

September 30, 2010

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Mr. Russell L. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities (File Reference No. 1810-100)

Dear Mr. Golden:

Vanguard appreciates the opportunity to comment on the Financial Accounting Standards Board's proposed accounting standards update referenced above (the "Proposed ASU"). In addition to the comments contained in this letter, Vanguard fully supports the comments submitted with respect to the Proposed ASU by the Investment Company Institute, the trade association representing U.S. investment companies, of which Vanguard is a member. We write separately to emphasize our concern with the effect the Proposed ASU, if adopted, would have on investment companies.

As a manager of investment companies (mutual funds and exchange-traded funds), Vanguard is concerned about two aspects of the Proposed ASU that would have disruptive effects on such companies and would ill serve their investors. First, we oppose any accounting standard that would require investment companies to treat the transaction costs associated with the purchase and sale of financial instruments² as an expense, rather than a capital item. The proposed treatment would cause such transaction costs to be reflected in the expense ratio that every investment company must publish in its prospectus and certain marketing materials. Because of the difficulty of quantifying transaction costs and the variability of such costs, the proposed treatment would result in inconsistent reporting of the results of fund operations, make expense ratios and yield quotations more volatile and less useful to investors, and result in book-tax differences that would be costly and burdensome for funds to maintain – with no offsetting benefits to investors. Second, we oppose any accounting standard that would require money

¹ Vanguard, headquartered in Valley Forge, PA, is one of the world's largest investment management companies. In the U.S., Vanguard manages more than 170 mutual funds with approximately \$1.4 trillion in assets and serves approximately 17 million shareholder accounts. Vanguard also offers more than 50 other funds in non-U.S. markets.

² The term "financial instrument" is defined in the Glossary on page 29 of the Proposed ASU.

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market funds to report their investments at fair value, rather than at amortized cost. This change would fundamentally alter the money market fund industry, change a standard that has served money market fund investors well for decades, and preempt a working group of experts who are currently considering money market fund reform proposals.

A. Treatment of Transaction Costs

Vanguard has built its reputation on the principle that costs matter. The funds we offer are the lowest cost, or among the lowest cost, funds available in their peer groups. We are keenly aware of the importance of costs to fund shareholders.³ As a result, we are committed to providing investors with disclosure about fund expenses that is clear and accurate, and can be used to make informed investment decisions.

Under current generally accepted accounting principles ("GAAP"), the transaction costs associated with an investment company's acquisition of a security are included as part of the security's cost basis, and transaction costs associated with an investment company's sale of a security are subtracted from the sale proceeds. The Proposed ASU would change this treatment, requiring an investment company to recognize such transaction costs as an expense when incurred.⁴ The proposal would change a fund's statement of operations by reducing net income by the amount of the transaction costs and increasing (decreasing) realized and unrealized capital gains (losses) by a comparable amount.⁵

Treating transaction costs as expenses would have a significant detrimental effect on funds and fund investors because it would (i) introduce uncertainty and subjectivity into fund financial statements, given that it is not possible to precisely quantify transaction costs; (ii) alter quotations of a fund's expense ratio and yield in a way that would make those metrics less useful for investors; and (iii) introduce a book-tax difference that would create additional complexity and cost with no benefit to fund investors. For these reasons, Vanguard opposes the Proposed ASU to the extent it would require investment companies to treat transaction costs as expenses rather than capital items.

³ A recent Morningstar study concluded that low fees are likely to be the best predictor of a mutual fund's success. According to the study: "If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds." Russ Kinnel, "How Expense Ratios and Star Ratings Predict Success" (August 9, 2010).

⁴ See Paragraph 12 (page 33) and Paragraph BC 51 (page 123) of the Proposed ASU.

⁵ Because the change in the two line items would exactly offset one another, there would be no net effect on the fund's results of operations, *i.e.*, no effect on the fund's total returns.

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1. The proposal would result in inconsistent reporting of the results of fund operations.

The current accounting treatment, whereby transaction costs are reflected in capital gains and losses, has served mutual fund investors well by providing consistent and objective reporting of fund operations. The proposal would introduce uncertainty and inconsistency into fund financial statements because of difficulties in defining and quantifying transaction costs.

There are many ways to measure transaction costs. According to the Securities and Exchange Commission, there are four types of transaction costs: brokerage commissions, spread costs, market impact costs, and opportunity costs. Brokerage commissions are explicit costs, readily identifiable and quantifiable. The other three types of transaction costs are implicit costs, which the SEC has noted are difficult to quantify and can greatly exceed explicit costs. Given the difficulty of quantifying the majority of transaction costs, the Proposed ASU would make preparing and auditing financial statements far more difficult and time-consuming, and would make the line items for expenses and net income in a fund's statement of operations products of subjective judgment rather than amounts derived from the objective application of accounting principles.

2. The proposal would make expense ratios less useful to investors.

As noted above, the majority of transaction costs are implicit costs that cannot easily be quantified. There are many methodologies for measuring implicit costs, but ultimately all are estimates, and different methodologies can yield significantly different results. By including implicit transaction costs in the expense ratio, this important metric would become an estimated, subjective amount rather than an objective amount derived from reliable data. Two funds that are otherwise identical would carry different expense ratios, depending on the methodology each uses to calculate intrinsic costs. Adding such an element of uncertainty into the expense ratio would be extremely detrimental as investors would no longer be able to meaningfully compare one fund's expense ratio with another.

This uncertainty could be alleviated by limiting transaction costs to readily quantifiable explicit costs, but this approach creates problems of its own. Whereas

⁶ Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, SEC Release No. IC-26313 (Dec. 18, 2003), Part II.A. The SEC describes spread costs as the costs incurred indirectly when a fund buys a security from a dealer at the "asked" price (slightly above current value) or sells a security to a dealer at the "bid" price (slightly below current value). The SEC describes market impact costs as the costs incurred when the price of a security changes as a result of the effort to purchase or sell the security. The SEC describes opportunity costs as the costs of missed trades; the longer it takes to complete a trade, the greater the likelihood that someone else will decide to buy (or sell) the security and, by doing so, drive up (or down) the price.

⁷ *Id.*, Part Il.A.5.

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transactions in equity securities typically generate a mixture of explicit and implicit costs, transactions in fixed income securities typically generate only implicit costs. As a result, limiting transaction costs to explicit costs would cause stock fund expense ratios to rise, while bond fund expense ratios would stay the same. This would destroy the ability of investors to meaningfully compare the costs of investing in stock, bond, and balanced funds. It also would make stock funds appear relatively more costly than bond funds, possibly skewing investment decisions. Finally, focusing solely on explicit commissions can be misleading because, for some trades, paying a higher commission results in lower total transaction costs and thus a better outcome for fund shareholders. For example, paying a higher (explicit) commission to a broker who commits capital or works a trade gradually into the market can significantly lower the (implicit) market impact costs of that trade.

The expense ratio shown in a fund's prospectus is based on the actual operating expenses incurred by the fund during its previous fiscal year, as reflected in its financial statements. The operating expenses incurred by a fund tend to vary little from one year to the next. This makes the expense ratio very useful to investors because the previous fiscal year's expense ratio is likely to reflect what an investor will actually experience in the present year. Transaction costs tend to be far more variable than operating expenses, rising and falling with investor purchase and redemption activity and the portfolio manager's trading activity, which may vary significantly from year to year. Thus, the inclusion of transaction costs in the expense ratio would make traditional operating expenses less transparent and would make the expense ratio less predictive, and therefore less useful, to investors.

3. The proposal would make fund yields more volatile and appear artificially low.

When calculating yield, every investment company must use a standardized formula promulgated by the SEC. That formula is based in part on the dividends and interest earned by the fund during a 30-day period minus expenses accrued during that period. The SEC requires the use of a standardized formula in order to ensure comparability among the yield quotations of different funds. By introducing subjectivity and uncertainty into one component of that formula -i.e., expenses - comparability would be lost. In addition, because transaction costs are more variable than operating costs, the proposal would make yield quotations more volatile, with fund yields rising and falling from month to month for reasons wholly unrelated to the fund's receipt of interest and dividends.

If the Proposed ASU is implemented, a fund's expenses would increase by the amount of its transaction costs, lowering the fund's 30-day yield quotation. As discussed below in Section 4, a fund's distributions are based on taxable income, not on book income. As a result, although the fund's yield quotation would decline, the net amount

⁸ Indeed, if operating expenses for the present fiscal year are expected to differ materially from the previous year, SEC rules require that the fund restate the expense information in the fee table.

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distributed to shareholders would remain unchanged, making the yield quotation misleading to investors.

4. Book/tax difference

Under current GAAP, transaction costs are an intrinsic part of the cost of buying and selling securities, and thus are included in the price of a security for purposes of calculating gain and loss. Tax law treats transaction costs the same way as GAAP does. If the Proposed ASU is adopted, tax law and GAAP would treat transaction costs differently. A fund's expenses and realized and unrealized gains and losses on the securities in its portfolio would be different for tax and financial reporting purposes, requiring the fund to maintain two separate sets of books. A typical fund may have hundreds and sometimes thousands of securities, and each security may have been purchased in multiple distinct lots. The maintenance and reconciliation of separate book and tax records for every security lot would be an extremely burdensome task. Vanguard estimates that it would cost approximately \$7-10 million dollars up front and \$1.5 million each year thereafter to build and maintain the systems necessary to track the book-tax differences of the various security lots. Other investment companies likely would have to expend similar amounts on their systems. These costs would provide no added value to users of the financial statements (i.e., investors) because the changes would result solely in reclassification between captions within a fund's statement of operations, with no effect on the total results of operations or the reported returns of the fund.

Under the Internal Revenue Code, an investment company must distribute all or virtually all of its net income (as determined under tax law) to qualify for favorable pass-through tax treatment. If the Proposed ASU is adopted, net income would be different for tax and financial reporting purposes. Section 19(a) of the Investment Company Act of 1940 prohibits a fund from paying a dividend from any source other than "accumulated undistributed net income determined in accordance with good accounting practice" unless such payment is accompanied by a written statement disclosing the source(s) of the payment. Currently, most funds' net income for tax purposes and net income for accounting purposes are the same, so 19(a) notices are rarely needed. If the Proposed ASU is adopted, however, these two measures would be different, with dividends paid by a fund (based on net income for tax purposes) exceeding net income for accounting purposes. This would require the fund to send a Rule 19(a) notice to every shareholder with every distribution – a change that would be costly to funds and confusing to fund shareholders.

We believe that the proposed expensing of transaction costs, by creating a difference between book- and tax-basis net income and realized gains and losses, would severely diminish the relevance and usefulness of financial statements for fund shareholders. Fund shareholders are keenly interested in the tax impact of their investments and the tax attributes of any distributions they receive from their fund holdings. Funds calculate their distributions on a tax basis. Under the Proposed ASU, income dividends paid to shareholders would be unaffected, but the reported net income of the fund would be reduced by the amount of any transaction costs treated as expenses.

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Similarly, capital gain distributions would be unaffected, but reported capital gains would reflect differences in both cost basis and proceeds of sales as a result of the expensing of transaction costs. In addition, reported amounts of unrealized gains would be overstated relative to the tax-basis amounts that are most relevant to shareholders. The disconnect between the reported amounts and the tax-basis amounts would cause the financial statements to be less relevant as an indicator of the amounts shareholders ultimately realize in net income and capital gains on their investments. In addition, the financial statement disclosures would become increasingly lengthy and complex due to the need to explain the book-tax differences.

B. Money Market Funds

The Proposed ASU would require money market funds subject to Rule 2a-7 under the Investment Company Act of 1940 to measure their investments at fair value, rather than at amortized cost. This proposal would fundamentally change the way money market funds operate and would be contrary to Rule 2a-7. As a procedural matter, we believe that any proposal that would have such a profound effect on a regulated entity should be considered by the regulating agency – in this case the SEC – rather than as part of a general review of accounting standards. In this regard, we note that the President's Working Group on Financial Markets (consisting of representatives from the SEC, the U.S. Treasury, and the Federal Reserve) currently is conducting an in-depth review of money market funds and is actively considering several reform proposals, including a similar floating NAV requirement. We believe it would be inappropriate for FASB to preempt the working group on this important issue. Substantively, we do not believe that the proposal would provide investors with decision-useful information, and accordingly recommend that the Board allow money market funds that comply with Rule 2a-7 to continue to measure their investments at amortized cost for financial reporting purposes.

Rule 2a-7 permits SEC-registered money market funds to value investments at amortized cost in calculating net asset value per share for purposes of issuing and redeeming fund shares, provided that the fund's investments meet certain conditions that limit credit, liquidity, and interest-rate risk. As a result, under normal circumstances, any deviation between the amortized cost value and the fair value of the fund's holdings will be insignificant. Rule 2a-7 also requires funds to perform a periodic "shadow pricing" process, in which the fund calculates net asset value per share based on available market quotations, to confirm that there is no significant deviation between amortized cost and fair value. Earlier this year, the SEC adopted a requirement that every money market fund disclose its shadow price in a new Form N-MFP to be filed monthly with the SEC and made available to the public on a delayed basis.

One of Rule 2a-7's risk-limiting conditions requires money market funds to maintain a weighted average portfolio maturity of 60 days or less. Many of the securities in the fund's portfolio will have matured by the time the fund's financial statements are published, limiting the usefulness of security-level details about portfolio holdings presented in the financial statements. The SEC recently amended Rule 2a-7 to require

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public disclosure of money market fund holdings on a monthly basis, providing investors with more timely and decision-relevant information about portfolio holdings.

We encourage the Board to clarify that money market funds may continue to measure their investments at amortized cost. In lieu of requiring money market funds to measure their investments at fair value, we recommend that the Board consider requiring these funds to disclose the fair value of the investment portfolio at the reporting date in the notes to the financial statements. Such disclosure would enable financial statement users to assess any difference between the amortized cost and fair value of the fund's portfolio as of the report date.

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Vanguard appreciates the opportunity to comment on the Proposed ASU. If you have any questions or would like additional information, please feel free to contact me at 610-669-8573 or Kathryn Hyatt at 610-669-6140.

Sincerely,

Thomas J. Higgins Bary
Thomas J. Higgins

Chief Financial Officer of the Vanguard funds

cc: F. William McNabb, Chairman and Chief Executive Officer of the Vanguard funds

Kathryn Hyatt, Treasurer of the Vanguard funds