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THE Vanguard GROUP

S7-20-03

VIA OVERNIGHT MAIL

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January 7, 2004

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 5th Street, NW
Washington, D.C. 20549-0609

RE: **Exemption from Shareholder Approval for Certain Subadvisory Contracts Release No. 33-8312; File No. S7-20-03**

Dear Mr. Katz:

The Vanguard Group, Inc. ("Vanguard")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's recent proposal to codify its prior exemptive orders for "manager of managers" arrangements.[2] In 1993, Vanguard became one of the first mutual fund companies to obtain this relief,[3] and currently uses a manager of managers structure for 37 Vanguard funds that receive portfolio management services from 21 independent advisory firms.[4] The total assets in these Vanguard funds currently exceed $200 billion, and therefore represent more than half the assets cited by the Commission as participating in manager of managers programs.[5]

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[1] Headquartered in Malvern, Pennsylvania, Vanguard is the nation's second largest mutual fund company. Vanguard serves 17 million shareholder accounts, and manages more than $650 billion in U.S. mutual fund assets. Vanguard offers 118 funds to U.S. investors and over 20 additional funds in foreign markets.

[2] Exemption from Shareholder Approval for Certain Subadvisory Contracts, SEC Release 33-8312 (October 23, 2003) (hereafter, "Proposing Release").

[3] The Vanguard Group, Inc., *et al,* Investment Company Act Release Nos. 19411 (April 16, 1993) (notice) and 19471 (May 12, 1993) (order) permitted the Vanguard funds to enter into new or revised investment advisory contracts without the delay and expense of a shareholder vote, subject to certain conditions. In 2003, that order was superceded by Vanguard Convertible Securities Fund, *et al,* Investment Company Act Release Nos. 26062 (May 29, 2003) (notice) and 26089 (June 29, 2003) (order), which updated the Vanguard funds' exemptive relief to make it comparable to manager of managers orders more recently issued by the Commission to other mutual fund companies.

[4] For ease of reference, we refer to the Vanguard funds in our manager of managers program simply as "Vanguard funds."

[5] Proposing Release at text accompanying note 5.

Vanguard is a strong supporter of the manager of managers concept and believes it has greatly benefited shareholders, who have come to regard the independence, timeliness, and cost-efficiency with which manager changes may be made as major advantages of the Vanguard funds. We therefore support the concept of a rule to permit these arrangements without the need to obtain individual exemptive orders. However, we have significant comments on the proposed rule. The Vanguard funds cannot rely on the rule as drafted because Vanguard's manager of managers program differs significantly from those of other fund companies. We are very concerned that if the Commission adopts the proposed rule and rescinds prior orders, Vanguard will not be able to continue its manager of managers program.

It is almost impossible to overstate the importance of Vanguard's manager of managers order ("Order") to the Vanguard funds' operations during the past decade—and its importance moving into the future. The Order has made it possible for the Vanguard funds, on an ongoing basis, to improve their investment advisory arrangements quickly and cost-effectively in the best interests of shareholders. The primary mechanism for this task has been Vanguard's Portfolio Review Group (PRG). PRG is a dedicated group of investment professionals who work closely with the funds' boards of trustees to select or replace external managers, oversee their investment performance, analyze the effectiveness of their investment styles and strategies, negotiate advisory fees, and recommend allocations of fund assets among managers. As the Commission has consistently recognized, there are substantial benefits to these arrangements:

- Diversity of thought. Vanguard funds and shareholders benefit from the diversity of thought that a variety of external advisers brings to the asset management process. Investment styles and strategies in fund offerings across the complex are distinct. Funds that use multiple advisers reduce the risk that poor security selection by one or more managers will cause the fund to underperform other funds with a similar investment objective.
- Larger pool of investment talent. Vanguard funds and shareholders benefit from the additional investment talent that they are able to attract through manager of managers arrangements. The Vanguard funds' ability to hire independent investment managers quickly and cost-effectively, wherever they may be located, is a great strength.
- Capacity to grow. Vanguard funds and shareholders benefit from the potential to absorb new investments without diluting the effectiveness of existing managers. Introducing new managers can increase a fund's capacity to grow and increase economies of scale without diminishing its potential investment returns.

While possibly well suited to most other mutual fund companies, the proposed rule simply does not fit the Vanguard funds' unique management structure and existing manager of managers approach. Since Vanguard cannot rely on the rule as proposed, we strongly object to the proposal to rescind prior Commission orders. We do not believe that rescission of prior orders is either necessary or appropriate in the public interest or for the protection of investors.

As the Commission has long recognized, Section 6(c) of the Investment Company Act of 1940 has enabled the Commission to approve innovative and useful investment products and services for the benefit of investors. A great strength of that provision is that it permits individual companies, like Vanguard, to make good ideas even better by tailoring them to unique circumstances or objectives.[6] The Commission should not force Vanguard to dismantle and rebuild its manager of managers approach at considerable cost with no tangible benefit to investors.[7] In the past, the Commission has been sensitive to the pitfalls of rescinding prior orders and has generally not done so when approving new exemptive rules.[8] We urge the Commission to take that approach in this instance.

If the Commission determines to proceed with its proposal to rescind prior orders, we strongly recommend that it also adopt a solution to ensure that the Vanguard funds may continue to operate the same way they have for the past decade. We suggest two options: First, the Commission could reissue the Vanguard order under Section 6(c) to coincide with the effective date of the new rule. While this might be considered an unusual approach, it seems entirely appropriate given Vanguard's unique structure. As a second option, we would recommend certain changes to the proposed rule which, although cumbersome, would at least permit the beneficial manager of managers structure used by the Vanguard funds and other funds that may now or in the future employ a similar structure. We explain these recommendations in the Discussion section below.

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[6] As David Schenker, one of the principal authors of the Investment Company Act, stated, "the difficulty of making provision for regulating an industry which has so many variants and so many different types of activities...is precisely [the reason that Section 6(c)] is inserted." *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 197 (1940). In his article about the Investment Company Act, Alfred Jaretzki, Jr. recognized that, "Without these exemptive powers and without a wise exercise of discretion thereunder, the Act would be unworkable, unduly restrictive and would cause unnecessary hardships." Alfred Jaretzki, Jr., *The Investment Company Act of 1940,* 26 Wash. U. L.Q. 303, 344 (1941).

[7] The Commission cites a possible effect on competition as a potential reason to rescind prior orders. We see no evidence that competition has been affected by variations in manager of managers orders over the past decade. Similarly, it is hard to see how competition would be adversely affected by adopting a new rule to apply prospectively only. As the Commission notes, the proposed rule is intended to codify existing exemptions. The slight variations that may result with pre-rule and post-rule programs would hardly be significant from a competitive standpoint.

It has been noted elsewhere that the elimination of prior orders would assist the Commission staff in performing examinations. We disagree that this objective warrants the disruption that would be caused by rescinding prior orders. SEC examiners have easy access to details regarding the operation of a manager of managers program. Since all related activity is reviewed and approved by a fund's board of trustees, it is relatively easy for an examiner to review the operations of a particular program.

[8] *See,* e.g., SEC Release Nos. 33-7143, IC-20915 (February 23, 1995) (adopting Rule 18f-3 under the Investment Company Act to permit funds to issue multiple classes); SEC Release No. IC-20916 (February 23, 1995) (adopting Rule 6c-10 under the Investment Company Act to permit funds to charge deferred sales loads).

The proposed rule would apply only to subadvisory contracts that do not directly or indirectly increase the fund's management and advisory fees. While we understand and support the Commission's interest here, we are concerned that the provision is overly broad. As long as the principal adviser cannot act, directly or indirectly, to increase its *own* fee or the fee of an affiliate at the fund's expense, subadvisory contracts that increase fees should not be excluded under the rule. Due to its ownership structure and active negotiation on behalf of Vanguard fund shareholders, Vanguard has the lowest advisory fees in the industry. As discussed in greater detail below, we are aware of a number of situations that do not involve conflicts of interest where it would be appropriate to raise an advisory fee. Requiring a shareholder vote in these situations would not serve shareholder interests and would greatly reduce the overall benefits of a manager of managers program. It is indeed another reason why rescinding Vanguard's Order is not in the best interests of shareholders. We discuss these concerns in greater detail below.

DISCUSSION

I. Background

The Vanguard funds are a unique group of mutual funds. Unlike most other mutual funds, which are organized and controlled by a single separately owned investment adviser, the Vanguard funds have joined together and created a wholly owned subsidiary—Vanguard—that enables the funds to operate with their own staff on an "internalized," at-cost basis.[9] By doing so, the Vanguard funds have achieved substantial economies in their corporate management and distribution services, and significantly lower advisory fees compared to industry norms.[10]

As previously noted, in 1993, Vanguard became one of the first mutual fund companies to receive a manager of managers order. Our purpose in requesting the Order was to capitalize on the Vanguard funds' independence from external entities by enabling the funds to continuously improve their investment advisory arrangements without the expense and delay of repeated shareholder votes. These improvements have taken a variety of forms over the years, and, altogether, the Vanguard funds have made dozens of advisory contract changes in reliance on their Order. Shareholders are comfortable relying on Vanguard's expertise in selecting and overseeing investment managers, where all relationships are at arm's length and involve no conflicts of interest. As a result of our Order, Vanguard shareholders have saved millions in

[9] The Vanguard funds operate under this structure pursuant to a number of exemptive orders. *See,* e.g., Wellington Fund, Inc., Investment Company Act Release Nos. 8644 (Jan. 17, 1975) (notice) and 8676 (Feb. 18, 1975) (order); and The Vanguard Group, Inc., Investment Company Act Release Nos. 9850 (July 15, 1977) (notice), 9927 (Sept. 13, 1977) (temporary order) and 11645 (Feb. 25, 1981) (Opinion of the Commission and Final Order).

[10] In 2002, the average expense ratio for all Vanguard funds, including those that are managed internally, was 0.26%. The industry's average expense ratio was 1.36%. Source: Lipper Inc.

proxy expenses since 1993 on manager changes alone. The savings are considerably more if the funds' various reorganizations, assignments and other material, yet largely routine, changes to advisory contracts are also taken into account.

In 1993, there was no generally accepted contractual template for manager of managers relationships. Perhaps in contrast to subsequent entrants to the multi-manager arena, Vanguard envisioned an arrangement where a fund's board of trustees would continue to play a seminal role in advisory decisions. Consequently, we have always structured advisory contracts as agreements directly between a Vanguard fund and its subadvisers. Also towards this end, in the 1993 proxy vote that laid the foundation for our manager of managers program, the Vanguard funds' shareholders specifically authorized the boards of trustees—*not* Vanguard or any other "principal adviser," as contemplated by the proposed rule—to enter into such agreements.

Specific comments on the proposed rule follow.

II. Definitions

Under the proposed rule, Vanguard could not serve as the "principal adviser" who supervises and oversees subadvisers to the Vanguard funds. This is because the proposal's definition of "principal adviser" would exclude persons providing advisory services to funds on an <u>at-cost</u> basis, like Vanguard. Clearly, requiring shareholders to pay more for the services of the principal adviser would be no solution to this dilemma. That approach would only add costs and conflicts to the Vanguard funds' advisory process, negating two key benefits of their internalized management structure.

The following changes to the proposed rule text in Section 270.15a-5(b) would address this issue (as well as the subadvisory contract issue noted below):

> *"(2) <u>Principal adviser</u> means an investment adviser, as defined in section 2(a)(20)(A) of the Act (15 U.S.C. 80a-2(a)(20)(A)<u>, who is not subject to the supervision and oversight of another investment adviser in providing services to a fund. For these purposes, a person described in clause (iii) of section 2(a)(20) of the Act will be considered an investment adviser.</u>*

Moreover, the Vanguard funds' existing agreements with subadvisers do not qualify as "subadvisory contracts" as defined under the proposed rule. The Commission has narrowly tailored the proposed rule to situations where a fund's principal adviser enters into a contract with a subadviser to manage fund assets. Under our program, however, Vanguard funds have always contracted <u>directly</u> with their subadvisers. As a result, in order to avail themselves of the benefits of the rule, Vanguard funds would need to restructure all of their existing agreements with subadvisers.

The following changes to the proposed rule text in Section 270.15a-5(b) would address this issue:

> *(3) Subadviser means an investment adviser as defined in section 2(a)(20)(A) or 2(a)(20)(B) of the Act (15 U.S.C. 80a-2(a)(20)(A) or 15 U.S.C. 80a-2(a)(20)(B)).*
>
> *(4) Subadvisory contract means a contract between (i) a fund or its principal adviser and (ii) a subadviser to ~~a~~ the fund, under which contract the subadviser agrees to perform investment advisory services on behalf of the fund, and which is terminable at any time by the principal adviser or the fund, as applicable, on no more than 60 days written notice, without payment of penalty."*

III. Shareholder Authorization

The Vanguard funds would incur an estimated $7.5 million in proxy costs to conform their existing shareholder authorization to the proposed rule's requirements. As a condition of relying on the proposed rule, a fund's shareholders must authorize the principal adviser to enter into subadvisory agreements. By contrast, in 1993, the Vanguard funds' shareholders authorized their boards of trustees to enter into these arrangements. Needless to say, we do not think it is in our shareholders' best interests to spend $7.5 million in fund—and shareholder—assets to achieve compliance with a standard that does not provide additional shareholder protection.

The following changes to the proposed rule text in Section 270.15a-5(a)(3) would address this issue:

> *Shareholder authorization. Shareholders of the fund have authorized, as applicable, the fund's board of directors or a principal adviser, subject to approval by the board of directors, to enter into contracts with subadvisers without approval by a vote of the outstanding voting securities of the fund. ~~or,~~ If the fund's securities have not been publicly offered or sold to persons who are not promoters or affiliated persons of the fund, the directors of the fund, have authorized the principal adviser, if applicable, to enter into such contracts.*

IV. Supervision of Subadvisers

The proposed rule requires a contract between the fund and the principal adviser to provide that the principal adviser must supervise and oversee the activities of the subadviser under the subadvisory contract. Most exemptive orders already require the principal adviser to supervise the subadvisers as a condition of relief without stipulating contractual requirements. Mandating changes to contractual requirements would add unnecessary complexity and expense to implementation of a new manager of managers rule.

A better approach would be to impose the supervision requirements directly as a condition of relying on the rule, similar to the structure of current orders.[11] Under the current orders, the manager of managers has the responsibility to supervise and oversee each subadviser's management of the fund. It is unclear why it is necessary to require changes to existing contracts to achieve the same result, and the Commission has not offered any particular reason for this change. If the Commission determines to retain this provision as proposed, we strongly recommend that the Commission state that a shareholder vote will not be necessary to add this requirement to existing contracts with principal advisers. Doing so would save mutual fund shareholders the substantial cost associated with a proxy on this limited issue and for which vote results would have no practical impact.

V. Fee Increases

We are concerned about the practical benefits of limiting the rule to subadvisory contracts that do not directly or indirectly increase the management and advisory fees charged to a fund or its shareholders. As long as there is no current benefit to a principal adviser or an affiliate, nor any possibility of a future benefit, subadvisory contracts that increase fees should not be excluded from relief under the proposal. To do so would greatly diminish the utility and value of the manager of managers structure to shareholders.

While Vanguard is certainly a strong supporter of lower fees, the amount of fees payable under a new subadvisory contract is only one factor in determining whether to engage an adviser. Equally important are the structure of the subadviser's compensation (i.e., appropriate use of asset breakpoints and incentive/penalty fees) and the subadviser's expertise relative to other available firms. Vanguard attempts to balance all three of these considerations when negotiating subadvisory contracts, and sometimes that balance leads to increased fees.

Since all of Vanguard's negotiations with unaffiliated subadvisers are at arm's length and all Vanguard fund services are provided "at cost," there can never be a benefit to Vanguard (or a conflict of interest) associated with an increased fee. Vanguard has no basis for retaining part of a fee charged for the services of an external manager. An increase in fees in this context should not require a shareholder vote. In fact, it is Vanguard's expertise as a manager of managers, and its lack of conflicts regarding fees, that makes it entirely appropriate for a Vanguard fund's board of trustees to approve a fee that might cause the overall cost of advisory fees to increase. The board is, of course, subject to the highest standards of fiduciary responsibility in selecting an adviser and approving advisory fees. Consider the following examples from Vanguard's experience as a manager of managers:

- **Impact of incentive fees:** The majority of Vanguard funds use performance incentive fees or penalties that we believe appropriately align the subadvisers' interests with those

[11] See Proposing Release at note 27.

of the funds' shareholders. However, a fund with incentive fees could pay more in subadvisory fees after replacing an underperforming subadviser even if an identical or reduced base fee and incentive schedule is negotiated with the new subadviser. This would occur if the subadviser who is being replaced has underperformed its comparative benchmark, resulting in a reduction in total fees paid according to the incentive schedule. The new adviser would, of course, be hired without inheriting a performance penalty. Ironically, if a shareholder vote is required to hire the new manager in a case like this, the proposed rule would make it more difficult and costly to replace poorly performing managers.

- **Replacing a subadviser:** When a subadviser is replaced within a single manager fund, a new base fee and incentive schedule will be established. Despite our best efforts to negotiate the lowest possible fees at all times, it may be necessary to agree to pay more to secure the prospective subadviser's services. This is possible if, for instance, the subadviser has limited capacity to take on more assets, the firm's services are in high demand, or the firm's investment strategy is more costly to implement. For example, quantitative strategies are typically less costly than those requiring rigorous ongoing fundamental analysis, which are people intensive.

- **Hiring managers for multi-manager funds:** Vanguard has successfully introduced multi-manager funds that increase diversification and reduce single adviser risk. When a subadviser is added to a fund, it is possible that the fund's total subadvisory fees will increase slightly. This is because we use breakpoints in our fee schedules to ensure that the fund's shareholders benefit from reduced expense ratios as fund assets increase. With these arrangements, fees are paid at the highest fee level until reaching a certain asset breakpoint(s), at which fees decline. It is often prudent to start a new subadviser with a lower asset level, so that Vanguard and the fund's board of trustees can gain familiarity with the subadviser and increase assets under management gradually. In this scenario, assets are commonly moved from a low fee/high asset level breakpoint with the existing subadviser into a higher fee/low asset level breakpoint with the new subadviser. Consequently, total advisory fees may increase over the short term.

- **Removing a subadviser from a multi-manager fund:** Vanguard could also end a relationship with an existing subadviser within a multi-manager fund and redeploy the assets to the remaining subadviser(s). If the manager being terminated had a low fee schedule relative to the other manager(s) and/or was underperforming and being penalized, it is possible that the overall subadvisory fees paid could rise.

Each of these examples demonstrates that an increase in fees may be entirely appropriate and in the best interests of shareholders, provided the principal adviser or an affiliate does not benefit from the increase.

The following changes to the proposed rule text in Section 20.15a-5(a)(1) would address this issue:

> "*No increase in fees*. *The subadvisory contract does not directly or indirectly increase the management and advisory fees retained by the principal adviser or its affiliates; provided, however, that a subadvisory contract may increase the management and advisory fees retained by the principal adviser or its affiliates if no other subadvisory contract has ever directly or indirectly increased the management and advisory fees charged to the fund or its shareholders.*

VI. Number of Subadvisers

We strongly agree with the Commission's decision to extend the proposed relief to funds with single managers as well as to those with multiple managers. The benefits of a manager of managers arrangement extend equally to funds with single and multiple managers. In our experience, we are just as likely to replace a single manager, as we are to add a manager to a fund. The benefits to shareholders of a manager of mangers program are compelling in single manager and multi-manager funds. We see no reason to adjust the scope or conditions of relief for single manager funds. The flexibility afforded by the current orders are appropriate and should be retained in any final rule.

VII. Shareholder Notice

The proposed rule requires that, when the principal adviser enters into a subadvisory contract or makes a material change to a wholly-owned subadviser's contract, the fund furnish shareholders with (and file with the Commission) an information statement that includes information required by Regulation 14C, Schedule 14C, and Item 22 of Schedule 14A under the Securities Exchange Act of 1934 (an "Information Statement"). This is a standard condition in manager of managers exemptive orders. It is certainly important to inform shareholders of the relevant details of manager changes. In our opinion, however, an Information Statement is the wrong prototype for such a notice, and we strongly recommend that the Commission instead model its content requirements for shareholder notices on Items 6, 13(b)(10) and 15 in Form N-1A.

- Item 6 requires a fund to disclose in its prospectus key information about the fund's advisory arrangements, including: each adviser's name, address, and experience; the total advisory compensation paid by the fund to its advisers; and information about the fund's portfolio managers.

- Item 13(b)(10) requires a fund to discuss in its statement of additional information (SAI) the material factors and conclusions with respect thereto that formed the basis for the board of directors approving an investment advisory contract.

- Item 15 requires a fund to disclose in its SAI more detailed information about investment advisers, including: controlling persons of each adviser, affiliated persons of the fund and its advisers, and the method of calculating advisory fees.

In our experience, this is the information shareholders care about, and it may be presented effectively in a concise, plain English format that shareholders appreciate. Moreover, this N-1A-based approach to shareholder notices would foster beneficial consistency in the level of information provided to a fund's existing shareholders and to prospective investors.

By contrast, we believe that there is a great deal of information required in the Information Statement that is of limited use to shareholders wanting to learn about a new adviser or other material changes to advisory arrangements. In particular, the following items are examples of required information not very useful for this purpose:

- Information on a fund's voting securities and principal shareholders (required by Item 6 of Schedule 14A (which is required by Item 1 of Schedule 14C)). This information does not inform shareholders about a fund's investment advisory arrangements.
- A statement that proxies are not being solicited (required by Item 2 of Schedule 14C). This statement is not relevant, and is especially confusing to shareholders accustomed to manager changes without proxy votes.
- Information on shareholder proposals (required by Item 4 of Schedule 14C). This is also not relevant if there is no shareholder meeting.
- Information on how to obtain shareholder reports (required by Item 22(a)(3)(iii) of Schedule 14A). Shareholders receiving the Information Statement already receive shareholder reports.
- Table of current and pro forma fees (required by Item 22(a)(3)(iv) of Schedule 14A). It would be more appropriate to show the total advisory fees paid by the fund, and what effect, if any, the new adviser or advisory agreement would have on those fees.
- Date of existing advisory contract and the date that it was last submitted to a shareholder vote, including the purpose of the submission (required by Item 22(c)(1)(i) of Schedule 14A). This information is not relevant for subadvisory agreements in a manager of managers program because they are not submitted to a shareholder vote.
- Name, address, and principal occupation of the principal executive officer and each director or general partner of the adviser (required by Item 22(c)(2) of Schedule 14A). Many investment advisory firms have complex, multi-tiered organizational structures, and the response to this Item can be very lengthy. We believe that the names, occupations, and experience of those who will manage the fund are the most relevant and interesting details for the large majority of shareholders. Registrants can explain in the Information Statement that additional information about the adviser, including the adviser's officers, directors, or partners, is available in the adviser's Form ADV, which is available on the SEC's website.
- Names and addresses of all parents of the adviser, and the basis of control of each parent and its immediate parent (required by Item 22(c)(3) of Schedule 14A). As described above, many advisory firms have complex ownership structures. Often, describing these structures in the detail required greatly detracts from the readability of the Information Statement. We believe

S7-20-03 #4

that a brief description of the adviser's ultimate parent is more informative. Registrants also can refer shareholders to the adviser's Form ADV for this information.

- Names and addresses of other 10% owners not otherwise named (required by Item 22(c)(4) of Schedule 14A). This information is also available in the adviser's Form ADV.

The information listed above may be more appropriate in a proxy statement, but not should not be required in a document that is used to inform shareholders about a new adviser or advisory agreement. The greater the length of an Information Statement, the less likely most shareholders are to review the statement and learn important information about the new investment adviser. As noted above, extensive information is available in the adviser's Form ADV for those investors who are interested in that degree of detail.

VII. Conclusion

We appreciate this opportunity to comment on the manager of managers proposal. For the reasons stated, Vanguard urges the Commission to maintain existing exemptive orders. We strongly believe that the proposed rescission of the Vanguard Order is not in the best interest of our shareholders. We would be happy to meet with the Commission or its staff to discuss these issues in greater detail or to provide additional information that would assist the Commission in considering the proposed rule. Please do not hesitate to call me at (610) 503-4016, or Suzanne Barton at (610) 669-8717, if you have any questions.

Sincerely,

Heidi Stam
Principal
Securities Regulation

cc: Paul F. Roye, Director
Robert E. Plaze, Associate Director
C. Hunter Jones, Assistant Director
Adam B. Glazer, Attorney
Division of Investment Management

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