July 20, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street N.W.
Washington, DC 20549

Re: Securities and Exchange Commission's Request for Comments on Enhancements to the New York Stock Exchange's Existing Automatic Execution Facility Pilot (File No. SR-NYSE-2004-05)

Dear Mr. Katz:

The Vanguard Group, Inc. appreciates the opportunity to respond to the Securities and Exchange Commission's (the "Commission") request for comments on the New York Stock Exchange's (the "Exchange") most recent Amendment No. 5 to its proposal to enhance its Direct+ system.[1] The proposal would create a hybrid market that combines automation with certain aspects of the auction market. As a mutual fund provider with approximately $850 billion invested in 18 million accounts, we believe these issues are very important for investors.

The Exchange's proposal is a significant step in the evolution of the U.S. marketplace. A fair and efficient market structure is paramount to facilitate the flow of capital, while minimizing transaction costs for investors. As we have stated in other comment letters on market structure[2], we believe that markets should develop through competition with a reasonable set of rules; however, the markets have not evolved commensurate with technology in the last 30 years for reasons involving self-interest of the intermediary system. While this proposal would bring much needed automation to the Exchange, we are concerned that several aspects of the proposal raise investor fairness and logistical issues related to the perpetuation of this self-interest. Given the significance of the Exchange as a source of liquidity for investors, we ask that the Exchange consider modifying the proposed rules in a way that provides more fairness for investors and encourages the display of limit orders.

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[1] Securities Exchange Act Release No. 51906 (June 22, 2005), 70 FR 37463 (June 29, 2005) (the "Release").
[2] *See* Letters on Regulation NMS from George U. Sauter, Managing Director, The Vanguard Group, Inc., to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 14, 2004 and January 27, 2005.

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Specialist Participation in the Hybrid Market

The proposal provides several ways in which specialists can participate in the hybrid market. Among other things, specialists would be permitted to interact with incoming orders and quotes on the Exchange's limit order book by means of proprietary algorithms. As discussed in more detail below, we are concerned that the way specialists could use such algorithms raises issues of transparency and fairness to investors.

Hidden Limit Orders

The proposal allows specialists to participate in the hybrid market via algorithmically-generated messages to the Display Book to electronically quote and trade. The specialist algorithms will have access to several types of data, including information about orders on the Display Book (such as limit orders) as well as incoming orders as they enter the Exchange's systems. In response to this information, specialists can systematically generate trading messages to provide price improvement to all or part of incoming orders subject to certain parameters.

We are concerned that the ability of specialists to access information before other markets participants and price improve limit orders provides them with the equivalent of a hidden limit order. We believe that this is fundamentally unfair to other market participants and a disincentive to displaying limit orders. If the specialist is willing to provide liquidity at a price that is better than the best bid or offer ("BBO") on the Display Book, the specialist should be required to display that liquidity.[3]

As we have noted in our previous comment letters on market structure issues, transparency of limit orders is crucial to promoting liquidity. Displaying limit orders runs contrary to most traders' instincts. However, transparency of limit orders promotes competition among them. If investors see a superior limit order on the book, they might be incented to further improve it. This creates narrower spreads and additional depth of book, both of which serve to reduce transaction costs for investors.

All of this points to the need to overcome the inherent impediments to creating limit orders. These types of orders should be encouraged. The perpetuation of specialist protection impedes this goal.

Floor Broker Participation in the Hybrid Market

The proposal allows a floor broker to place on the Display Book an agency interest file at various prices at or outside the Exchange's BBO with respect to orders the broker represents. When agency interest is at or becomes the BBO, a broker would be required to display a minimum of 1,000 shares. Such displayed interest would be on parity with other displayed orders at the BBO. Reserve broker agency interest would

[3] We note that Amendment No. 5 in fact removes Amendment No. 2's requirement that specialists be represented in the published bid or offer "in a meaningful amount." Amendment No. 5 merely requires that the specialist be represented in the published bid or offer, which is the minimal amount of 100 shares.

yield to displayed interest at the BBO; however, reserve agency interest at other prices would be on parity with all other orders, included displayed orders.

Reserve Order Parity With Displayed Orders Outside the BBO

We believe it is unfair to allow broker reserve interest outside the BBO to trade on parity with displayed investor orders. There is no logical reason for the Exchange to protect displayed limit orders only at the BBO. Parity for hidden orders is a disincentive for investors to display liquidity on the book. We believe that the hybrid market should be based on rules that entice investors and other market participants to place limit orders on the book. And certainly any rules that disincent limit orders are contrary to this objective. Displayed orders at all price points should be provided priority over hidden orders.

Requirement to Use Floor Brokers to Place Reserve Orders

Unlike other electronic venues, market participants would be required to use floor brokers to place reserve interest in the hybrid market. In our view, the opportunity for investor orders to interact anonymously without unnecessary intermediation is paramount to efficient market operations. This is consistent with the principle of direct investor order interaction set forth in Section 11A of the Securities Exchange Act of 1934 (the "Exchange Act"), which was enacted as part of the Securities Act Amendments of 1975.[4] Rather than providing a special advantage to floor brokers, we believe that the hybrid market should allow all market participants to place reserve orders on the book directly.

Liquidity Refreshment Points

Under the proposal, the unfilled portion of an automatically executing order sweeps existing orders on the Display Book and agency interest files until, among other things, a price-based or momentum-based Liquidity Refreshment Point ("LRP") is reached. LRPs are pre-determined price points at which the hybrid market converts to a non-automated market on a temporary basis. The Exchange believes that LRPs are necessary to moderate volatility.

A price-based LRP would be between 5- and 9- cent increments from the BBO. A momentum-based LRP would be the greater of 25 cents or 1 percent away from a security's lowest and highest price, respectively, within a rolling 30-second period. The hybrid market would switch to automatic trading when a manual trade occurs or at a 5- or 10-second interval, according to certain parameters.

We do not believe that market volatility should be artificially limited through the LRP mechanism. Investors should be free to place, and interact with, orders at all price

[4] Section 11A(a)(1)(C)(v) of the Exchange Act. The proposal notes that "[t]he proposed rule change also is designed to support the principles of Section 11A(a)(1) in that it seeks to assure economically efficient execution of securities transactions, make it practicable for brokers to execute investors' orders in the best market and provide an opportunity for investors' orders to be executed without the participation of a dealer." *See* the Release at p. 37484. We do not believe that this aspect of the proposal supports economically efficient executions or the ability of investor orders to interact directly.

points without unnecessary market center intervention. Without such artificial limits, we believe that investors would adapt to any volatility by placing tighter price limits on their orders.

We also are concerned that the proposed parameters of the LRPs may be overly restrictive for very liquid securities that could reach the limits in a short period of time. In such situations, the automated portion of the hybrid market may shut off with a frequency and duration that would be disruptive to investors. Frequent changes in automated status could make it difficult for investors to adjust their trading to respond to such changes and may lead them to consider the hybrid market to be unreliable for automatic execution. We recommend that the rules governing halts and resumptions of automation be reexamined to ensure that the LRP parameters are realistic.

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The Vanguard Group, Inc. is pleased to have the opportunity to comment on the proposal to establish a hybrid market. While we understand that the Exchange is free to structure its operations as it sees fit as a business matter, the issues discussed in this letter raise concerns about fairness to investors. By continuing the protection of specialist and floor broker self-interest in the electronic context, certain aspects of the proposal would impede the fair and efficient operation of the hybrid market. Ultimately competition will determine the survival of a particular business model; however, given the importance of the Exchange as a source of liquidity for investors, we ask that the Exchange consider modifying hybrid market rules to better protect investors. Please feel free to call with any questions regarding our comments.

Sincerely,

George U. Sauter
Managing Director
The Vanguard Group, Inc.

cc: John J. Brennan, Chairman and Chief Executive Officer
Heidi Stam, General Counsel
The Vanguard Group, Inc.