July 14, 2004

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 Regulation NMS (File No. S7-10-04)

Dear Mr. Katz:

The Vanguard Group, Inc. appreciates the opportunity to respond to the Securities and Exchange Commission's request for comments on proposed Regulations NMS. As a mutual fund provider with more than $725 billion invested in over 17 million accounts, 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.

Accordingly, 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.

Best Price Versus Speed and Certainty

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, 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.

The Value of the Limit Order

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. 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. Without a book of limit orders, market orders have no meaning. Limit orders frame the market-clearing price of a stock.

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 book acts as a safety net against which the investor can trade. Similarly, if an investor must buy a stock, the best offer, or offers, can be taken. The limit order provides immediate execution to anyone who requires it.

Impediments to the Creation of Limit Orders

Traders and other market participants have an inherent bias against placing limit orders. Like a poker player who does not want his opponents to see his hand, traders have a natural desire to not divulge their orders, for fear of being "picked off."

Furthermore, economically, a limit order grants a free option against which traders can execute their orders. This free option creates a profitable opportunity for traders who are allowed to step in front of a limit order with the knowledge that they are protected from adverse price movement by the book of limit orders. If the market moves against their position, they can always "put" their position to the book of limit orders. Since one trader's gain (from taking advantage of the free put) is another trader's loss (from providing the free put), there is a disincentive to place limit orders, which negatively impacts liquidity, thereby increasing transaction costs incurred by investors in total. Consequently, many investors prefer not to take the risk of placing a limit order with the possibility that their order may never be executed even if their order was the first to the market at the best price. The option granted by limit orders is valuable to the marketplace and should be rewarded, or at the very least, not be disadvantaged. Interestingly, the current market structure of manual exchanges 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, protecting limit orders and enhancing liquidity.

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, we would note that the current 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, in this example, established the NBBO are not completed in volatile markets because of the time required by the manual market or the time required to transmit the order. This delay can result in unfilled orders as the market moves away. As a result, an immediate execution outside the NBBO in another market may actually be superior to such an unfilled trade.

We have certainly experienced this in our trading. Nevertheless, we do not 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 failure 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? Of course, the order taking the liquidity is immediately filled in a fashion that is satisfactory to the trader, but why should the order taking liquidity out of the market be favored over the order contributing to liquidity in the marketplace? This is a short-term solution to satisfy market orders. It could significantly negatively impact liquidity, and the ability to fill market orders efficiently, in the future.

We prefer a system of market linkages that provides immediate access to the NBBO, essentially functioning as a national CLOB. 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 and expand the trade-through rule and promote price/time priority, we would support an exception to the rule that allows trade-throughs by "fast" or automated exchanges when the NBBO is on a manual exchange. We recommend that the Commission eliminate the proposed de minimis trade-through limit amount and permit an automated exchange to trade-through a manual exchange for an unlimited amount. While this might seem to violate the spirit of price/time priority, we see it as a means to an end of greater market liquidity. In the short run, we believe it will entice manual exchanges to provide an automated facility, which we prefer. In the long run, we think the provision will "sunset" on its own, as all market centers eventually become automated.

While we support the automated market exception to the trade-through rule, we recommend that the Commission set minimum performance standards to distinguish between an automated and non-automated market. We do not believe that the Commission should adopt a specific timeframe to define what constitutes an "immediate" response under Regulation NMS. Rather, we recommend that the Commission require that an automated market must provide prompt automatic execution to incoming orders (or automatic cancellation of those orders) without manual or human intervention. Automated markets also should provide prompt automatic updates of their quotes to provide full pricing transparency.

In addition, we urge the Commission to require that any market center that wants to be considered automatic 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.

As previously stated, 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 on the book is certainly disadvantaged.

We 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 must be willing to make a market.

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 of a penny price improvement.

b. Manual Quote Exception

Following a hearing on proposed Regulation NMS, the Commission issued a supplemental release to request additional comment on issues raised at the hearing. The supplemental release notes that panelists at the hearing expressed the view that a distinction could, and perhaps should, be made between automated and manual quotes rather than automated and manual markets. As the supplemental release discusses, the capability of noting that a particular quotation was not accessible through an Auto-Ex Facility would potentially give exchanges with trading floors the flexibility to integrate effectively their trading floor with an Auto-Ex Facility, thus providing a 'hybrid' market.

Based on these views expressed at the hearing, the Commission requests comment on whether an exception from the proposed trade-through rule should apply to quotes that are not immediately accessible through an automatic execution facility, rather than providing an overall exception for a manual exchange. We support the concept of such an exception, subject to certain considerations.

We recommend that the Commission define what constitutes an automated quote and set minimum performance standards as to what constitutes an immediate response to an automated quote. Similar to the standard relating to automated markets discussed above, an automated quote should be firm, automatically executable, and no manual intervention should be involved in responding to an order seeking to interact with that quote. Furthermore, an automated quote should be immediately updated.

We also urge the Commission to consider carefully how a manual quote exception would operate in practice. Although panelists at the Regulation NMS hearing stated that it would be possible to attach an identifier to manual quotes in the consolidated quote stream, it is unclear if it is really technologically feasible to distinguish between manual and automated quotes. We also share the ICI's concern about whether a market would have the unfettered ability to "turn off" and "turn back on" a quote's automated feature. If so, a market could base such a determination on its own best interests rather than considering the best interests of investors. We believe that a security must be declared either automated or manual and maintain that status until it goes through a formal process to switch to the other execution type.

c. 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 potentially significantly reducing liquidity in the long term. In our view, such an exception risks destroying any incentive to place limit orders.

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 de minimis 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. The proposal would help attract limit orders by compensating those who put quotes on the book.

The Vanguard Group, Inc. is pleased to have the opportunity to comment on this proposal to reform the current market structure. We are excited about the prospect for a more fair and efficient marketplace. Please feel free to call with any questions regarding our comments.

Sincerely,

/S/ George U. Sauter

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

cc: John J. Brennan, Chairman and Chief Executive Officer
R. Gregory Barton, Managing Director and General Counsel
The Vanguard Group, Inc.