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August 17, 2015

Submitted electronically
Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: **Request for Comment on Exchange-Traded Products – File No. S7-11-15**

Dear Mr. Fields:

Vanguard appreciates the opportunity to comment on the Securities and Exchange Commission's Request for Comment on Exchange-Traded Products.[1] Vanguard is a global provider of more than 290 mutual funds and exchange-traded funds with aggregate global assets of approximately $3.3 trillion. We launched our first ETF in 2001 and now offer 67 U.S. ETFs with total assets of approximately $471 billion.[2] Most ETFs offer benefits to investors that are similar to those associated with traditional mutual funds, such as low cost access to professionally managed and diversified portfolios. ETFs also provide investors with intraday liquidity through the ability to purchase and sell shares on exchanges. Vanguard ETFs are widely recognized for their low costs, broad diversification, and proven ability to track indexes.

I. Executive Summary

We summarize our key points below:

- **ETFs Are Highly Regulated Investment Products.** ETFs are different from other exchange-traded products because ETFs are subject to the Investment Company Act of 1940, a robust regulatory regime designed to protect both the national public interest as well as the interests of investors.

- **The Arbitrage Mechanism Is Effective and Efficient.** Market participants use many tools to evaluate whether an arbitrage opportunity exists and to hedge any corresponding exposure. These tools provide market participants with the necessary information to engage in an effective and efficient arbitrage process, which ensures that the market prices of ETFs do not significantly deviate from their NAVs.

A more detailed discussion of each of these points follows.

[1] *Request for Comment on Exchange-Traded Products*, SEC Release No. 34-75165 (June 12, 2015) (the "Request for Comment"), available at http://www.gpo.gov/fdsys/pkg/FR-2015-06-17/pdf/2015-14890.pdf.
[2] Vanguard's U.S. ETFs are structured as separate share classes of open-end investment companies that offer one or more conventional share classes.

II. ETFs Are Highly Regulated Investment Products

The term *exchange-traded product* ("ETP") captures a diverse group of products in today's marketplace, including highly regulated ETFs as well as less regulated exchange-traded notes and other pooled investment vehicles.[3] ETFs are different from other ETPs because they are subject to a robust regulatory regime designed to protect both the national public interest as well as the interests of investors.[4] This regulatory regime–anchored by the Investment Company Act of 1940 ("Company Act")–imposes strict requirements upon traditional mutual funds and ETFs structured as open-end investment companies relating to, among other things, corporate governance, investment activities, transparency, and affiliated transactions.[5] In addition, ETFs are subject to the terms and conditions established in Commission exemptive orders under the Company Act permitting them to issue shares that can be traded on a national securities exchange at negotiated market prices.[6]

Together, the numerous protections contained within this regulatory regime ensure that registered investment companies, such as traditional mutual funds and ETFs, operate in the best interests of the national public and investors. ETFs regulated by the Company Act are among the most stringently regulated investment products in the world. ETFs, unlike other ETPs, typically register with the Commission as open-end investment companies and are subject to periodic and rigorous examinations. These ETFs are typically governed by an independent board of directors, which is elected by shareholders and charged with a fiduciary duty to act in the best interests of the ETF and the ETF's shareholders. This board oversees the operations of the ETF, including the performance of the ETF's registered investment adviser and the adoption and implementation of written policies and procedures reasonably designed to prevent violation of the federal securities laws.

ETFs regulated by the Company Act must hold at least 85% of their net assets in liquid assets and must value portfolio holdings on a daily basis. In addition, ETFs are limited to a simple capital structure that constrains the use of leverage, either explicitly through borrowing money or implicitly through activities such as short sales, securities lending, and derivative transactions that could create leverage.[7] For example, ETFs are generally limited to borrowing only from a bank and must maintain a 300% asset-coverage ratio for all such borrowings. ETFs that operate as diversified ETFs under the Company Act are also subject to limitations on the amount they may hold in a single issuer.[8]

Furthermore, ETFs are subject to robust disclosure requirements that ensure a high degree of transparency. ETFs provide investors with highly detailed information via their prospectuses and statements of additional information and typically make this information publicly available on their websites.[9] ETFs are also required to disclose audited financial statements within shareholder reports and quarterly portfolio holdings

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[3] Exchange-traded notes are exchange-traded securities whereby a bank promises to pay the return of a specified security, commodity, or index (including a leveraged or hedged index) over a specified period. As such, investors in these notes may be exposed to significant counterparty credit risk.
[4] *See* 15 U.S.C. § 80a-1.
[5] Some ETFs are structured as unit investment trusts and are subject to many of the same provisions under the Company Act.
[6] These Commission orders contemplate the existence of an effective and efficient arbitrage mechanism that will ensure that the difference between an ETF's market price and NAV remains narrow.
[7] *See* 15 U.S.C. § 80a-18(f).
[8] *See* 15 U.S.C. §80a-5(b)(1). A diversified ETF is generally an ETF that, with respect to 75% of its total assets, does not (1) purchase more than 10% of the outstanding voting securities of any one issuer; or (2) purchase securities of any issuer if, as a result, more than 5% of the ETF's total assets would be invested in that issuer's securities.
[9] Each Vanguard ETF's prospectus and statement of additional information is available at www.vanguard.com.

information. The information contained within these disclosure documents ensures that investors and market participants have the necessary information to make informed investment decisions.

During the Commission's review of the listing and trading of new, novel, and complex ETPs, we encourage you to take into consideration the robust regulatory regime already applicable to ETFs regulated by the Company Act. This regulatory regime already serves to protect investors and markets by imposing strict requirements upon ETFs registered as investment companies. We also encourage you to consider regulatory initiatives designed to help investors distinguish between highly regulated ETFs and less regulated ETPs in the marketplace. Because ETPs can be purchased easily by ordinary investors on the secondary market, it is important for investors and other market participants to understand when an ETP (e.g., an exchange-traded note or leveraged ETF) has characteristics that are different from traditional ETFs.

III. The Arbitrage Mechanism Is Effective and Efficient

The arbitrage mechanism ensures that an ETF's market price does not vary substantially from its NAV. The arbitrage mechanism occurs through the creation and redemption process executed by various market participants, such as Authorized Participants and market makers. Generally, market participants will create or redeem when an ETF's market price exceeds or falls below the value of its portfolio holdings after accounting for transaction costs.[10] This arbitrage process functions to bring the ETF's market price in line with the value of its underlying holdings. In addition, the existence of similar ETF products within the marketplace helps to keep an ETF's market price tethered to its NAV. Specifically, to the extent more than one ETF tracks a similar or highly correlated index, market participants may be able to hedge their exposure to one ETF with exposure to another ETF. This can enhance the liquidity associated with these ETFs and cause corresponding spreads to narrow. Market participants, such as Authorized Participants and market makers, may also arbitrage two ETFs that track similar or highly correlated indexes by purchasing the ETF with the lower premium and selling the ETF with the higher premium. These actions can impact ETFs' spreads and premiums and discounts and help to ensure that each ETF's market price does not deviate substantially from its NAV.

Market participants use many tools to evaluate whether an arbitrage opportunity exists and to hedge any corresponding exposure. These tools primarily include the intraday indicative value, the ETF's published basket or its last published portfolio holdings list,[11] the index tracked by the ETF, the historical ability of the ETF's NAV to track its index, and the historical ability of the ETF's basket to track the ETF's NAV. Market participants also rely on technology and comprehensive data feeds from various third-party vendors to assess the value of an ETF's portfolio holdings, its basket, its NAV, and/or the relevant index as well as any current or historical tracking differences among them. These tools provide market participants with the necessary information to engage in an effective and efficient arbitrage process, which ensures that the market price of the ETF does not significantly deviate from its NAV.[12]

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[10] These creations and redemptions typically consist of exchanging a basket of securities for ETF shares.

[11] Each Vanguard ETF's basket is published daily on our public website and our ETF Portal and is provided to the National Securities Clearing Corporation for dissemination to its members.

[12] In addition, skilled portfolio managers can minimize differences between an ETF's market price and NAV by, among other things, tracking a large and diverse index, demonstrating an ability to tightly track benchmark indexes, and focusing on basket construction. Skilled portfolio managers can reduce the number of securities within an ETF's basket while continuing to track its target index. By reducing the number of securities within its basket, an ETF can reduce the transaction costs associated with the arbitrage process. This, in turn, typically causes market participants to narrow spreads paid by investors

A robust and efficient arbitrage mechanism does not require an ETF to disclose portfolio holdings on a daily basis. Our index ETFs and index mutual funds, for example, do not promulgate a complete list of portfolio holdings on a daily basis because doing so could harm the fund and its shareholders. It could harm the fund and its shareholders by arming professional traders with sensitive fund information that could be used to decipher proprietary portfolio management and trading techniques.

Although this is often a key concern among actively managed funds, it can be a concern for index funds as well. Skilled index fund managers use an array of proprietary portfolio management and trading techniques to effectively produce the risk and return profile of a target index. These index fund managers typically adjust techniques based on a variety of market factors when in the best interests of the fund and its shareholders. Some techniques involve holding all, or substantially all, of the securities within the target index at their prescribed weights. Other techniques involve holding a representative sample of the securities within the target index. The composition of a representative sample is determined through investment expertise and proprietary research and analysis.

Disclosing a complete list of portfolio holdings on a daily basis could permit market participants to harm funds. It would be particularly concerning for index funds during specific events impacting a target index, such as publicly announced corporate actions and index reconstitutions. In such instances, market participants may use a fund's list of portfolio holdings to reverse engineer its proprietary portfolio management and trading techniques, anticipate the amount of a particular security the fund must buy or sell, and profit by transacting in the security prior to the fund's transactions. This would harm the fund and its shareholders by causing the fund to pay more, or receive less, for the securities in which it transacts. Consequently, our index funds–including our index ETFs–protect fund shareholders by disclosing portfolio holdings in a manner that addresses these concerns.

ETF sponsors can protect index ETF shareholders from this harm and continue to offer ETFs with narrow spreads and market prices approximating NAV. This is possible because of the array of tools market participants use to monitor, value, and hedge an ETF's portfolio, basket, and index. Through these tools, market participants can efficiently and effectively arbitrage ETFs and maintain organized markets featuring narrow spreads. Market participants can efficiently price, arbitrage, and hedge exposure to ETFs by calculating intraday NAVs based on the contents of their baskets. Another method to efficiently price and arbitrage ETFs is by reference to their target index levels, which can be highly correlated to ETFs' NAVs.

Years of market experience demonstrate that a well-constructed basket with performance that closely tracks the performance of an index promotes efficient arbitrage. Vanguard's real-world experience is instructive as the spreads and premiums and discounts associated with our index ETFs are quite narrow.[13] In addition, the market prices of our index ETFs typically are extremely close to NAV, and the tracking error of Vanguard ETFs in most cases is equal to or lower than comparable ETFs.[14]

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in the secondary market. Portfolio managers can also create custom baskets when in the best interest of the ETF and its investors to either improve the ETF's ability to track its index or facilitate narrower spreads in the secondary market.

[13] For example, Vanguard's domestic stock ETFs have an average spread of 5 basis points, our international stock ETFs have an average spread of 5 basis points, and our bond ETFs have an average spread of 8 basis points.

[14] Information about premiums and discounts and performance versus target index is available for every Vanguard ETF at www.vanguard.com.

Even during volatile markets, as well as large-scale fixed income market disruptions, bond ETFs have historically remained liquid and have often served as a price discovery mechanism for the broader marketplace.[15] Although the normally small difference between an ETF's market price and NAV may temporarily increase during such disruptions, the ability for this price to fluctuate helps to facilitate more efficient markets. Nonetheless, we are strong supporters of the limit-up/limit-down structure implemented recently by the Commission and exchanges. This structure is designed to prevent the execution of erroneous trades and allow markets to pause when significant intraday movements occur in particular securities. We encourage the Commission to continue to monitor the limit-up/limit-down structure and analyze whether modifications to the existing structure (e.g., tighter bands for certain products) could further protect retail investors from erroneous trades.

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We appreciate the opportunity to comment on the Commission's Request for Comment. ETF investors benefit from a vibrant ETF marketplace, which the Commission can facilitate by ensuring that the process by which new ETFs are listed and traded includes clearly defined and consistently applied regulatory requirements. If you have any questions about Vanguard's comments or would like any additional information, please contact Brian P. Murphy, Senior Counsel, at [redacted].

Sincerely,

Heidi Stam
Managing Director and General Counsel

cc: The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
Stephen Luparello, Director, Division of Trading and Markets

[15] An ETF's spread, as well as related premium or discount, typically reflects the cost of transacting in the securities within the ETF's basket.