Good morning. My name is Gus Sauter, and I am the Chief Investment Officer and a Managing Director of The Vanguard Group, a mutual fund company based in Valley Forge, Pennsylvania. Vanguard is the world’s second largest fund family, managing more than $725 billion for more than 17 million investor accounts. I oversee the management of approximately 70% of Vanguard’s assets, including equity index funds, active quantitative equity funds, active bond funds, index bond funds and money market funds. The remainder of the assets invested in Vanguard funds are managed by third party advisers we select and oversee on behalf of our funds.
I am pleased to be here representing Vanguard to discuss the U.S. capital market structure, and, in particular, proposed Regulation NMS. We believe these issues are very important for investors. Simply stated, a fair and efficient market structure is paramount to facilitate the flow of capital, while minimizing transaction costs for investors.

We strongly support the Commission’s efforts to reform the current market structure. Many of the rules governing market structure were adopted decades ago and do not allow for technological advancements that can provide the advantages of speed, certainty and minimization of transaction costs. Furthermore, some rules inhibit the natural interaction of orders. Therefore, we believe that significant reform of the current market structure is required to address these issues. Proposed Regulation NMS will go a long way toward achieving that goal.

The Debate

Some observers claim that investors are best served by obtaining the best possible price, while others advocate speed and certainty of execution. We believe that both of these are important considerations in achieving best
execution. There is no need to debate whether best price or speed and certainty is better. Investors require both, and both are provided by a perfectly liquid market.

Given this fundamental objective, market structure rules should be designed with the simple goal of providing maximum liquidity. This is achieved by creating rules that entice investors and market makers to place limit orders on an order book. And, certainly, any rules that disincent limit orders are contrary to the objective.

The Value of the Limit Order

Based on the desire to be able to execute orders immediately at the best price, we believe that limit orders should be encouraged and provided a certain level of protection. We note, however, that many existing rules favor market orders, which take liquidity out of the market.

Limit orders are the building blocks of transparent price discovery.

Although there may be many market participants willing to trade at a certain
price, it is only the limit order on the book that enables transparent price discovery.

Another important feature that limit orders provide to the marketplace is the ability of an investor to immediately execute a trade. If an investor must get out of a stock, the limit order acts as a safety net against which the investor can trade. Similarly, if an investor must buy a stock, the best offer can be taken. The limit order provides immediate execution to anyone who requires it. Economically, this is the same as granting a free option. This option is valuable to the marketplace and should be rewarded. Interestingly, the current market structure of the New York Stock Exchange significantly disadvantages limit orders and provides little incentive for investors to enhance the depth of the book with their own limit orders.

Proposed Regulation NMS

The Commission has presented four interrelated proposals that we believe are a significant step in reforming market structure and protecting limit orders.
1. **Uniform Trade-Through Rule**

We support the Commission’s proposed uniform trade-through rule, as it would further the goal of promoting total market liquidity. The requirement that trading occur at the national best bid and offer (NBBO) ensures that limit orders have standing in the marketplace. However, the linkage between markets and the nature of manual markets inhibits the efficient execution of trades.

If there were only one marketplace, or a centralization of the marketplace in a Central Limit Order Book (CLOB), then there would be no need for a trade-through rule. An order could simply ‘walk the book,’ taking all of the successive inside orders on its way to completion.

However, critics of the trade-through rule point out that often those trades that must be forwarded to a manual exchange that established the NBBO are not executed in volatile markets because of the time required to transmit the order or the time required by the manual market. This delay can result in unfilled orders as the market moves away. As a result, an immediate
execution outside of the NBBO in another market may actually be superior to such a failed trade.

We have certainly experienced this in our trading. Nevertheless, we don’t believe the trade-through rule is the cause of the problem. Instead, we believe the antiquated linkages between markets and the slower execution of manual markets are the culprits. Addressing these issues would be a better approach to solving trading delays and failures of execution.

Furthermore, we worry that completely abandoning the trade-through rule could produce some very unfavorable consequences, namely the total disincentive to provide liquidity—i.e. place limit orders. If executions outside of the NBBO proliferate, the investor that placed the limit order at the NBBO is disadvantaged by not receiving an execution. Why would an investor place subsequent limit orders when they can simply be circumvented?

We prefer a system of market linkages that provide immediate access to the NBBO, essentially functioning as a national central limit order book.
Opponents of this concept claim that there would be no incentive for innovation. However, we observe today that marketplaces compete even when they do not have the best bid or offer. They route to the best bid or offer on another market and attract orders by competing on price (commissions), better service and trading enhancements, as they become a portal into a larger market system. Innovations, such as a reserve book or other service, still provide a competitive advantage.

a. **Automated Order Execution Facility Exception**

Despite our desire to retain the trade-through rule, we would support an exception to the rule that allows de minimus trade-throughs by ‘fast’ exchanges when the NBBO is on a manual exchange. While this might seem to violate the spirit of price/time priority, we see it is a means to an end of greater market liquidity. In the short run, we believe it will entice manual exchanges to become automated, which we prefer. In the long run, we think the provision will “sunset” on its own, as all market centers eventually become automated.
In addition, we urge the Commission to require that any market center that wants to be considered ‘fast’ for purposes of the trade-through rule must automate its entire limit order book. This is imperative to ensure immediacy and certainty of execution as well as best price at that instant in time.

I would like to comment at this point more generally on automatic execution. We support automatic execution. We believe that the role of the intermediary is to facilitate the functioning of the market, not to inhibit the natural interaction of order flow. If two orders naturally cross, then they should both be filled. Indeed, we believe it is inappropriate to delay execution of the orders on the chance that an intermediary or a floor trader would like to price improve one of them. While the one order might obtain a better price, the unfilled limit order is certainly disadvantaged.

I would note that automatic execution does not reduce the specialist’s obligation to make a fair and orderly market. Even when there are volatility spikes, there is still a price at which the specialist is willing to make a market. To assume that the specialist/market making community makes a
continuous market does not comport with the reality of the crash of 1987, or even the addition of stocks to the Standard & Poors’ 500.

Automatic execution may result in one, or both, of the executing parties foregoing price improvement. But, I can assure you that we would prefer the certainty of an immediate fill at an acceptable price versus the mere possibility a penny price improvement.

b. **Opt Out Exception**

The proposal asks for comments on an “opt out” exception to allow an order to be executed at a price that trades through a better-priced displayed bid or offer on another market if the customer makes an informed decision to affirmatively opt out of the trade-through rule’s protections. We do not support the opt out exception and urge the Commission not to include it in the final rule. We believe that such an exception might serve the short-term desire to fill an execution immediately without recognizing the second order effect of reducing liquidity in the long term.

2. **Market Access**
The proposing release notes that currently there are few regulatory standards governing the manner of access among competing market centers. To address this, the Commission is proposing a uniform market access rule that would modernize the terms of access to quotations and the execution of orders in the national market system. We believe that this is a positive step in promoting a national standard and support the Commission’s proposal.

3. **Sub-Penny Quoting Proposal**

We support the Commission’s proposal that generally would prohibit quotes for NMS stocks in an increment less than one penny. We believe this prohibition will discourage market participants from stepping ahead of limit orders for the smallest economic increment possible. At such a de minimus level, stepping ahead discourages investors from placing limit orders, which are the backbone of market liquidity. It will also reduce the amount of flickering quotes.

4. **Market Data Proposal**

We support the Commission’s proposal to amend the rules and joint industry plans relating to the dissemination of market information to the
public. In particular, the proposal would amend the three joint industry plans (the CTA, CQ and Nasdaq UTP Plans) to modify the current formulas for allocating the plans’ net income to their Self Regulatory Organization participants. Generally, the new formula would divide market data revenues equally between trading and quoting activity so that markets would be rewarded for publishing the best quotes. This proposal would help attract limit orders by paying those who put quotes on the book.