40% of its net assets in three Portfolios (including a money market portfolio) that invest primarily in fixed income securities. Since its inception, the STAR Portfolio has maintained fixed allocation targets for its investments in equity, fixed income, and money market Portfolios.

6. The LIFEStrategy Portfoilos' different asset allocations provide investors with four distinct options that meet a wide array of investor needs. Currently, each LIFEStrategy Portfolio invests its assets in a "fixed mix" of shares of Vanguard Portfolios to provide its investors with a targeted asset allocation. Each LIFEStrategy Portfolio currently invests 30% of its net assets in the Vanguard Asset Allocation Fund (the "Asset Allocation Fund") which allocates its assets among an equity portfolio, a band portfolio, and money market instruments.

7. As of December 31, 1994, the Asset Allocation Fund had assets of \$1.1 billion and the LIFEStrategy Portfolios had invested \$37.6 million in the Asset Allocation Fund. Because of the 10% limitation imposed by the STAR Order upon investments by STAR in any Vanguard Fund, at December 31, 1994 the maximum amount which STAR could invest in the Asset Allocation Fund was \$110 million. As a result of the 10% limitation, when the LIFEStrategy Portfolios reach assets of approximately \$400 million (at March 1, 1995 assets were \$215 million), applicants state that the only solutions will be for the LIFEStrategy Portfolios to begin investing directly in securities at an additional cost estimated to be \$100,000 per LIFEStrategy Portfolio,4 or to cease offering shares because Vanguard has no comparable and suitable alternative Portfolio in which the LIFEStrategy Portfolios may invest.

8. STAR has entered into a special servicing agreement (the "STAR Servicing Agreement") with TVGI, under which TVGI provides all management, administrative, and distribution services to STAR and acts as STAR's dividend disbursing, shareholder servicing, and transfer agent. To avoid imposing a duplicate capital contribution on STAR's shareholders, STAR is not a party to the general Funds' Service Agreement and, therefore, is not a member of The Vanguard Group.

9. Under the STAR Servicing Agreement, the STAR Fund Portfolios are obligated to pay for services rendered by outside parties, including auditors, STAR's custodian, and outside legal counsel. The STAR Servicing Agreement provides, however, that each STAR Fund Portfolio's expenses will be offset, in whole or in part, by a "credit" from TVGI for: (a) That STAR Fund Portfolio's contributions to the cost of operating the underlying Vanguard Portfolios in which it invests, and (b) certain savings in transfer agency, administrative, and marketing costs that TVGI derives from the operation of the STAR Fund Portfolios. These reimbursements by TVGI have been, and should continue to be, sufficient to offset all of the STAR Fund Portfolios' expenses.

10. Under current provisions of the Funds' Service Agreement, STAR cannot become a member of the Vanguard Group without making a capital investment in TVGI, and being allocated a portion of TVGI's corporate management and distribution expenses, even though STAR shareholders already bear a portion of these expenses through the fees they pay with respect to the Portfolios. The Boards of Directors of the Funds propose to amend the Funds' Service Agreement to permit a Vanguard Fund of Funds, such as STAR, whether structured as a separate investment company or as a portfolio of a Vanguard Fund, to become a member of The Vanguard Group. Applicants believe that, although the STAR Service Agreement has worked well in practice, the same result can be achieved by amending the Funds' Service Agreement to permit a Vanguard Fund of Funds to become a member of The Vanguard Group without a requirement that such fund of funds bear the TVGI capital contribution and expense allocation assessments borne by the other Vanguard Funds.

11. The amendment to the Funds' Service Agreement would provide, in substance, that: (a) The obligation of a Vanguard Fund of Funds to make capital contributions to TVGI would be reduced or eliminated to the extent that its assets consist of shares of Vanguard Portfolios that are already contributing to the capital of TVGI; (b) a Vanguard Fund of Funds would not be allocated any portion of the corporate management and administrative expenses, or the distribution expenses, that are allocated under the Funds' Service Agreement; and (c) a Vanguard Fund of Funds would be obligated to pay for services rendered by outside parties and certain other direct Vanguard Fund of Funds expenses

customarily borne by each Fund pursuant to the Funds' Service Agreement, subject to the partial or complete elimination of these charges by the savings which would accrue to the benefit of the Vanguard Portfolios.

Applicants' Legal Analysis

A. Section 12(d)(1)

1. Section 12(d)(1)(A) provides that no registered investment company may acquire securities of another investment company if such securities represent more than 3% of the acquired company's outstanding voting stock, more than 5% of the acquiring company's total assets, or if such securities, together with the securities of any other acquired investment companies, represent more than 10% of the acquiring company's total assets. Section 12(d)(1)(B) provides that no registered open-end investment company may sell its securities to another investment company if the sale will cause the acquiring company to own more than 3% of the acquired company's voting stock, or if the sale will cause more than 10% of the acquired company's voting stock to be owned by investment companies.

2. Section 6(c) provides that the SEC may exempt persons or transactions if, and to the extent that, such exemption 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. Applicants request an order under section 6(c) exempting them from section 12(d)(1) to permit STAR, and any future Vanguard Fund of Funds, to invest in the Vanguard Portfolios in excess of the percentage limitations of section 12(d)(1). The STAR Order permitted STAR to acquire up to 10% of any acquired Vanguard Fund's outstanding voting stock. The requested order would eliminate this 10% limitation.

STAR was created to provide investors with an investment service through which they could diversify and maintain investment holdings balanced among asset types or classes of assets selected to meet long-term retirement and savings objectives. Currently, more than 287,000 investors have entrusted more than \$3.7 billion to STAR. Absent an investment service such as STAR, an "asset allocation" approach to investing requires that an investor establish accounts in two or more portfolios, and, at least periodically, take the steps to "rebalance" his or her account so that the ratio selected is maintained. If Vanguard were not able to offer STAR as an investment alternative, it would

⁴The additional cost would be cause because each LIFEStrategy Portfolio would own shares of a number of issuers rather than shares of a single fund, and would incur additional custody fees; investment portfolio, tax accounting, and administrative expenses; audit fees; and printing and postage costs.