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The Vanguard Group, Inc.
Senate Permanent Subcommittee on Investigations hearing on
"Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets"
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Thank you Chairman Levin, Ranking Member McCain and members of the Committee for inviting me to participate today. My name is Joe Brennan. At Vanguard, I am responsible for overseeing the investment professionals who manage our equity index mutual funds. Vanguard is one of the world's largest mutual fund organizations, serving more than 20 million investors who entrust us with $2.6 trillion of their retirement and education savings. Vanguard's investing principles are simple and straightforward: create clear goals, develop a suitable diversified allocation, minimize cost, and maintain a long-term perspective. Vanguard's core mission is equally simple and straightforward: To take a stand for all investors, to treat them fairly, and to give them the best chance for investment success.

My comments are informed by the billions of dollars we regularly invest in the equity markets, with the goal of trading effectively and efficiently on behalf of our mutual fund clients. Before getting into specific comments on potential improvements to our current market structure, I must make two fundamental points.

First, the markets are not "rigged." We have a high degree of confidence in the markets as a safe place for investors to place their assets for the long term. Frankly, sweeping conclusory statements that the markets are "rigged" do nothing to instill investor confidence. To the contrary, they undermine the efforts of regulators and the vast majority of industry participants who have strived for years to continue to create a market that functions in the best interests of investors.

Second, all investors have benefitted from improvements to our equity market structure. Through various regulatory initiatives over the past two decades, most notably, Reg NMS, our equity markets have evolved to a competitive marketplace that is connected through highly advanced technology. Over time, this structure has resulted in significantly lower transaction costs for all market participants. Individual investors who access the equity markets through asset managers like Vanguard have, without question, benefited from the market structure improvements that have been made over the last twenty years.

That said, additional improvements can be made and we appreciate the opportunity to discuss these matters. We also commend SEC Chair White for initiating a comprehensive review of ways to further strengthen the markets. We look forward to working with the Commission in this regard.

<u>High Frequency Trading</u>

I will now discuss a topic that has garnered considerable public attention recently - high frequency trading. While the term “high frequency trading” has become shorthand for disruptive trading, there is a significant amount of legitimate activity, such as market making, which falls under this broad umbrella. Today’s markets contain many venues in which trades can be executed. Professional traders and technology are the yarn that knits these venues together. There are extensive rules and regulations governing trading in place today and manipulative activity can be dealt with through vigorous enforcement. Regulators have made significant progress over the last few years in obtaining access to better information allowing them to better enforce existing rules. We expect those efforts to continue.

It is important to understand that much of the recent discussion about high-frequency trading really involves a faster, highly automated version of an issue that institutional traders have dealt with since the beginning of trading – information leakage. Even before computers dominated the marketplace, institutional traders always had to deal with the risk that their trading interest would be signaled to the market enabling others to step in and make a small profit. This risk was perhaps at its highest when institutional traders had to call a broker (or several brokers) to attempt to execute a large trade. While technology has benefitted high frequency traders, it has also provided institutional traders with the tools to control the manner in which their trading needs are submitted to the market.

Our efforts should not be focused on banning high frequency trading. We suggest examining our market structure holistically to ensure it is providing incentives for the type of activity we want to see.

Review of Regulation NMS

Vanguard supports efforts by regulators to comprehensively reevaluate Reg NMS. As time has passed and the markets have changed, most would agree that it is time to assess whether this regulation continues to further the goals of our national market system. Reg NMS has been successful in promoting the goal of enhancing competition among market centers as evidenced by the proliferation of off-exchange trading in recent years. Off-exchange trading is not bad and plays an important role in our markets by, among other things, providing a venue for the trading of large institutional orders without market impact. However, another goal of our national market system is to foster the competition of orders. As our markets have evolved under Reg NMS, it is time to explore ways to better balance the sometimes incompatible goals of encouraging competition among market centers and facilitating the interaction of orders.

Publicly-displayed liquidity is the foundation of a transparent and efficient market. We would suggest the most important goal of a national market system is to create a structure that encourages market participants to publicly display limit orders. A structure that encourages publicly displayed limit orders reduces spreads, increases liquidity, promotes price discovery, and lowers transaction costs for all investors.

Maker/Taker Pricing Models

As part of an analysis of Reg NMS, Vanguard supports regulatory efforts to revisit the current maker/taker pricing models. Fundamentally, it is important to understand that these models did not develop from any nefarious intent. Maker/taker models were created for an important purpose – to attract liquidity to the public markets and thereby promote price discovery. What has developed over time, however, as the different exchanges have implemented different pricing points, is the ability for certain traders to engage in "rebate arbitraging" which is really just trading focused on profiting from these rebates. This was not the purpose of this fee/rebate structure. More importantly, as the amount of fees and rebates differ across exchanges, it creates the appearance of a potential conflict in which brokers posting liquidity may be motivated to send an order to the exchange that offers the highest rebate while brokers routing market orders taking liquidity may be motivated to send their orders to the exchange that charges the lowest fee. While firms have a best execution obligation to ensure their routing decisions are based on the best interests of their client, we think there is an appearance of a conflict which is not necessary. The models have become unnecessarily complex and the decision to submit orders to the public markets should not be driven by the desire to capture a rebate or avoid a fee.

“Trade-At”

Any reevaluation of the maker/taker models must be connected to an analysis of other ways to encourage publicly displayed orders. Specifically, we believe the analysis of Reg NMS should also consider a pilot of a “Trade-At” rule. Today, a market center can execute an order at the best publicly displayed price without actually contributing to the public price discovery process. Generally speaking, those that publicly display their interest should be first in line for any execution at that price across the markets.

The current “Trade Through” protections of Reg NMS prohibit the purchase or sale of a stock at a price outside the national best bid/offer. Any market participant can execute trades at these prices regardless of whether the market participant is also publicly displaying that price. Because market participants can use the publicly displayed prices provided by other market participants, the “Trade-Through” rule provides little incentive for market participants to display their own trading interest and, thereby, deepen or tighten the public quote.

Conversely, a “Trade-At” rule would encourage market participants to contribute to the public price discovery process could help enhance confidence in the public markets. A well-designed pilot of a “Trade-At” rule under Reg NMS that also considers changes to the maker/taker models could help strike the appropriate balance between promoting the public competition of orders while still encouraging competition among a variety of market centers.

Access to Information

Finally, there has been much discussion about the direct market data feeds provided by the exchanges. These proprietary data feeds provide certain market participants with a snapshot of the markets moments before the same information is disseminated more broadly through the consolidated market data feed – the "SIP." The structure should not create the appearance of an informational advantage. Market participants who choose to invest in technology to act on market data faster than others is *not* the issue. Rather, it is the unequal access to information that raises the appearance of an unfair market. We support the regulators' attention to improving the integrity and resiliency of market-wide data feeds.

Conclusion

I will close by saying these are not "new" topics. Regulators and industry participants have been working diligently over the past few years to take steps to continuously improve the manner in which our markets operate. The equity markets are extremely complex. It is vitally important to recognize and examine the unintended consequences of any changes to our structure. We believe the SEC and FINRA are well equipped to continue to evaluate ways to improve our markets and we commend them on the work they have already performed.