perspective, applicants contend, the evidence establishes that each Vanguard Fund, including Wellington, has received, is receiving and will continue to receive significant benefits and has been treated fairly, and that no Fund has been or will be unduly disadvantaged. These contentions will now be considered.[46/]

Increased Independence

As a general proposition, the external management structure which is typical in the mutual fund industry precludes true independence for funds having that structure, even if they

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46/ However, the question whether the new distribution system is in fact more effective than the old would seem to be beyond the purview of these proceedings. In any event, as applicants acknowledge, any definitive judgment concerning the success of the new structure would be premature. Moreover, the many variables that enter into sales volume make any determination of the influence of one factor at best a hazardous enterprise.
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have a majority of independent directors. In its 1966 Report on Public Policy Implications of Investment Company Growth, the Commission, discussing possible ways to improve shareholder protection against unfair management compensation, rejected as an effective check negotiations between the unaffiliated directors of an externally managed investment company and its adviser-underwriter. It pointed out that even if all directors of such a company were required to be unaffiliated, they could not bargain with the adviser at arms length because the "adviser-underwriter permeation of investment company activities" made rupture of existing relationships a difficult and complex step for most companies.[47]

At least in part because of the unusual circumstances involving Bogle, the Vanguard Funds, atypically, were in a position in 1974 to rupture their relationships with WMC (through mutualization) and seriously considered doing so. Though less drastic, the subsequent internalization of corporate management and administration, by providing the Funds with management and staff responsible and loyal solely to them and making them substantially self-sufficient, moved them toward the existence of a true arms-length relationship with WMC.

46/ (Continued)
On the other hand, I do not question that the directors' determination on this aspect of the matter was based on a thorough consideration of the various alternatives and represented a reasonable business judgment.

47/ Public Policy Report, p. 148.

Bogle acknowledged that the Funds' bargaining position was substantially enhanced as a result of the 1975 internalization.

Applicants contend that the internalization of distribution represents a further major step necessary for the Funds' attainment of complete independence from their investment adviser. Pending this step, they note, the Funds were still dependent on an external organization for a bundled package of advisory and distribution functions. As a practical matter, a particular Fund within the complex could not have obtained its own adviser or distributor. With distribution internalized, each Fund stands on its own in selecting an adviser and negotiating advisory fees. Applicants point out that the universe of advisers from which each Fund can choose has been substantially expanded, because the adviser's distribution capability, if any, is irrelevant. One manifestation of this added independence is the fact that Warwick Municipal Bond Fund, the youngest member of the Vanguard Group, chose as its adviser a bank -- and as such prohibited from acting as distributor -- charging a very low advisory fee.

Degrees of independence and bargaining power do not lend themselves to precise measurement. But it seems clear that in some measure internalized distribution has enhanced the Funds' position in these respects. I find no merit in WMC's argument (endorsed by Silberman and to some extent by the Division) that as a

corollary to a lessened dependence on WMC, the Funds have become more dependent on the Vanguard staff. WMC characterizes this as a "trade-off," implying that there has been no net gain. Applicants are justified, in my opinion, in pointing out that reliance on a corporation's internal management and staff whose loyalties are to that corporation alone (putting aside the conflict of interest problem discussed above) cannot properly be characterized as "dependence." At least it is not comparable to dependence on persons whose interests also include maximizing the profits of an external organization.

Savings to Funds

In connection with the 1977 internalization of distribution, the advisory fee schedules for the Funds advised by WMC were revised downward. Under the pre-existing advisory agreements, the Funds, with minor exceptions, had the same fee schedule. In 1977, a number of different schedules were adopted, including separate ones for Wellington and certain other Funds and shared schedules for the remaining Funds. Based on January 1, 1977 assets, aggregate fee reductions amounted to $2,131,000. On the basis of December 30, 1977 assets, which were some $200 million lower, the fee reductions totalled $1,976,000. Deducting from those figures the distribution expenses of $1.3 million in the initial Vanguard distribution budget, net savings of $831,000 and $676,000, respectively,

were indicated for the complex.[48] On an individual fund basis, projected net savings during the first year of internalized distribution ranged from $5,000 to $212,000 on the basis of January 1, 1977 assets and from $5,000 to $248,000 on the basis of December 30, 1977 assets.[49] In each case the largest figure is that for Wellington Fund, although in terms of projected percentage of savings the figure for several other Funds exceeded that for Wellington.[50] The projected savings for each Fund were a major factor in the directors' determination to proceed with internalized distribution, and, as noted, they constitute one of the principal bases advanced in support of the application.[51]

48/ The figures in the text reflect calculations included in two exhibits introduced by applicants. (Exs. 23 and 23-1). The figures which the Fund boards had before them prior to their February 1977 decision reflected net assets as of a different date and, as a result, were somewhat, though not materially, different.

49/ These figures do not include First Index, which has no investment adviser, or Warwick, which was created subsequent to the decision to internalize distribution and has an investment adviser other than WMC.

50/ Bogle testified that an attempt was made to have the percentage of savings substantially similar for each Fund, except that the three principal income funds of the complex were given a somewhat higher percentage of savings so as to make their expense ratios more competitive with those of other income funds. The figures support that testimony. Silberman, while arguing most strongly that the "purported savings" are really illusory, suggests at the same time that the variances in savings percentages present an element of unfairness. However, in view of the conclusion reached regarding the fairness of the asset-allocation method, there is no need to deal with that question.

51/ More recently, advisory fee schedules for seven of the Funds have been further revised. As to five of the Funds, including Wellington, the new schedules would result in aggregate annual fee reductions of $619,000, based on December 30, 1977 net assets. On the same basis, Gemini Fund's fees would increase by $22,000. The new schedule for Windsor Fund would generate the same fees, based on December 30, 1977 assets, but would increase fees at higher asset levels and decrease them at lower asset levels.

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The Division and Silberman urge, however, that applicants' attribution of the net expense reductions or "savings" entirely to the internalization of distribution is unwarranted. I agree. For one thing, the cost to a distributor of operating a no-load distribution system is much less than that of operating a load distribution system through a network of dealers.[52/] Thus, even without internalization, reduced fees could undoubtedly have been obtained merely by switching to a no-load system.[53/] Indeed, a December 1976 memorandum from the Vanguard staff to the independent directors (Appl. Exh. 11-15) points out that it is the savings resulting from adoption of a less costly distribution system which the Funds would be receiving. The mechanism for accomplishing this was to reduce total advisory fees by approximately the amount representing WMC's net distribution expenses.

Further, as the Division stresses, the Funds had been in a strong bargaining position vis-a-vis WMC since at least 1975, and it seems clear that they could have obtained reductions in the advisory fee levels wholly aside from internalization of distribution or any other change in the distribution system. The Division cites various instances beginning in 1974 in which WMC had accommodated the Funds at

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51/ (Continued)
By order of September 7, 1978, I accepted these post-hearing facts as part of the record. But I also ruled that because there had been no opportunity for cross-examination or rebuttal evidence, I would not draw inferences from the new facts where more than one inference could reasonably be drawn. Here it is by no means clear that, as applicants would have me infer, the new fee reductions could be achieved only because of the internalization of distribution.

52/ This fact undercuts Silberman's arguments seeking to impeach the credibility of Vanguard's initial distribution budget by comparing it with WMC's distribution costs in prior years.

53/ It is a different question whether WMC, with its orientation toward the dealer system, would have been an effective no-load distributor or whether it would even have agreed to act as distributor on that basis.

considerable expense or loss of revenue to itself. Moreover, in connection with the internalization of distribution, WMC did not bargain or negotiate with the Funds regarding the total amount of reductions in advisory fees which were to be achieved, but accepted the amount proposed. Applicants' argument that WMC had offered no fee reductions until internalization was imminent has little substance, since "normal" fee negotiations responsive to expiration of the advisory contracts in April 1977 never commenced.

Of course, the amount of fee reductions which could have been obtained under other circumstances is speculative. And the fact remains that on the basis of the initial distribution budget each Fund other than First Index realized a net expense reduction as of October 1, 1977. But Silberman makes the further point that applicants' savings projections are based on the assumption that marketing and promotional expenditures will remain at the initial level of approximately .05% of net assets.[54/] As he notes, the application would place a ceiling of .20% of net assets on such expenditures. Up to that point, the amount spent would be in the directors' discretion, although it is the directors' stated expectation that expenditures will not exceed

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54/ Silberman's argument that the initial distribution budget was prepared on a purely arbitrary basis for the purpose of coming up with a savings figure is not supported by the record.

.10%. While urging that it must be anticipated that the full extent of the power sought will be used, Silberman points out that even on the basis of a .10% figure for marketing and promotional expenditures, the savings would turn into losses for several of the Funds, including Wellington.[55/]

Economies of Scale

Applicants assert that additional benefits are likely to be realized by the Funds through economies of scale resulting from sales produced by distribution expenditures. The argument rests on a series of cost-benefit analyses prepared by the Vanguard staff for presentation at the hearings (Exhs. 27, 28-1 through 28-4) and Bogle's extensive explanatory testimony.

This type of analysis, apparently novel in the present context, was not considered to be essential in the deliberative process leading to the internalization decision, in part because the distribution expenditures to be made under internalized distribution were perceived not as "extra" expenditures or investments but as a reduction of savings achieved through the advisory fee reductions. In light of the findings made in the preceding section, the soundness of that perception is questionable. In any event, it was only at the last minute, at the suggestion

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55/ As will be discussed below, the Division urges that any order granting the application be subject to the condition that promotional expenditures not exceed .10% of aggregate net assets.

of special counsel Smith, that the boards directed the Vanguard staff to prepare a cost-benefit analysis showing economic benefits to the Funds and their shareholders from distribution expenditures resulting in various sales levels. Such an analysis, but only on a complex-wide basis, was submitted by Bogle to the boards on February 8, 1977 (Appl. Ex. 11-23). Based on the data, which were in the form of return over a ten-year period on a specified investment in distribution expenses, Bogle concluded that economic justification for sales, even under relatively modest sales assumptions, could be demonstrated in terms of net cost savings resulting from the lower incremental advisory fee rate on new assets and from spreading fixed costs over a larger asset base. Bogle was careful to point out, among other things, that any linkage between dollars spent on distribution and dollars brought in through new sales was very tenuous. The analysis, although it did not deal with individual Funds, was deemed to lend additional support to the view that internalized distribution would be of benefit to them.

The analyses produced at the hearing included a complex-wide analysis and analyses for three individual Funds, among them Wellington, which have different characteristics in terms of size and recent sales volume. They reflect the fact that each Vanguard Fund can benefit from sales of its own shares in two ways: (1) assuming it has reached at least the first breakpoint in its advisory fee schedule,

the effective advisory fee rate will be reduced,[56/] and (2) its own fixed expenses are spread over a larger asset base. In addition, the expense ratio for each Fund is reduced by sales of shares of any of the Funds in the complex, including any new Funds which may be added to the complex, since the complex has certain relatively fixed expenses which are shared by the Funds on an asset-related basis. By way of example, the Wellington Fund cost-benefit analysis shows that if Wellington "invested" $400,000 in distribution expenditures in one year but no Wellington shares were sold, it could still realize a positive annual return on the investment over a ten-year period if share sales of the other Funds in the complex reached a level somewhere between $100 million and $150 million.[57/] At the $150 million level, that return would be 5.1%. The complex-wide analysis shows annualized returns on a $1 million investment in distribution expenses at various annual sales levels, ranging from a negative return up to a sales level between $25 million and $50 million to a return of over 79% at a $250 million sales level. At the $100 million sales level, which is close to actual aggregate sales for 1977, the annual return on investment was shown

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56/ This benefit is of course not available to First Index which has no investment adviser.

57/ The calculations reflect only changes in assets resulting from sales volume and an assumed redemption rate of 10% per year with respect to new assets; they do not take into account asset changes attributable to portfolio performance.

as 25.1%. On the basis of the more recent higher sales level, that return would be considerably larger.

The Division and Silberman raise various questions concerning some of the premises underlying and figures reflected in the applicants' analyses. While conceding that a return-on-investment analysis is useful in conceptualizing how each Fund can benefit from growth of its own assets and from growth of the total complex assets, the Division claims that in those analyses the benefits are significantly overstated. Among other things, it asserts that certain types of sales, such as most of those made to existing shareholders, are not properly attributable to promotional expenditures; that certain expenses which rise to some extent with sales are treated as 100% fixed; and that the assumed redemption rate is lower than that reasonably expectable.

Applicants defend the reasonableness of the analyses. Their main arguments, however, are that those analyses are necessarily based on a number of assumptions each of which is debatable; do support the general proposition that at reasonable sales volumes, substantial returns on distribution investments may be realized; and in any event were at most a subsidiary factor in the directors' evaluation of benefits from the distribution restructuring.

On balance, it appears to me that, as applicants acknowledge, the precision which the analyses convey is not warranted, but

that they do give a rough indication of benefits which are obtainable through share sales attributable at least in substantial part to promotional expenditures. Moreover, since the analyses for the individual Funds rest on the same assumptions, they appear to afford a valid basis for comparing relative benefits.

Unfairness of Proposed (Existing) Allocation System

On their face, the facts that Wellington Fund is to pay (and is paying) roughly 40% of Vanguard distribution expenses while at the same time sales of its shares were expected to amount to less than 2% of complex sales and only a minuscule portion of the promotional expenditures are being used to promote its shares raise serious questions of fairness. While each Fund in the complex derives some benefit from sales of shares of its sister Funds, an individual Fund can benefit far more, in terms of expense ratio reduction, from sales of its own shares. Thus, for example, Warwick Municipal Bond Fund, a type of fund currently favored by investors, has been heavily promoted since internalized distribution began in October 1977, with very favorable results. Because it is still in its infancy and relatively small, Warwick's contribution to the distribution budget has been and for at least

a number of years will be far smaller than Wellington's. [58/] No cost-benefit analysis for Warwick was submitted. It is clear, however, that for the foreseeable future Warwick will benefit from the joint distribution arrangement to a far greater extent than Wellington. While applicants point out that the mutual fund industry is characterized by great fluctuations in sales volume of particular types of funds, they acknowledge that there are no indications that balanced funds such as Wellington, which have not sold well for a number of years, will regain popular favor in the near future.

Consideration of the cost-benefit analyses for Wellington and the other two individual Funds, Wellesley Income Fund and Westminster Bond Fund, also demonstrates the great disparity in benefits obtainable by the various Funds. The latter two Funds, both far smaller than Wellington, have had recent sales exceeding those of Wellington, but nowhere near the spectacular level of Warwick. The cost-benefit calculations for Wellesley and Westminster were based on distribution investments of $75,000 and $25,000, respectively, reflecting approximately .05% of their net assets. Using the Vanguard staff's sales projections for the first year under no-load distribution of

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58/ According to figures recently submitted by applicants, Wellington's net assets at the end of June 1978 were $672 million, Warwick's $46 million. During the nine months since internalized distribution began in October 1977, sales (excluding reinvested dividends) totalled $1.3 million for Wellington, $58.8 million for Warwick.

$2 million for Wellington, $7 million for Wellesley, $8 million for Westminster and $110 million for the Vanguard Funds in the aggregate, the approximate annual rate of return would be over 15% for Wellesley and over 50% for Westminster but about 0% for Wellington.[59/] Recent sales figures show that complex sales volume is surpassing projections by a substantial margin, with the consequence that, under the cost-benefit analysis, Wellington's rate of return would be considerably higher. But since Wellington's own sales volume is running slightly below the projected level, the disparities between its rate of return and that of various other Funds would only be increased.

What, then, is applicants' defense of a system which, on its face, appears to justify Silberman's characterization that Wellington Fund is being used as a "deep pocket" to finance the newer and smaller Funds' distribution expenses? On a broad level, it is applicants' position, as spelled out above, that the internalized distribution arrangements must be viewed as a whole and as providing continuing benefits for each Fund largely in terms of enhanced independence and expense savings.

59/ The Division points out that the cost-benefit calculations indicate that annual returns would be vastly unequal among the participants in the joint distribution arrangements even if identical sales totals are assumed.

The analysis to which these asserted benefits have been subjected indicates that they have been overstated, particularly the savings attributable to the internalization of distribution. And in any event, those benefits are shared by all of the Funds in roughly equal measure. Moreover, as WMC points out, any consideration of savings must at the same time take into account the fact that internalization also carries with it certain risks, including the risk of higher expense ratios if assets should decline. This risk derives from the fact that internalization, while reducing management fees paid as a percentage of net assets, converts these variable expenses into the fixed (or relatively fixed) costs of supporting the internal distribution effort.

With reference more specifically to the joint distribution arrangements, applicants point out that the mutual fund complex, rather than the individual fund, is the normal "operating unit" today, in part because constituent companies can benefit from economies of scale resulting from joint performance of various functions. In addition, each member company can realize reduced expense ratios as complex assets grow. Wellington provides a dramatic illustration of this characteristic. In 1970, when it had average net assets of $1.38 billion, Wellington's expense ratio was .47%. In 1976, even though its net assets had been reduced to about $800 million, its expense

ratio (adjusted to reflect the internalized distribution arrangements) was almost unchanged, undoubtedly due in large part to the growth of the complex through the formation of new Funds and the asset growth of these and the already existing Funds (other than Wellington).

Silberman takes a sharply different view of the relationship between Wellington and its sister funds. In his view, Wellington has been harmed, not helped, by the creation and promotion of those funds, which he asserts are in competition with Wellington. In fact, he attributes Wellington's asset shrinkage to such competition. Silberman asserts that Wellington's contribution to the joint distribution budget would be (and is) counter-productive, by subsidizing more competition against Wellington. He points out, in this connection, that Wellington's own shareholder list and most of its contribution to the distribution budget are being used to promote and solicit sales of shares of other funds. However, the argument that the other funds compete with Wellington for investors' money is not established by the record.[60/] On the contrary, there is simply no basis for contending that, for example, Warwick, a municipal bond fund on which Marketing's promotional

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60/ That the Court in Taussig v. Wellington Fund, Inc., 187 F. Supp. 179 (D.Del., 1960), aff'd. 313 F.2d 472 (C.A. 3, 1963), found that Windsor Fund (then Wellington Equity Fund), although having different investment objectives than Wellington, competed with it "at least to a limited extent." (187 F. Supp. at 204) is not determinative of the current situation.

efforts have been concentrated, competes with Wellington. The decline in popularity of balanced funds such as Wellington is well documented in the record. It would of course be a cause for concern if persons about to invest in Wellington, whether or not they were already Wellington shareholders, were being encouraged to invest in other Vanguard Funds, or if Wellington shareholders were being urged to exchange their Wellington shares for shares in another Fund. But the record does not show that such practices are being followed. Merely urging such shareholders to invest in other Vanguard Funds, when the alternative may be no investment in any Vanguard Fund, is a different matter entirely.

The next strand of applicants' argument in support of the proposed internalized distribution system is that distribution is a collective function for a fund group and can best be performed jointly. In part, this is said to be so because economies are realized by joint performance of distribution services, just as by joint performance of administrative services, and because each fund can benefit from growth of the group's assets. Reference is also made to the considerable volatility in sales results achieved by a fund group and by each participating fund. In light of that fact, it is argued, joint sharing of distribution expenses is essential if a fund group is to have the opportunity to grow in the face of

changing conditions, develop some consistency of cash inflow and build assets. Although these arguments are not wholly convincing, I am persuaded that under suitable safeguards the joint sharing of distribution expenses of a complex may well be appropriate and that it may be appropriate for assets of one fund to finance the distribution of another fund's (including a new fund's) shares to some extent.

That still leaves the necessary justification for the asset allocation method, however. Aside from the argument that each Fund is charged the same percentage of assets -- an argument which looks at only one side of the cost-benefit equation -- and the arguments, previously discussed, regarding increased independence and alleged savings for each Fund, applicants present certain additional justifications. They assert that no Fund's participation can be deemed more or less advantageous than any other's, since the largest Funds, which pay the largest share of the distribution costs, are also in a position to receive the largest dollar savings from the joint distribution effort. The argument is weak since it is percentage of savings and not dollar savings which is the significant statistic. Applicants further claim that there is no feasible alternative allocation system. To base the assessment on sales volume, the most obvious alternative, would lead, according to applicants, to totally impracticable charges against any Funds which generate

large sales volume in relation to assets and would make it practically impossible to introduce new funds. Bogle testified that allocation on a sales basis would reduce the income of such funds to a point where their shares would not be saleable, or would even eliminate income, and would in addition violate state expense ratio limitations. Allocation based on actual expenditures for each Fund would, according to applicants, be similarly flawed. The claim that no feasible alternative exists will be examined below in considering the alternative which the Division believes is both feasible and fair. In any event, however, if the only system which applicants deem workable leads to unfair results, approval could not be granted.

Applicants present a further argument, to the effect that the asset allocation system is consistent with industry practice and with the situation that existed when WMC was the distributor, in that a large part of the resources expended for distribution and the creation of new Funds was derived from asset-related advisory fees. Thus, they assert, the proposed arrangement merely makes explicit (with the attendant benefits of full disclosure) what was previously implicit. My prior comments indicate that the record supports the argument's factual underpinning. And it is clear that in effect revenues obtained by WMC from the larger Funds were used to pay for the distribution of the new and smaller Funds' shares. But it does

not follow that a practice which has not received express Commission sanction, involving advisory fees which presumably met standards of reasonableness, provides a basis for express approval under a wholly different structure.

It follows from what has been said that the proposed system for allocating distribution expenditures, which assumes an essential equivalence of benefits to each of the Funds and their shareholders, is not consistent with the standards of Rule 17d-1.

The Division's Alternative Proposal

As noted, the Division takes the position that the application should be approved only if amended or conditioned to provide a different allocation system which would apportion the costs of distribution so as to recognize differences in benefits received. Pointing out that each Vanguard Fund will benefit in part as its shares are sold and in part as shares of other Funds in the complex are sold, the Division proposes an allocation system which it believes gives recognition to this fact and which it deems both workable and fair.[60/]

The proposed alternative system would operate in the following manner: Half of the total distribution budget would

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61/ The Division states that it believes other formulations might be devised which would yield cost allocations within the range of fairness.

be allocated on the basis of relative net assets. The other half would be allocated on the basis of relative sales volume in the most recent 12-month period. Computations would be made, as now,at the end of each quarter. The Division states that the use of a one-year period would tend to obviate unusual quarterly sales fluctuations. And the use of a moving period would mean, according to the Division, that a new Fund could be introduced without having to bear high distribution expenses in its first year of operation. As to an existing Fund such as Wellington, which has not sold well in the past and is not expected to sell well in the foreseeable future, its burden would be substantially reduced. The Division calculated that, assuming Wellington share sales totalled $5 million in a year in which the other funds sold $155 million and Wellington's assets constituted 40% of complex assets, Wellington's share of the distribution expenditures would be about $520,000 under applicants' proposal and about $280,000 under the Division's proposal.[62/]

Applicants contend that the Division's proposed formula is mechanistic, conceptually deficient and unworkable. Among

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62/ The Division's proposal would make an exception for Whitehall Money Market Trust which experiences both inordinate sales and redemptions, by assessing distribution expenditures against it solely on a relative net asset basis.

other claimed flaws, they point to the following:

1. A two-year table presented by the Division to show that under its formula an attractive new fund accounting for fully half of the complex's total sales could feasibly be introduced incorrectly assumes a redemption rate of 0% and presents distribution charges on a quarterly rather than an annual basis. As modified to reflect a 10% annual redemption rate and distribution expenses on an annualized basis, the table would show such expenses as 0.40% of net assets by the middle of the second year and still in excess of 0.25% by the end of that year.

2. The Division's formula would only modestly reduce the costs of Wellington Fund, whose expense ratio has already been reduced to one of the lowest in the industry, but would increase massively the costs of those Funds which have small assets and large sales. In addition, that formula would make it almost impossible for prospective investors to rely on a relatively stable expense ratio and a commensurately stable rate of income and would periodically place one or more of the Vanguard Funds in violation of state expense ratio limitations. Accordingly, applicants claim, the formula, like one based on sales volume only, is unworkable as a business matter.

3. Most importantly, it is claimed, the Division's formula, unlike applicants' proposal which permits variations to be made, is rigid, precluding appropriate modification by

the independent directors in light of changing circumstances.

In a supplemental brief, the independent directors agree with applicants that the Division's formula is not commercially workable. Stating that they have explored and will continue to explore possible alternatives to the asset allocation method, they attach a possible formula based to some extent on sales which "appears to be workable." Basically, however, they oppose imposition by the Commission of any "rigid formula," on the ground that it would remove an important element of informed business judgment from their discretion and would limit their flexibility in dealing with new fact situations as they develop.

I have previously commented on the plea that the Commission should not restrict the flexibility and discretion of the Funds' management, noting that in my opinion the plea is misplaced in its implication that the proposal now before the Commission is not so restricted. Obviously, the particular method for allocating distribution expenses is a critical factor in determining whether the proposed internalization of distribution meets the standards of Section 17(d) and Rule 17d-1. The only method for which Commission approval is sought is an asset-based allocation system (with specified exceptions for Gemini and First Index). If approval were granted, that method could not be changed without further Commission approval.

I am not prepared, on the other hand, to hold that applicants must adopt the Division's proposed alternative formula as a condition to approval of the application. Unfortunately, that formula was put forward for the first time in the Division's brief, filed in stage two of a three-stage briefing process. It appears to produce more equitable results. But absent the testimonial exploration and full briefing which could have been obtained had it been offered in the course of the hearings, the record does not provide an adequate basis for determining whether the formula is or is not fair and feasible. In any event, however, it would be inappropriate to impose on applicants and their independent directors an allocation method which they deem both unfair and unworkable.

As a consequence of the above findings, it follows that in its present form the application for relief under Section 17(d) and Rule 17d-1 must be denied. However, that does not mean that the Vanguard Group must promptly return to an external distribution system, even assuming such a step could be taken promptly. Although the present allocation method has been found to be unfair, particularly to Wellington Fund, the harm is mitigated by the current high level of complex-wide sales. Under all the circumstances, it seems preferable to permit applicants to continue for a brief period with the present method of operation and to afford them a

reasonable opportunity to amend the application. Such amendment could be in the form of a revised method for allocating distribution expenditures overcoming the defects in the presently proposed method. Alternatively, if, consistent with Silberman's suggestions, the Funds' management were restructured so as to provide independent representation for each of the Funds and thereby obviate the conflict of interest previously discussed, a basis would exist for reserving to the applicants a far greater measure of flexibility in determining the allocation method and adjusting it from time to time than is otherwise warranted. Amendment of the application in either of the above directions would presumably necessitate some supplemental hearings.

Rejection of the application in its present form should not be taken as criticism of the independent directors' effort to move the Vanguard Funds toward an improved structure. Rather, it reflects the complexities involved in allocating distribution expenditures fairly among a group of funds with widely disparate characteristics in terms of size and saleability.

Other Conditions Proposed by Division

The Division proposes the imposition of two further conditions in any order granting the application.[63/] One

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63/ While I have concluded that the application must be denied, my decision includes findings on the remaining issues, in contemplation of the possibility of applicants' filing appropriate amendments or the Commission's reaching a different conclusion on review.

would limit promotional expenditures by applicants to .10% of aggregate net assets, the other would impose on the directors of each Fund a duty of continued evaluation and review with respect to the amount of the Fund's ongoing payments for distribution expenses and benefits received by it from its participation in the joint distribution arrangement.

1. The .10% limitation on promotional expenditures is sought on the basis of the uncertainty of the effect of promotional efforts on sales and the large amount of money that would be at risk if such expenditures reached the level of .20%, the ceiling which applicants proposed. Applicants oppose the Division's proposal. They note that they have represented that they do not expect to spend more than .10%, but they point out that there may be circumstances in the future when, possibly for only a brief period, expenditures in excess of that percentage would be in the best interests of all the Funds. Applicants further stress that competing funds with external distribution are not subject to any such limitations and that various business factors impose practical restraints on the amount of the Vanguard Funds' distribution expenditures.

Assuming submission and approval of an amended application, including imposition of a condition (as proposed by applicants) requiring the filing of annual distribution reports, which will permit distribution expenditures to be monitored,

I am persuaded that the objections raised by applicants outweigh the concerns cited by the Division, and that the proposed condition need not be imposed.

2. The other proposed condition, pertaining to directorial evaluation and review of each Fund's continued participation in the distribution arrangement, is occasioned by the Division's concern that a duty on the part of directors to assure themselves that each Fund will benefit sufficiently to warrant its continued participation in that arrangement is not expressly imposed by Section 15 of the Act and may not be wholly certain under Section 36(a). Applicants state that the directors recognize that they have a fiduciary duty to each Fund, derived from state and common law and possibly from Section 1(b)(2) of the Act, to provide a continuing review of the Fund's participation in the distribution arrangement. While they urge that there is no need to make this duty an express condition of approval of the application, they object strongly only to any statement or indication that, as claimed by the Division, such duty is created by Section 36(a) of the Act. The differences between the parties on this issue are thus of a minimal nature. And there is no need for present purposes to determine the precise source of the acknowledged fiduciary duty. Imposition of the requested condition (without any reference to Section 36(a)) appears appropriate as a means of additional protection for the Funds' shareholders.

Exemptions from Sections 2(a)(35) and 22(c) and Related Rules; Fairness to Shareholders Who Paid Sales Load

Applicants state that it has been asserted that Sections 2(a)(35) and 22(c) of the Act, and Rules 2a-4 and 22c-1 thereunder, alone or in combination, might be interpreted to prohibit the proposed distribution arrangements. These provisions deal generally with the price at which shares of mutual funds may be sold to or redeemed from investors. Applicants state that they do not believe that such provisions would be violated by those arrangements. With a view to resolving any doubt on the matter, however, they request, pursuant to Section 6(c) (the Act's catchall exemptive provision), that, if necessary, the Funds be exempted from those provisions.

The Division, the body that has in the past suggested the interpretations giving rise to the questions raised here, acknowledges that those interpretations, and in particular the treatment of distribution expenditures such as those proposed here as "sales loads," are not clear under the Act.[64/] In any event, however, the Division concludes that it would be appropriate under Section 6(c)'s standards to grant the requested exemption. I see no reason to disagree.

64/ A recent commentator concludes that the view that distribution charges constitute sales loads under the Act is "highly questionable." Freeman, The Use of Mutual Fund Assets to Pay Marketing Costs, 9 Loy. Chi. L.J. 533, 545 (1978).

A related, and more serious, question is involved in the argument made by Silberman that the assessment of distribution charges against Wellington (as well as that against other Funds which were load funds prior to February 9, 1977) is unfair to those shareholders who paid a sales load when they purchased their shares. The briefs filed by applicants, the independent directors and the Division do not adequately come to grips with this argument. That the issue presented has substance is confirmed by the manner in which the Commission addressed it in its recent release on the use of mutual fund assets to finance distribution. The Commission there stated, in part, that

> ". . . it must be recognized that, in some cases, the use of fund assets to pay distribution expenses might be in the interest of one group of investors, but contrary to the interest of another group of investors. Specifically, existing shareholders would in effect be asked to pay further amounts for distribution and, to the extent that they did not invest in additional shares of the fund, they would not enjoy any direct benefit from the reduction or elimination of the sales load.
>
> It might be feasible to avoid any such unfairness to existing shareholders by providing that a mutual fund whose shares have previously been sold with a sales load may bear distribution expenses only if such expenses are not charged against shares which were purchased during that prior time." 65/

The Commission solicited comment on the feasibility of the above suggestion, as well as on possible alternatives.

65/ Investment Company Act Release No. 10252 (May 23, 1978), 14 SEC Docket 1203, 1207-8.

If the Commission ultimately adopts a rule on the subject of mutual fund distribution, such rule may be dispositive of the question under consideration (as well as of other aspects of applicants' proposal).[66/] Pending such development, it appears to me that the method suggested in the Commission's release has the serious drawback of introducing significant complexities into fund accounting and disclosure and, in the case of the Vanguard Funds, further complicating any system of allocating distribution expenses among the various funds. No other feasible method for resolving this element of possible unfairness is apparent. However, if fairness in the allocation method can be achieved, the overall benefits of the internalized distribution system would be sufficient, in my opinion, to outweigh the disparity in impact upon different groups of investors.

May the Vanguard Funds Characterize Themselves as "No-Load"?

As noted previously, one of the conditions imposed in the Commission's temporary exemption order was that once distribution expenditures were internalized, no Vanguard Fund could refer to itself as "no-load" until such time as the Commission, by an action of general applicability, defined on what basis mutual funds bearing distribution expenses out of fund assets may

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66/ Applicants expressly agreed that any order granting the relief they request would be subject to preemption by any such rule.

refer to themselves as "no-load." One of the issues to be considered at the hearing was whether it was appropriate for the Vanguard Funds to characterize themselves as "no-load," and whether any final order granting the requested exemptions should include conditions prohibiting such characterization or subjecting the Funds to other disclosure requirements if such a phrase were used.

In its recent release on the use of mutual fund assets to finance distribution, the Commission stated that "at the present time" it was of the opinion that the term "no-load" or equivalent terminology should not be used to characterize a fund whose shares are sold without a sales load at the time of purchase but which uses assets to pay for distribution. Such a fund, the Commission said, might state that it charges no sales commission, but would have to make clear that shareholders will pay for distribution by means of charges against assets. Noting the condition it imposed in its temporary order with respect to applicants, the Commission stated that it would give further consideration to the issue in connection with the instant application.[66/]

The Division urges that any order issued herein include as a condition a prohibition against applicants' use of the term "no-load." This position is urged on the grounds that

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66/ Investment Company Act Release No. 10252 (May 23, 1978), 14 SEC Docket 1203, 1208-9.

(1) the definition of "sales load" in Section 2(a)(35) of the Act may include, "at least by its intent," the distribution charges proposed by applicants, and (2) the term "no-load" may have a special significance in the market place, so that its use here could be misleading. The Division has no objection, however, to applicants' indicating in their sales material that there is no "sales charge" at the time of purchase, as long as they also indicate that distribution charges are assessed against Fund assets and describe such charges in the Funds' prospectuses. That is, in essence, the form which applicants' advertising materials and prospectuses have followed since internalized distribution commenced in October 1977.

Applicants, opposing the Division's position, point out that the term "no-load" is not defined in the Act and assert that it is simply a descriptive term used in the marketing of mutual fund shares to indicate that there is no "front-end" deduction. Applicants further assert that there is no valid distinction between "traditional" no-load funds and the Vanguard Funds, since in both cases the monies used to support the distribution effort are derived from shareholders. The sole difference, it is claimed, is that in the Vanguard situation the distribution expenditures are undertaken directly and are fully disclosed, rather than filtered through the investment adviser as "profits." Further, applicants contend that no

showing has been made that investors would be misled if the Funds used the "no-load" designation.

As applicants point out, the Act does not define the term "no-load." While it may be true that the Vanguard internalized structure is as deserving of that characterization as those funds with external distributors which are now designated "no-load" funds, the fact remains that there is a structural distinction. In light of the views expressed by the Commission and the possibility that extension of the "no-load" designation to a type of structure for which it has apparently never been used could well be misleading to investors, the position urged by the Division is the better one at this time.

Exemption of Independent Directors From "Interested Person" Definition

As noted, the Funds' independent directors are also directors of Marketing, which is principal underwriter for the continuously offered Funds and a registered broker-dealer. By virtue of the Act's definitions of "interested person" in Section 2(a)(19) and "affiliated person" in Section 2(a)(3), each of those directors is an interested person of Marketing and of each Fund. Applicants seek an order, pursuant to Section 6(c), exempting present and future directors who would otherwise be considered independent from Section 2(a)(19)'s definition of "interested person" to the extent that status arises solely from their relationship to Marketing. Absent such exemption, applicants

would be unable to comply with Sections 10(a) and (b) and 15 of the Act. Those provisions require, in substance and as pertinent here, that the board of a fund be composed of a specified percentage of directors who are not interested persons of the fund or its principal underwriter, and that a principal underwriting contract be approved by a majority of directors who are not interested persons of the underwriter.

The Division favors the grant of the requested exemption, while Silberman urges denial on the ground of conflict of interests. It does not appear, however, that the directors' affiliation with Marketing, the Funds' wholly-owned subsidiary, adds anything to the conflicts, discussed previously, arising from their service on the boards of all of the Funds. They have no interest in Marketing which could conflict with their responsibilities as directors of the Funds. Accordingly, it is appropriate to grant the exemption.

Exemption from Section 17(a) for Admission of New Funds to Vanguard Group

Pursuant to Section 17(b) of the Act, applicants seek an exemption from Section 17(a) to the extent if would otherwise preclude any new funds organized by Vanguard from participating in its ownership and would preclude other periodic adjustments of Vanguard's ownership among the Funds in accordance with the

terms of the Funds Service Agreement. The Division favors the grant of this exemption. No one opposes it. Assuming appropriate amendment of the application as discussed above, it would be consistent with the standards of Section 17(b) to grant the exemption.

May Distribution be Internalized Without Internalization of Investment Advisory Services?

An issue specified for consideration at the hearing was whether it was appropriate for the Vanguard Funds to internalize their distribution services without also internalizing their investment advisory services. No party or participant now urges that permission for internalization of distribution be contingent upon simultaneous internalization of the advisory function. Applicants strongly urge that this is an area of business judgment which should be left to the determination of the Funds' boards of directors. The Division suggests certain concerns resulting from separation of responsibility for the two functions, but finds them not persuasive. I concur in its conclusion that since the potential benefits of internalizing distribution are not significantly affected by whether investment advice is provided externally or internally, there is no compelling reason to require the two functions to be internalized in tandem, and that the determination of whether the Funds would benefit from

internalization of the advisory function should be left to the directors.[67/]

IV. Order

On the basis of the above findings and conclusions,[68/] IT IS ORDERED that the application pursuant to Section 17(d) of the Act and Rule 17d-1 thereunder is hereby denied, provided, however, that, in order to provide applicants with a reasonable opportunity to amend the application in accordance with the findings herein, the effectiveness of the Commission's interim and temporary order of exemption, including

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67/ Applicants recently called to my attention the fact that by letter dated October 20, 1978, they had filed the annual financial report on their distribution activities required by the Commission's temporary exemption order of September 13, 1977, and they stated that they had no objection to the report being made part of the record herein. Silberman thereupon advised that he did so object. The Division stated that, if I chose to rule on the question whether the report should be treated as part of the record, it would like an opportunity to present its views opposing admission of the report. It went on, however, to express those views in summary form.

By order issued on September 7, 1978, I dealt with essentially the same question, relating at that time to an earlier submission of post-hearing information by applicants. For reasons there expressed at length, I ruled that new matters of a factual nature would be made part of the record, but that I would draw no inferences from those facts except where only a single inference was compelled. My ruling on the latest material is the same. However, the new facts do not materially affect the findings made in this decision.

68/ All proposed findings and conclusions and contentions have been considered. They are accepted to the extent they are consistent with this decision.

all conditions imposed therein, is hereby extended to February 1, 1979. 69/ A further appropriate order will be entered on or before that date.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to that rule, this initial decision shall become the final decision of the Commission as to each party or participant which has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon it, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to it. If a party or participant timely files a petition for review, or the Commission takes action to review as to a party or participant, the initial decision shall not become final with respect to that party or participant.

Max O. Regensteiner
Max O. Regensteiner
Administrative Law Judge

Washington, D.C.
November 29, 1978

69/ Because the requested exemptions pursuant to Sections 6(c) and 17(b) of the Act have no significance absent approval of the application under Section 17(d) and Rule 17d-1, the order does not encompass those exemptions.