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Committee on Financial Services
United States House of Representatives

Market Structure III: The Role of Specialists in the Evolving Modern Marketplace

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Chairman Baker and Members of the Subcommittee:

Good morning. My name is Gus Sauter, and I am the Chief Investment Officer and a Managing Director of The Vanguard Group, a mutual fund company based in Valley Forge, Pennsylvania. Vanguard is the world's second largest fund family, managing more than $725 billion for more than 17 million investor accounts. I oversee the management of approximately 70% of Vanguard's assets, including equity index funds, active quantitative

equity funds, active bond funds, index bond funds and money market funds. The remainder of the assets invested in Vanguard funds are managed by third party advisers we select and oversee on behalf of our funds.
I am pleased to be here representing Vanguard to discuss the U.S. capital market structure, and, in particular, the specialist system. 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 in that marketplace.

Many of the rules governing the current market structure were adopted decades ago and do not allow for technological advancements that can provide the advantage of speed and certainty of trade execution. 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.

The Debate

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. However, as an institution representing millions of individual investors, we believe that our needs, and those of all investors, are best served very simply—by a perfectly liquid market. 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 should be designed with the simple goal of providing maximum liquidity. This is achieved by creating rules that entice investors and market makers to place limit orders on the order book. And, certainly, any rules that disincent limit orders are contrary to the objective.

Under existing market structure rules, limit orders are not protected from traders jumping in front of them even though they have no standing on the limit order book. Since these orders are allowed to 'jump in line' ahead of limit orders, there is little incentive to take the risk of placing a limit order. There is a much greater incentive to join the ranks of the 'line jumpers.'

Accordingly, we believe the market structure should protect limit orders. Equally important, investors need to be able to access those limit orders.

The Value of the Limit Order

The order book consists of limit orders, which represent all of the transparent liquidity in the marketplace. Therefore, based on the desire to maximize liquidity, 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 a critical feature 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.

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

Economically, this is the same as granting a free option. This option is valuable to the marketplace and should be rewarded. Interestingly, the current market structure significantly disadvantages limit orders and provides little incentive for investors to enhance the depth of the book with their own limit orders.

Require Traders to Put Their Orders on the Book

Floor traders are permitted to step in front of a limit order at a better price, or even participate in a trade at the same price as the limit order even though they had not previously indicated any interest in the stock. This is the famous notion of price improvement. By allowing a better price, even if by only one penny, the availability of price improvement creates serious disincentives to place limit orders, a significant source of market liquidity. Indeed, why would an investor place a limit order when a floor trader has the ability to ‘trump’ that order on every single trade that goes to the floor? In short, the market order, which takes liquidity *out of* the market, has been favored over the limit order, which provides valuable liquidity *to* the market.

While floor traders are permitted to participate in an order after it comes to the market, the specialist can only step in front of a natural limit order before another order comes to the market. However, both of these orders are placed with the knowledge that if the market turns against the trade, it can always be liquidated against the limit order which provides a backstop for the 'line jumpers.' We support the placement of limit orders inside the 'inside spread,' which thereby increases liquidity in the stock, when they are placed on the limit order book in transparent fashion, but not when they remain hidden in the crowd.

Access to Limit Orders

Even if limit orders are granted protection from 'line jumpers,' there remains an impediment to enticing them. They must enjoy reasonable success of execution, and for that, they must be accessible within a market. We believe this is best accomplished by providing automatic execution of naturally crossing orders.

Automatic Execution

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 to determine if a floor trader would like to price improve one of them. While the one order obtains a better price, the unfilled order is certainly disadvantaged.

Automatic execution capability does not reduce the specialist's obligation to make a fair and orderly market. Even if there is a market order that would naturally cross with a limit order at a price that is substantially away from the market, the specialist must still ensure that the bid-offer spread is fair and orderly, thereby becoming the best bid or offer against which to execute the market order.

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 a penny price improvement.

We therefore commend the new leadership of the New York Stock Exchange for taking the first steps toward improving the market structure of the exchange by proposing to permit the automatic execution of certain types of orders on the exchange. While we are encouraged by the Exchange's proposal, and look forward to commenting, we believe that additional reforms are necessary.

The Trade-Through Rule

Limit orders must be accessible from other marketplaces. This is ensured by the trade-through rule, which requires that trading occur at the national best bid and offer (NBBO), regardless of which exchange establishes those quotes. However, the linkage between markets and the nature of manual markets prevents this from occurring efficiently.

If there were only one marketplace, or a centralization of the marketplace in a Central Limit Order Book (CLOB), then there could be no logical argument against the trade-through rule. An order would 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 the manual exchange that established the NBBO are not executed in volatile markets because of the time required to transmit the order and the time required by the manual market. Indeed, an execution outside of the NBBO in one market may actually be superior to such a failed trade.

We have certainly experienced this in our trading. Nevertheless, we don't believe the trade-through rule is the cause of the problem. Instead, we believe the antiquated linkages between markets and the slower execution of a manual market are the culprits. Addressing these issues would be a better approach to solving trading delays and failures of execution.

Furthermore, we worry that completely abandoning the trade through rule could produce some very unfavorable consequences, such as widespread internalization. If executions outside of the NBBO proliferate, two investors lose. First, the investor receiving a fill outside of the NBBO has either paid too much when purchasing a stock, or received too little when selling one. In behavioral terms, the investor that initiated the execution will suffer remorse that the trade was actually filled, knowing that it could have been executed at a better price. At the same time, the investor with the limit order at the NBBO has lost by not receiving an execution.

As the scenario plays out, both investors will roam from marketplace to marketplace chasing the market that would have provided them the best execution on the last trade, without the assurance that they will receive it on the next trade.

We prefer a system of market linkages that provide immediate access to the NBBO, essentially functioning as a CLOB. Opponents of this concept claim that it will stifle competition. However, we believe that marketplaces will be forced to compete on price (commissions), better service and trading enhancements, as they become a portal into a larger market system. Innovations, such as the reserve book, would still provide a competitive advantage.

Despite our desire to retain the trade-through rule, we would support a rule for a trial period that allowed *de minimus* trade-throughs by automatic exchanges when the NBBO is on a manual exchange. We regret that the limit order on the manual exchange is disadvantaged, but it does not seem appropriate to put another order at risk of not being executed simply because the NBBO has been established on a manual exchange.