INVESTMENT COMPANY INSTITUTE

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March 21, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Summary Report of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues

Dear Mr. Stawick and Ms. Murphy:

The Investment Company Institute[1] is writing to provide comments on the Summary Report of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues ("Committee").[2] As the Report notes, the "flash crash" of May 6, 2010 and the subsequent CFTC and SEC staff reports highlighted several important weaknesses affecting the current structure of the financial markets. ICI believes the recommendations contained in the Report will facilitate the continued examination of issues surrounding the market events of May 6, as well as issues relating to market structure in general.

As we have stated in several recent letters, the structure of the financial markets has a significant impact on ICI members, who are investors of over $12 trillion of assets on behalf of more than 90

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

[2] *Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010*, Summary Report of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, February 18, 2011 ("Report").

million shareholders. We have therefore strongly supported efforts to address issues that may impact the fair and orderly operation of the financial markets and investor confidence in those markets and have long advocated for regulatory changes that would result in more efficient markets for investors.[3]

Our comments below reinforce many of our previous recommendations on issues discussed in the Report. ICI looks forward to the opportunity to assist the CFTC and the SEC as they continue to examine issues relating to the structure of the financial markets.

I. Volatility

The Report provides several recommendations to address issues relating to volatility in the financial markets, particularly issues that were raised by the events of May 6. The flash crash highlighted the evaporation of liquidity in individual securities during times of sudden market volatility. To this end, ICI strongly supported efforts post-May 6 to implement single-stock circuit breakers to limit extreme price moves and allow for liquidity to re-enter the market.[4]

ICI therefore supports the Committee's recommendation to expand the current circuit breakers to cover all but the most inactively traded listed equity securities, ETFs, options and single stock futures on those securities. We also support implementing a more flexible "limit up/limit down" process to supplement the existing circuit breakers.

While the proposed expansions to the circuit breakers are a meaningful first step, ICI believes other inefficiencies in the current market structure highlighted by the events of May 6 also must be addressed without delay including the lack of coordination across markets in the event of a market disruption. We therefore also support the Committee's recommendation to evaluate the current system-wide circuit breakers.

As regulators continue to examine methods to address volatility in the financial markets, ICI believes that given the multitude of approaches already implemented and being considered (*e.g.*, circuit breakers, short sale price tests), it will be critical that all of these methods be coordinated across markets and that any rules or regulations be well defined and facilitate compliance.

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[3] *See, e.g.*, Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated April 21, 2010; available at http://www.ici.org/pdf/24266.pdf (SEC Concept Release on Equity Market Structure).

[4] *See, e.g.*, Letters from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 3, 2010 and July 19, 2010; available at http://www.ici.org/pdf/24364.pdf and http://www.ici.org/pdf/24438.pdf (Circuit Breakers) and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated July 19, 2010; available at http://www.ici.org/pdf/24437.pdf (Clearly Erroneous Executions).

II. Liquidity Enhancement Issues

The Report puts a strong emphasis on the importance and need for robust liquidity in the financial markets, particularly in the current high-speed, electronic trading environment. Liquidity is critical for ICI members, who frequently must trade in large size blocks. We agree with the Committee that legitimate concerns remain over the absence of incentives for certain market participants to provide liquidity under the present market structure.

A. Liquidity Pricing and Liquidity Rebates

The Report discusses the importance of the public display of liquidity and efficient price discovery. To further these goals, the Committee suggests that incentives be considered to supply liquidity that varies with market conditions. Specifically, the Committee recommends that the SEC evaluate the potential benefits that might be gained by changes in the current "maker/taker" pricing practices, including providing incentives for exchanges to provide "peak load" pricing models that could have access fees rise to dissuade, and liquidity rebates rise to encourage, liquidity in volatile markets.

ICI has previously urged that the incentives currently existing for market participants to route orders to particular venues, and any related conflicts of interest that may arise due to these incentives, be examined. For example, we continue to be concerned that brokers may refrain from posting limit orders on a particular exchange because it offers lower liquidity rebates than other markets, even though that exchange offers the best possibility of an execution for those limit orders. Practices such as these may ultimately harm investors because their limit orders may not be executed.

ICI has not recommended that liquidity rebates be prohibited. We have suggested, however, that liquidity rebate practices be examined and that more disclosure regarding incentives for order flow be required. At this time, therefore, ICI would not support the Committee's recommendation for peak load pricing without further clarity regarding the potential impact of such a pricing model on markets and investors.

B. Market Maker Obligations

The Committee suggests that the SEC should consider encouraging, through incentives (including differential pricing and preferential co-location provisions) or regulation, persons who regularly implement market maker strategies to maintain the best buy and sell quotations that are "reasonably related to the market." The Report notes that because many high frequency traders, who often use market maker type strategies, are not registered as broker-dealers, their compliance with quoting requirements would have to be addressed primarily through pricing incentives.

While high frequency traders largely have replaced more traditional types of liquidity providers in the equity markets and generally are not given special time and place privileges in exchange trading, they also are not subject to the trading obligations that in the past had accompanied such privileges. Therefore, while we agree that persons, such as high frequency traders, should be encouraged to provide liquidity in all types of markets, we are skeptical that sufficient incentives exist, particularly without associated regulatory responsibilities, that would encourage such persons to provide the valuable and needed liquidity investors seek during times of extreme market disruption.

We therefore recommend that regulators continue to examine the trading activity of persons who regularly implement market maker strategies versus the liquidity they provide and consider whether such persons should be subjected to quoting obligations similar to that of market makers or any other regulations similar to the affirmative and negative obligations of specialists and market makers. We also recommend that regulators seek to provide further incentives to the more traditional types of liquidity providers to encourage those regulated entities to stay in the business of market making.

C. Preferencing, Internalization, and Routing Protocols

The Report states that another area that has impacted liquidity in the public, or "displayed," markets is the substantial expansion of order flow that is executed by individual broker-dealer firms through "internalizing" their customer's order flow or as a result of agreements with order routing firms "preferencing" their order flow to a particular broker-dealer, usually as a result of a payment for order flow agreement. The Report adds that the impact of the substantial growth of internalizing and preferencing activity on the incentives to submit order flow to public exchange limit order books deserves further examination.[5]

The Committee recommends that the SEC conduct further analysis regarding the impact of a broker-dealer maintaining privileged execution access as a result of internalizing its customers' orders or through preferencing arrangements. The Committee states that the SEC's review should, at a minimum, consider whether to, among other things, adopt a requirement that internalized or preferenced orders only be executed at a price materially superior to the quoted best bid or offer.

ICI has previously recommended that the SEC take action along the lines of the Committee's recommendations.[6] Specifically, any order executed through internalization should be provided with

[5] We are pleased that the Report states that the Committee is not focusing on concerns of the impact of undisplayed liquidity from trading systems that attempt to provide matching of "block sized" executions. We are similarly pleased that the Committee recognizes that these systems provide a variety of technological innovations aimed at reducing information leakage and important opportunities for large trades to be executed efficiently. ICI members are significant users of these types of systems. The confidentiality of information regarding fund trades is of significant importance to ICI members. Any premature or improper disclosure of this information can lead to frontrunning of a fund's trades, adversely impacting the price of the stock that the fund is buying or selling, to the detriment of the fund's shareholders.

[6] *See* ICI Letter on SEC Concept Release on Equity Market Structure, *supra* note 3.

"significant" price improvement. Such a requirement would potentially result in more customer orders being exposed to the market if the amount of internalized orders is reduced.[7]

D. Trade-At Rule and Trade-Through Rule with Depth of Book Protection

The Committee recommends that the SEC study the costs and benefits of alternative routing requirements. In particular, the Committee recommends that the SEC consider adopting a "trade at" routing regime and conduct an analysis of the current "top of book" protection protocol and the costs and benefits of its replacement with greater protection to limit orders placed off the current quote.

When Regulation NMS was proposed, ICI supported the establishment of a uniform trade-through rule for all market centers. By affirming the principle of price priority, a trade-through rule should, among other things, encourage the display of limit orders, which in turn would improve the price discovery process and contribute to increased market depth and liquidity.

ICI believes the same arguments set forth in support of the trade-through rule could apply to a trade-at rule and a trade-through rule with depth of book protection. For this reason, some ICI members would support implementation of such alternative routing requirements. Other ICI members, however, do not support implementing a trade-at rule or a trade-through rule with depth of book protection at this time, most significantly, because of the potential difficulties in implementing and operating these rules under the current market environment.

For example, a trade-at rule would be difficult to operate given that published quotes today may not reliably indicate the true prices that are actually available to investors due to the disparities that exist in the fees charged by market participants.[8] A trade-through rule with depth of book protection also has potential downsides. Such a rule could, to some extent, turn the market into a large consolidated limit order book, a so-called "CLOB." While some ICI members would support a CLOB-like market structure, others believe that a CLOB could stifle the creation of new or different trading systems and could make it more difficult for a broker-dealer to work a large order, as it would have to satisfy interest on one or more markets that was below the top of book.

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[7] The Committee also suggests that the SEC require firms internalizing customer order flow or executing preferenced order flow to be subject to market maker obligations that require them to execute some material portion of their order flow during volatile market periods. ICI would support such a requirement.

[8] Many trading venues that display their quotes in the public quotation system typically charge per share access fees to non-subscriber market participants that trade with the orders that the venues display. ICI does not believe that access fees should be reflected in the displayed quote because this would lead to subpenny pricing, which we oppose.

III. Disclosure and Transparency of Market Information

The Report contains several recommendations to increase the disclosure of information regarding market liquidity as well as access to market information by regulators. Specifically, the Committee believes that providing information on variables related to the state of the order book and markets in general may provide a basis for market-generated responses to liquidity imbalances. As a result, the Committee recommends that the CFTC and SEC consider reporting requirements for measures of liquidity and market imbalance for large market venues. The Committee also recommends that the SEC proceed with a sense of urgency, and a focus on meaningful cost/benefit analysis, to implement a consolidated audit trail for the U.S. equity markets and that the CFTC similarly enhance its existing data collection regarding orders and executions.

ICI supports efforts to increase transparency of information about liquidity imbalances as such information could assist investors in making more informed and better investment decisions. We also support efforts to increase information needed by regulators to, for example, track suspicious market activity. As regulators examine methods to enhance data collection, however, we believe it will be critical that there is a strong focus on the costs, burdens, and operational challenges of any new requirements, particularly the inevitable costs that will be associated with a consolidated audit trail.[9]

IV. High Frequency Trading

The Report notes that high frequency trading has been a pervasive topic discussed in conjunction with the events of May 6 and market structure in general. Rather than provide specific recommendations about high frequency trading in the Report, the Committee discussed issues it considers associated with the practice.

Specifically, the Report raises a number of issues relating to the ability for market participants to co-locate and gain direct access to the markets and associated risks of erroneous trades or manipulative strategies. ICI strongly supported requiring broker-dealers to implement risk management controls and supervisory procedures reasonably designed to manage the risks associated with market access. We also supported ensuring that proper requirements are in place surrounding co-location. Finally, we supported efforts by the CFTC to address concerns surrounding disruptive or ineffectively supervised trading.

[9] *See, e.g.*, Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated August 9, 2010; available at http://www.ici.org/pdf/24477.pdf (Consolidated Audit Trail) and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 22, 2010; available at http://www.ici.org/pdf/24381.pdf (Large Trader Reporting System).

The Committee also recommends that the CFTC and SEC explore ways to fairly allocate the costs imposed by high levels of order cancellations, including requiring a uniform fee across all exchange markets that is assessed based on the average of order cancellations to actual transactions effected by a market participant. ICI has previously recommended that the SEC consider whether such a fee be implemented and supports regulators taking action to address the increasing number of order cancellations in the markets.[10]

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If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, or Ari Burstein at (202) 371-5408.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
Securities and Exchange Commission

Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O' Malia, Commissioner
Commodity Futures Trading Commission

[10] *See* ICI Letter on SEC Concept Release on Equity Market Structure, *supra* note 3.