

TESTIMONY OF GEORGE U. "GUS" SAUTER  
CHIEF INVESTMENT OFFICER AND MANAGING DIRECTOR  
VANGUARD

Before The Subcommittee on Select Revenue Measures

Committee on Ways and Means  
United States House of Representatives  
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Chairman Neal, Ranking Member English, and Members of the Subcommittee:

Good morning. My name is Gus Sauter, and I am the Chief Investment Officer and a Managing Director of Vanguard, an investment firm based in Malvern, Pennsylvania. Vanguard is one of the world's largest investment management firms, with nearly \$1.3 trillion in U.S. assets under management in more than 150 mutual funds. I directly oversee the management of approximately 70% of these fund assets, including both indexed and actively managed equity, bond, and balanced funds, as well as money market funds.<sup>1</sup>

I am glad to have this opportunity to share our views on "exchange-traded notes" or "ETNs." My perspective on these products is that of the Chief Investment Officer of Vanguard with professional responsibility for investing in financial products and capital markets for the benefit of millions of Americans. Our basic message is that now is the time to address these products that some in the press are calling "derivatives for the masses." Indeed, all one needs to begin investing in these derivatives is \$50 and a brokerage account.

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<sup>1</sup> The remainder of the assets invested in Vanguard mutual funds are managed by third party advisers we select and oversee on behalf of our funds.

Unparalleled and, I am told, *unintended* tax benefits have in part fueled the explosive recent growth of ETNs.<sup>2</sup> There were no ETNs at all in May 2006. Since then, 6 issuers have brought some 30 different ETNs to market, collecting more than \$6 billion. Assets have increased more than 400% over the past 12 months or so and more than 50% over the past few months despite market setbacks. New ETNs are now being announced on a regular basis. In our view, this explosive growth may have been many magnitudes greater if ETNs' current tax treatment had been thought relatively certain to continue.

ETNs are presented as a way to convert investment returns into long-term capital gains and to defer payment of tax until the derivative is sold or redeemed, possibly many years in the future. No comparable financial product is taxed so favorably. Regulated futures contracts, for example, are marked to market annually (that is, treated as sold at the end of each year, and taxes may be owed, without an actual sale), though they are also exchange-traded forward contracts like ETNs.<sup>3</sup>

I am told that this highly favorable treatment is the result of a gap or loophole and not an express policy decision, that ETNs are simply bringing to a head a question that has been left unresolved for many years: how prepaid forward contracts should be taxed.

The time has come to answer this question directly. As a manufacturer, seller, distributor, and consumer of investment products, Vanguard is keenly interested in how ETNs are, and will be, taxed. Their treatment should be the result of deliberate policy choices rather than legislative or administrative gaps. Under current conditions, retail investors can be expected to continue to buy these offerings, making it increasingly complicated to reset expectations and adopt a sound and comprehensive tax policy.

That is why we are here today -- to support H.R. 4912, introduced by Chairman Neal. It takes a significant step in what we regard as the right direction to address ETNs and other

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<sup>2</sup> No doubt part of ETN growth can be explained by factors that perhaps deserve attention in another forum. For example, ETNs are lightly regulated and can be designed to deliver nearly any investment exposure someone wants to sell.

<sup>3</sup> But ETNs are *prepaid* and futures are not.

prepaid forward contracts. Clarity is essential to enable firms and investors to plan for the future. We look forward to working with you to improve the situation going forward.

I thank you for the opportunity to share our views. I will be pleased to answer any questions that you might have.