THE Vanguard GROUP

January 27, 2005

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

Re: Securities and Exchange Commission's Request for Comments on Reproposed 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 reproposed Regulation NMS. As a mutual fund provider with more than $800 billion invested in 18 million accounts, we believe these issues 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 stated in our prior comment letter on Regulation NMS dated July 14, 2004, we believe that significant reform of the current market structure is required to achieve these goals. 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. In our view, reproposed Regulation NMS will help address this issue by promoting competition among both individual markets and individual orders, which we believe is critical to facilitate efficient markets. We strongly agree with the Commission that investor choice and competition should determine the relative success or failure of the various competing markets. We will focus our comments in this letter primarily on how the reproposed trade-through rule, one of the most significant and controversial aspects of the reproposal, furthers these goals.

The Limit Order's Role in Achieving the Goal of Market Liquidity

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.

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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. 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 is crucial to promoting liquidity. 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. However, 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.

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 natural disincentive to place limit orders.

All of this points to the need to overcome the inherent impediments to creating limit orders. These types of orders should be encouraged. They will benefit investors by lowering transaction costs.

Reproposed Trade-Through Rule

The reproposal would establish a uniform trade-through rule for all market centers that, subject to certain exceptions, would require a market center to establish, maintain, and enforce policies and procedures reasonably designed to prevent the execution of an order at a price that is inferior to a price displayed in another market. The rule would protect only quotations that are automated, which is defined as quotations that are displayed and immediately accessible through automatic execution.

1. Need for a Uniform Trade-Through Rule

We strongly support the Commission's preliminary determination that a uniform trade-through rule is required to further the goal of promoting total market liquidity. We agree that strengthened protection of displayed limit orders rewards market participants for displaying their trading interest. This encourages greater use of limit orders, which increases market depth and liquidity and ultimately reduces transaction costs incurred by investors.

Some industry commenters have urged that the Commission not adopt any form of trade-through rule. They believe that ready access by market participants to each market's publicly available quotations, combined with competition among markets, a broker's duty of best execution and economic self-interest, is sufficient to protect limit orders and efficient markets. However, 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.

These commenters have expressed particular concern about the extension of any trade-through rule to Nasdaq stocks, which currently are not subject to an intermarket trade-through rule. The sentiment is that the OTC market should be free to compete without regulatory interference. We note that the OTC market is already regulated---e.g., market makers have a best execution obligation that shapes fair and orderly markets. We agree with the Commission that an intermarket trade-through rule should be applied to Nasdaq stocks to strengthen price protection. As the reproposing release points out, competitive forces alone cannot overcome brokers' conflicts of interest and "free-riding" on displayed prices.[1]

2. Market BBO and Voluntary Depth of Book Alternatives

The Commission has proposed two alternatives for the protection of the trade-through rule. The first alternative would protect only the BBOs of the nine self-regulatory organizations and The Nasdaq Stock Market whose members currently trade NMS stocks. The second alternative also would protect the BBOs of the SROs and Nasdaq, plus quotations below a market's best bid or above a market's best offer for markets that choose to voluntarily disseminate these quotes.

We strongly support the depth of book alternative. We believe that protecting quotations at multiple price levels encourages the display of limit orders, thereby enhancing market depth and liquidity. Protecting only the top of the book at market centers obviously disadvantages certain limit orders. Furthermore, an investor who places a market order and receives execution at the top of the book at a market center at a price that is inferior to a price at another market center that is not at the BBO also is disadvantaged. In this scenario, the market order received an inferior price, the superior

[1] Brokers may have incentives to act other than in the best interest of their customers. Retail investors, especially, may have difficulty determining whether their orders were executed at the best displayed prices. In addition, even when brokers act in the best interest of their customers, they may choose for various reasons to execute particular orders at a price outside the NBBO. These orders "free-ride" on the price discovery provided by limit orders. This disincents limit orders, which negatively impacts liquidity as described above.

limit order (not at the BBO) was not executed, and the only winner was the limit order at the BBO that got an execution even though there was a better price.[2]

If one believes that the trade-through rule is important for the protection of investors, which we do, there is no logical reason why price protection should not be extended to all displayed liquidity. In fact, protection for just the BBO actually codifies trade-throughs.

By definition, the depth of book alternative will lower intraday volatility, which is, most certainly, a desired objective. The BBO alternative would produce greater volatility, as some executions would occur at inferior prices.

Many commenters have expressed concern that a uniform trade-through rule protecting depth of book will stifle competition. We disagree.

We do not believe that the depth of book alternative will convert markets into a government utility (essentially functioning as a national Central Limit Order Book), thereby reducing market competition to differentiation in amounts of payment for order flow. Instead, we believe markets will continue to compete on a total range of services, even when they do not have the best bid or offer. They will 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.[3] Furthermore, novel concepts for finding liquidity, such as ITG's POSIT Cross, would still be very competitive as it entices liquidity to trade at the mean of the NBBO.

We believe the best market structure enables the various marketplaces to compete for orders, but the orders across all markets should compete for best price. The markets have not and cannot ensure the best price on their own.

Opponents of the depth of book alternative contend that it will lead to the demise of the auction market. We believe that investor choice and competition should determine the relative success or failure of the various competing markets, including the auction market. If it serves a useful function, such as finding liquidity for illiquid securities or serving small investors, trades will be placed there. We believe that certain types of stocks are most efficiently traded on an auction market and, therefore, the auction process will survive. Other stocks have sufficient liquidity provided by investors and there is little need for an intermediary. Those stocks should be executed automatically against the most favorably priced limit orders available on any marketplace.

[2] Notwithstanding our support for the depth of book alternative as the best option, we note that the adoption of a trade-through rule for a fast market BBO would at least provide some advancement from the current situation where automation is not required. While this alternative would not be our first choice, it would be better than the status quo.

[3] As noted above, we do not believe a reserve book should have standing when another market center is required to access transparent limit orders. However, the reserve book should still have standing when market orders that are placed on that same market center are paired off against limit orders. So a market that has numerous reserve orders would be very competitive at attracting order flow.

Market Access Proposal

The Commission's reproposal is substantially similar to the market access rule as originally proposed. However, the reproposal simplifies the proposed limitation on fees any trading center can charge for accessing its protected quotes to no more than $0.003 per share. We support the proposal as a reasonable and positive step in promoting a national standard governing the manner of access among competing market centers. We agree with other commenters who have noted that protecting the best displayed quotes against trade-throughs would be futile if broker-dealers and trading centers were unable to access those quotes fairly and efficiently.

The Vanguard Group, Inc. is pleased to have the opportunity to comment on this proposal to reform the current market structure. We believe the reproposal supports the goal of encouraging competition among both individual markets and individual orders. It also promotes individual choice. We believe that competition and choice are necessary for markets to become more fair and efficient. 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.