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Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs

Oversight Hearing on
"Regulation NMS and Recent Market Developments"

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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, my name is Gus Sauter. I am the Chief Investment Officer and a Managing Director of The Vanguard Group. I oversee the management of approximately $600 billion in mutual fund assets. I am very pleased to be here representing The Vanguard Group. We have been working with various marketplaces over the past decade to improve the quality of the markets to meet investors' needs.

I would, therefore, like to thank the Committee for having this hearing on Regulation NMS and recent market developments. The issues surrounding market structure are very important issues for investors to ensure a fair and efficient marketplace. We believe that Regulation NMS, specifically the trade-through rule, will promote direct investor order interaction and support the best execution of investor orders.

I. National Market System Principles

The national market system (the "NMS") was created in 1975 through amendments to the Securities Exchange Act. These amendments set forth Congress' findings about our securities markets and directed the Securities and Exchange

Commission (the "SEC") to facilitate the establishment of an NMS. Congress recognized that new data processing and communications technology created the opportunity for the more efficient operation of markets. It also found that the linking of all markets would enhance competition, increase information available to intermediaries and investors, facilitate the offsetting of investors' orders and contribute to best execution.

Specifically, Congress directed the SEC to use its authority to assure the following five principles:

1. Economically efficient securities transactions (efficiency);
2. Fair competition among brokers and dealers and among markets (competition);
3. The availability of quotation and transaction information (price transparency);
4. The practicability of brokers executing investors' orders in the best market (best execution); and
5. The opportunity for investors' orders to be executed without the participation of a dealer (direct investor order interaction).

I would like to focus on two of the principles set forth in these amendments: (1) best execution and (2) the promotion of direct investor order interaction.

II. Best Execution

What is best execution? Some say it is obtaining the best price. Others say it is obtaining speed of execution and certainty. We believe it is a combination of both into something we call the ***expected best price***. It is the best price an investor thinks he or she can obtain for the entire trade at the instant the investor decides to buy or sell securities. This enables investors to minimize transaction costs and maximize returns.

What is the optimal market environment for achieving best execution? A perfectly liquid limit order book. Ideally there would be an infinite number of limit orders willing to buy or sell a stock with a very small spread between the bid and offer prices.

III. Limit Orders

The ideal national market system encourages a perfectly liquid limit order book by creating rules that entice investors, market makers and other market participants to place limit orders on an order book.

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.

Transparency of limit orders 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.

Displaying limit orders is crucial to promoting liquidity. But displaying limit orders runs contrary to most traders' instincts. Like a poker player, they desire to see everyone else's cards without revealing their own. 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 an economic disincentive to place limit orders.

IV. Trade-Through Rule

All of this points to the need to overcome the inherent impediments to creating limit orders. These types of orders should be encouraged. We believe that with a uniform trade-through rule, limit orders are protected and therefore encouraged.

We believe that those who opposed the Regulation NMS trade-through rule placed too much emphasis on the short-term goal of satisfying market orders. This disregards the longer-term effects on the markets of diminishing limit orders. If executions outside of the NBBO are permitted, 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? We believe this creates an unintended consequence of significantly negatively impacting liquidity, and the ability to fill market orders efficiently, in the future.

V. Competition and Free Markets

Much concern has been expressed over competition and free markets versus regulation. We absolutely think competition is imperative. But the competition that is most important for investors is the competition among orders -- bids competing against bids driving the willing purchase price higher, and offers competing against offers encouraging the sale at a lower price. This promotes the perfectly liquid limit order book we desire.

Our obligation is to get best execution for our trades. We execute against other orders. We do not execute against exchanges. Exchanges only provide services. They are a venue through which we execute our trades. The trade-through rule will have the effect of linking the exchanges into a more central marketplace. In this respect, the national market system will be analogous to the internet. The internet is a centralized repository of information with hundreds of internet service providers ("ISPs") that compete on speed, price and other services. But ultimately, each ISP provides its subscribers with access to the same internet as every other ISP. Similarly, each exchange is a portal into the national market system, and they can compete on speed, price and other services.

Concern also has been expressed about the extension of any trade-through rule to Nasdaq stocks. I would like to make two points about this. First, although Nasdaq does not formally have a trade-through rule, it operates as though it does. Applying the uniform trade-through rule to it will not be a large burden. Second, different types of markets may trade the same NMS stocks, regardless of where the stocks are listed. For example, today Nasdaq stocks are traded on Nasdaq's SuperMontage, ECNs and "listed" exchanges. And several NYSE listed stocks are traded on Nasdaq. This cross trading of stocks will certainly increase in the future. In this environment, it only makes sense that there should be intermarket protection against trade-throughs for all NMS stocks.

VI. Recent Market Developments

Two recent developments will intensify competition between markets and, hopefully, investor orders. The NYSE and Archipelago recently announced their proposed merger, followed a few days later by Nasdaq's agreement to purchase Instinet's electronic trading network.

On the surface, any contraction in the number of market centers could be worrisome. The devil is in the details, but these mergers will result in two major markets pitted against one another. Our view is that investors will be better served by two strong competitors fighting with more automated processes.

The consolidation of the order book on Nasdaq should reduce order fragmentation and increase competition among orders. Competition for listings and unlisted trading privileges will also increase.

In the case of New York and Arca, we will have to wait and see the details of the proposed merger. We would like to see the best aspects of both merged together. However, we understand that the platforms may not be merged together. If this is the case, there would be little upside advantage of the merger. There would not be a negative effect, but a significant opportunity to reduce order fragmentation and increase order interaction would be lost.

We want to see a competitive environment where various marketplaces offer value as venues into a more centralized market. Just as ISPs that offer cutting edge services are able to compete against the Comcasts of the world, we believe there will be opportunities for smaller exchanges that offer a value proposition to thrive. And, there will be sufficient competition between exchanges to keep each other in check and reduce order fragmentation. Depending on how the mergers play out, they could end up satisfying the Regulation NMS objective of promoting limit order competition.

Again, I would like to thank the Committee for allowing me to express our views. I would be pleased to answer any questions you may have.