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January 12, 2006

The Honorable Arlen Specter
Chairman, Committee on the Judiciary
United States Senate
711 Hart Senate Office Building
Washington, DC 20510

Re: *Judge Samuel Alito: Vanguard Recusal*

Dear Mr. Chairman:

This letter is offered to provide the Committee with background information respecting the question that has been raised as to whether it was appropriate under the canons of judicial ethics for Judge Alito to have participated in a case styled *Monga v. Ottenberg*, which was decided in 2002, at a time when he was a shareholder of mutual funds in the Vanguard family of funds (the "Vanguard funds"). As I understand from press reports, the question in part involves the unique management structure of the Vanguard funds, under which they, unlike other mutual funds, jointly own the company that acts as their investment adviser, *i.e.*, The Vanguard Group, Inc. (the "Vanguard adviser").

I am not addressing the application of the ethics rules to the issue, as the Committee already has received submissions on that point from experts in legal ethics. Rather, this submission is intended to assist the Committee in understanding the nature of a Vanguard fund shareholder's legal relationship with the Vanguard funds and the Vanguard adviser.

I write as a former General Counsel of the Securities and Exchange Commission, having served from 1971 to 1981, first on the executive staff of three Commission Chairmen and then as its General Counsel. Since then, my legal practice has focused on advising institutional, corporate and individual clients on the application of the federal securities statutes to their affairs in the area of securities regulation.

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Introduction

The Vanguard family of mutual funds has an internalized management structure, unique among mutual funds, under which Vanguard fund investors may be described as possessing certain ownership interests in the funds' investment adviser. The interest of a Vanguard fund shareholder in the investment adviser, however, does not have the usual attributes of corporate ownership. Rather, like policyholders of a mutual insurance company, a Vanguard fund shareholder is principally a customer of the financial institution – in this case, the investment adviser – in which he or she holds an ownership interest.

Management structure of Vanguard funds

The Vanguard Adviser is organized internally to provide low cost services to Vanguard mutual funds. The Vanguard Group, Inc. is organized as a corporation in the State of Pennsylvania. Its stock is owned jointly by the mutual funds it advises, which is the source of Vanguard's unique management structure. The same individuals belong to the boards of the Vanguard funds and the Vanguard adviser. The Vanguard adviser provides management services to the Vanguard funds at cost. The Vanguard adviser is responsible for managing the assets of the Vanguard funds for the benefit of Vanguard fund shareholders. Vanguard fund shareholders as such do not participate in the management of the funds.

A Services Agreement that governs the Vanguard adviser's obligation to provide management services to the Vanguard funds also establishes the Vanguard funds' obligation to contribute capital to the Vanguard adviser. A Vanguard fund that withdraws from the Services Agreement must surrender its shares in the Vanguard adviser.

Vanguard fund shareholders, therefore, possess an indirect interest in the Vanguard adviser through the Vanguard fund. Vanguard funds are organized as business trusts in the State of Delaware. Shareholders of the Vanguard funds own an indirect proportional interest in the trust property as a whole, which includes shares of the Vanguard adviser held by the Vanguard funds. Shareholders of the Vanguard funds have the right to vote for the governing board of the funds ("the Board of Trustees"), as required under the Investment Company Act of 1940 (the "1940 Act"). Vanguard shareholders also have the right to redeem their shares in the Vanguard funds for the net asset value of the trust property attributable to the shares. Generally, mutual funds redeem shares for cash. If a mutual fund exercises its option under the 1940 Act to redeem shares in kind, the Board of Trustees determines the selection and quantity of the securities or other trust property to be distributed; fund shareholders have no right to require that specific securities owned by the fund be distributed in an in-kind redemption.

Analysis

Because the Vanguard management structure is unique in the mutual fund industry, there is not any literature examining the ownership interests of fund shareholders in the fund adviser. An analogous relationship exists, however, in the context of mutual insurance companies where the individuals who purchase services from the financial institution are also its owners.

Ownership in a mutual life company arises from the policyholder's purchase of an insurance contract. The policyholder is considered an owner because like a shareholder in a corporation, the policyholder has the right to elect the management of the insurance company. Unlike a shareholder in an ordinary corporation, however, the policyholder does not look to the management to maximize profits. Rather, the policyholder is principally concerned with the insurance company's performance of its contractual commitments under the policy. As a result, commentators have noted that the policyholder is principally a customer of the insurance company.[1] The essential ownership attributes of a mutual insurance company policyholder have been characterized as 1) the right to vote; 2) the right to receive dividends; and 3) the right to share in the surplus upon dissolution or demutualization. Looking at these three factors, the indirect ownership interest of the Vanguard fund shareholder in the Vanguard adviser is similar to and in some respects more remote than the ownership interest of a policyholder in a mutual insurance company.

As to the first factor, Vanguard fund shareholders do not have any voting rights with respect to the Vanguard adviser. The members of the Vanguard adviser's board are selected by the Board of Trustees of the Vanguard funds. While the individuals who serve on the board of the Vanguard adviser are the same as those who serve on the Board of Trustees of the Vanguard fund, who are elected by Vanguard fund shareholders, this identity is not established in the organizational documents of the Vanguard funds, which define the rights of the Vanguard fund shareholders. Furthermore, Vanguard fund shareholders do not have any means to control the management of the Vanguard adviser by calling a vote of the shareholders of the Vanguard adviser. Mutual funds vote shares in the companies in which they invest according to the stated voting policies of the adviser without soliciting instructions from their shareholders. In contrast to Vanguard fund shareholders, policyholders in mutual insurance companies typically have a right under state law to vote for the board of directors of the insurance company, although voting procedures prescribed under state law for mutual insurance companies tend to facilitate management control.

As to the second factor, Vanguard fund shareholders do not have any direct claim on the profits (if any) of the Vanguard adviser. The stated policy of the Vanguard adviser is to provide services to the Vanguard funds at cost, which means that the Vanguard adviser ordinarily would not expect to have any profit to distribute to shareholders as dividends. Rather, any "profit" would be passed through in the form of reduced charges for the Vanguard adviser's services. The fact that the Vanguard adviser is not managed to make a profit is an integral component of its unique relationship with the Vanguard funds.

Vanguard fund shareholders also do not have a direct claim on the shares of the adviser. The Vanguard fund shareholder has the right only to receive cash equal to the value of his or her proportional interest in the trust property as a whole. If a fund makes a distribution in kind, the Board of Trustees determines what property of the trust to distribute. While any dividends paid

[1] *See, e.g.*, Hetherington, *Fact v. Fiction: Who Owns Mutual Insurance Companies*, 1969 Wisc. L. Rev. 1068 (1969).

by the Vanguard adviser to the fund would indirectly benefit Vanguard fund shareholders, this is not the principal purpose of the fund's investment in the adviser. Unlike other fund investments whose purpose is to generate dividend income or capital gains, the principal purpose of the Vanguard fund's interest in the adviser is to provide low cost services to the fund. In this respect, the Vanguard funds and their shareholders, like the policyholders of a mutual insurance company, are more like customers rather than investors in the financial institution in which they hold an ownership interest.

Finally, as to the third factor, in the event of the liquidation of a Vanguard fund, the fund shareholders would not receive any ownership interest in the Vanguard adviser. Under the Service Agreement, withdrawing from the management relationship with the Vanguard adviser terminates the fund's ownership interest in the Vanguard adviser. On terminating the managerial relationship with the adviser, the fund surrenders its shares in the adviser and receives an amount equal to its proportionate interest in the surplus of the adviser, which becomes part of the net asset value of the fund. That the fund's ownership interest in the adviser is contingent on the management relationship further differentiates the relationship between a Vanguard fund and its shareholders from the relationship between an ordinary corporation and its shareholders, and reinforces the conclusion that the fund shareholders' principal relationship with the Vanguard adviser, like the relationship of a policyholder with a mutual insurance company, is that of a customer rather than an investor.

Given the Vanguard fund shareholders exceptionally attenuated ownership interest in the fund adviser, their financial interest in the adviser is so insubstantial as to be immaterial.

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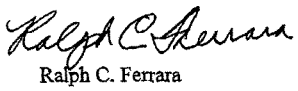
I hope that this information is helpful to the Committee. If you have any questions, I would be pleased to respond.

Sincerely,



Ralph C. Ferrara

cc: Members of the Senate Committee on the Judiciary
Counsel of the Senate Committee on the Judiciary
Members of the Majority Staff
Counsel of the Majority Staff
Members of the Minority Staff
Counsel of the Minority Staff