Vanguard

October 12, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
Station Place, 100 F Street, N.E.
Washington, DC 20549

Re: Securities and Exchange Commission's Request for Comments on Creating a New Order Type – Passive Liquidity Orders – for Use in the ArcaEx Trading Facility of the PCX (File No. SR-PCX-2005-53)

Dear Mr. Katz:

The Vanguard Group, Inc. appreciates the opportunity to respond to the Securities and Exchange Commission's request for comments on the Pacific Exchange, Inc.'s ("PCX") Amendment No. 2 to its proposal to add a new order type for use in the Archipelago Exchange ("ArcaEx") facility.[1] The new order type, the Passive Liquidity Order ("PL Order"), is an order to buy or sell a stated amount of a security at a specified, undisplayed price. As a mutual fund provider with nearly $895 billion invested in more than 19 million accounts, we believe the issues surrounding the new order type are very important for investors.

A fair and efficient market structure is paramount to facilitate the flow of capital, while minimizing transaction costs for investors. As we have noted in previous comment letters on market structure issues,[2] competition among individual limit orders helps create a perfectly liquid market, which is the best market environment for achieving the lowest transaction costs, or the best possible price, for investors. Transparency of limit orders is crucial to promoting competition among them, and therefore, liquidity. We believe that, in principle, "hidden orders," such as the proposed PL Order type, are a disincentive to displaying limit orders, which we do not believe is in the best interest of an efficient market structure. If investors can gain standing on the book without disclosing their interest, what is the incentive to show their orders? However, to the extent that market centers offer such order types, we agree that they should be available to all users, as the PCX proposes for the PL Order.

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[1] Securities Exchange Act Release No. 34-52436 (September 14, 2005), 70 FR 55441 (September 21, 2005) (the "Release").
[2] *See* letters on Regulation NMS and the New York Stock Exchange's Hybrid Market from George U. Sauter, Managing Director, The Vanguard Group, Inc., to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 14, 2004, January 27, 2005 and July 20, 2005.

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Limit Orders and Price Transparency

We believe that investors are best served by obtaining the best possible price, along with speed and certainty of execution. Both of these are important considerations in achieving best execution, and both are provided by a perfectly liquid market. This is achieved by creating rules that entice investors, market makers and other market participants to place limit orders on an order book. And, certainly, any rules that disincent limit orders are contrary to this objective.

Based on the desire to be able to execute orders immediately and at the best price, we believe that limit orders should be encouraged and provided a certain level of protection. Limit orders are the building blocks of transparent price discovery. Without a book of limit orders, market orders have no meaning. Limit orders frame the market-clearing price of a stock.

Transparency of limit orders is necessary, as it promotes competition among them. In order to improve the likelihood of execution, investors are incented to enter limit orders at improved prices. This creates narrower spreads and additional depth of book, both of which serve to reduce transaction costs for investors.

PL Orders

A PL Order would be an order to buy or sell a stated amount of a security at a specified, undisplayed price. Amendment No. 2 clarifies the execution priority of PL Orders in relation to other orders that are part of the Display and Working Order Processes and to Directed Fills in the Display Order Process. Importantly, PL Orders with a price superior to that of Directed Fills would have price priority and would execute ahead of inferior priced Directed Fills in the Directed Order Process.[3]

In proposing the PL Order, the PCX believes that the order type "adds significant value to investors and Users, [and] will enhance available order interaction opportunities …"[4] While this may indeed be the short-term outcome, we believe that "hidden" order types pose potential second-order market effects that could undermine the goals of order transparency and liquidity.

Unlike other order types that require some component of the order to be displayed, such as reserve orders, PL Orders are truly hidden; price and size are undisplayed by definition. This lack of transparency is a disincentive to investors to enter limit orders to increase their likelihood of execution at improved prices – they have no knowledge of the liquidity price points represented by the hidden orders. The consequence of this lack of transparency may be increased price spreads, with wider

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[3] We note that the PCX recently filed with the Commission Amendment No. 1 to a proposal, SR-PCX-2005-56, that would modify its Directed Order Process. This proposal does not reference the proposed execution priority of superior-priced PL Orders in the Directed Order Process; we assume that if SR-PCX-2005-53 is approved, the relevant language relating to PL Order execution priority would be incorporated into any proposed amendment to PCX Equities Rule 7.37 in SR-PCX-2005-56.

[4] *See* the Release at p. 55443.

displayed limit orders, and thus greater transaction costs for investors. Certainly trading behavior can be modified to account for this lack of transparency. Smart routers can be used to scrape hidden orders before displayed liquidity, but this will not remedy the potential for increased price spreads.

We recognize, however, that market centers offer order types similar to the PL Order. To the extent that these order types are available, we agree that they should be available to all users. While we do not believe that hidden order types are in the best interests of an efficient market structure, they certainly should not be used to provide advantages to certain market participants, such as specialists, at the expense of other investors.

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The Vanguard Group, Inc. is pleased to have the opportunity to comment on the proposal to add the PL Order type for use in the ArcaEx facility. While we believe that this order type is a disincentive to displaying limit orders, we agree that, if approved, it should be available to all users as proposed by the PCX, rather than only certain market participants. 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.