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April 15, 2010

Draft ICI Comment Letter on SEC Concept Release on Equity Market Structure

[24238]

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 13-10
SEC RULES COMMITTEE No. 17-10
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 8-10
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 8-10
ETF ADVISORY COMMITTEE No. 13-10
SMALL FUNDS COMMITTEE No. 4-10
RISK MANAGEMENT COMMITTEE No. 9-10 RE: DRAFT ICI COMMENT LETTER ON SEC CONCEPT RELEASE ON EQUITY MARKET STRUCTURE

As we previously informed you, the Securities and Exchange Commission has issued a concept release requesting comment on several aspects of the current U.S. equity market structure. [1] Specifically, the Release focuses on three issues – the performance of the current equity market structure, high frequency trading, and undisplayed, or "dark," liquidity. The Release emphasizes, however, that the SEC is interested in receiving comments on all aspects of the equity market structure that market participants believe are important.

The Institute has prepared the attached draft comment letter on the SEC's concept release. Comments on the release are due to the SEC on Wednesday, April 21. If you have comments on the attached draft letter, please provide them to Ari Burstein by e-mail at aburstein@ici.org or by phone at 202-371-5408 by April 20.

I. Market Structure Performance and Evaluation of Execution Quality

The Release first discusses and requests comment on issues relating to the performance of the current equity market structure, particularly for long-term investors, and related issues of how investors measure their execution quality.

The draft letter states that one of the areas where SEC action will be critical is the need for increased information to investors about the order routing and execution practices of broker-dealers and other trading venues to allow investors to make better informed investment decisions. Specifically, the draft letter recommends that, at a minimum, the SEC consider means to require disclosure or to improve the existing disclosure of certain information, either to the customer involved or the public, as is most appropriate, regarding order routing and execution practices. The draft letter then recommends several specific disclosures in this area.

In addition, the Release requests comment on whether the current public tools for measuring market quality and disclosing order routing practices should be updated or expanded to provide different or additional information to investors. The draft letter states that the current rules have not proven useful to institutional investors, including funds, regarding some of the information needed to determine how and where to route large orders under current market conditions. The draft letter therefore supports the SEC either updating or expanding current rules to provide additional information to investors.

The Release also requests comment on the circumstances when an investor should be considered a “long-term investor” and if a time component is needed to define a long-term investor. The draft letter states that it will be extremely difficult, and potentially problematic, to create an explicit definition of a “long-term investor” or to determine a time frame that would distinguish a “long-term investor” from other types of investors. For these reasons, the draft letter states that it is easier to consider who is not a long-term investor and distinguishing between types of investors in this manner. As a starting point, the letter suggests that the SEC should look to the characteristics of a proprietary firm engaged in high frequency trading identified in the Release.

II. Undisplayed Liquidity

The draft letter notes that mutual funds have long been significant users of undisplayed liquidity and the trading venues that provide such liquidity. As a consequence, the letter states that the Institute believes it is imperative that venues trading undisplayed liquidity remain available to funds as they buy or sell securities and we would be concerned if any SEC proposals resulted in unintended consequences that impeded funds as they trade securities in venues providing undisplayed liquidity. At the same time, the draft letter recognizes that while venues providing undisplayed liquidity bring certain benefits to funds, not displaying orders detracts from market transparency to some extent.

A. Public Price Discovery and Undisplayed Liquidity

The Release states that a long-standing concern regarding undisplayed liquidity is whether the trading volume of undisplayed liquidity has reached a sufficiently significant level that it has detracted from the quality of public price discovery.

The Release requests comment on undisplayed liquidity handled by OTC market makers through internalization and payment for order flow arrangements. The draft letter states that internalization and payment for order flow arrangements raise a variety of concerns. For example, such arrangements may increase market fragmentation because they can result in customer orders not being publicly exposed to the market. In addition, such arrangements may raise conflicts between broker-dealers and their customers because they can result in broker-dealers executing customer orders at the displayed quotations, thus foregoing the opportunity for price improvement for those orders. The draft letter states that the Institute does not believe that internalization should be prohibited, if internalized order flow is not going to be displayed to the public markets, the SEC should take further action to ensure that internalized orders receive best execution. One suggestion is to require that any order executed through internalization be provided with “significant” price improvement, i.e., that an order be executed only at a price at least a penny better than the NBBO.

The Release also requests comment whether one of the regulatory tools that the SEC should consider to promote public price discovery should be a “trade-at” rule that would prohibit any trading center from executing a trade at the price of the NBBO unless the trading center was displaying that price at the time it received the incoming contra-side order. The Release also revisits the issue of a “trade-through rule” with depth of book protection and requests comment whether trade through protections should be expanded to cover the depth of the book. The draft letter does not support the adoption of a trade-at rule for the securities markets or the expansion of the trade-through rule to cover depth of book protection. Most significantly, a trade-at rule would be difficult to implement and operate under the current market environment. A trade-through rule with depth of book protection also has potential downsides. Such a rule would, to some extent, turn the market into a large consolidated limit order book, a so-called “CLOB.” The draft letter states that while some Institute members would support a CLOB-like market structure, others believe that a CLOB could stifle the creation of new or different ATSs 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.

Finally, the Release notes that there may be greater incentives for broker-dealer internalization in low-priced stocks than in higher priced stocks as the minimum one cent per share pricing increment established under Regulation NMS is much larger on a percentage basis than it is in higher-priced stocks. In response to this concern, the Release requests comment on whether it should consider reducing the minimum pricing increment for lower priced stocks (i.e., allow for “subpennies”). The draft letter states that while the Institute strongly supported the move to decimalization and the trading of securities in minimum increments of one penny, we have strongly opposed the entry of orders and the quoting of securities in subpennies and would oppose any reduction in the minimum pricing increment for Regulation NMS stocks.

III. High Frequency Trading

The draft letter states that mutual funds do not object to high frequency trading ("HFT") per se. HFT arguably brings several benefits to the securities markets in general and to investors in the markets, including providing liquidity, tightening spreads, and playing a role as the "new market makers." At the same time, there are many costs to the markets associated with HFT that have been cited. These include concerns relating to operational advantages or the potential for gaming through the use of high-speed computer programs for generating, routing, and executing orders, and the use of co-location services and individual data feeds offered by exchanges and others to minimize network and other types of latencies. In addition, the submission of numerous orders that are cancelled shortly after submission can create unnecessary market traffic and misleading market "noise." Of particular concern are strategies employed by HFT that are designed to detect the trading of large blocks of securities by institutional investors and to trade with or ahead of those blocks.

A. Need for Increased Transparency of High Frequency Traders and HFT Practices

The draft letter states that, as a preliminary matter, there is an immediate need for more information about high frequency traders and the trading practices of HFT firms. Many of the Release's questions regarding the impact of HFT on long-term investors, including funds, are difficult to answer in any comprehensive manner due to the lack of transparency regarding the operations of HFT firms. The letter states that transparency about HFT firms is needed in several areas, including the manner in which HFT firms trade, liquidity rebates and other incentives for order flow received by HFT firms, and other potential conflicts of interest that may exist concerning their trading and routing practices.

B. HFT Strategies

The Release focuses on particular strategies and tools that may be used by HFT firms and examines whether these strategies benefit or harm market structure performance and the interests of long-term investors. In particular, the Release requests comment on the quality of liquidity provided by HFT firms that engage in "passive market making" and the benefits and drawbacks of liquidity rebates in light of their use by such firms. The draft letter states that the incentives that currently exist for brokers to route orders to particular venues, and any related conflicts of interest that may arise due to these incentives, needs to be examined. The draft letter does not recommend that liquidity rebates be prohibited. The letter recommends, however, that the SEC, at the very least, require more transparency surrounding rebates and the revenue to market participants generated by rebates, as well as other incentives provided to route orders. The draft letter further recommends that the SEC examine the data generated by the increased transparency of information about liquidity rebate practices and determine whether further rulemaking is necessary to address concerns in this area.

The Release also discusses two types of “directional strategies,” order anticipation strategies and momentum ignition strategies, where a HFT firm takes a significant, unhedged position based on an anticipation of an intra-day price movement of a particular direction that may contribute to the quality of price discovery in a stock. The Release notes that these strategies may pose particular problems for long-term investors. The draft letter discusses these strategies and states that while these strategies may not be in violation of any specific regulation, the Institute recommends that the SEC, at the very least, conduct regular and robust examinations of HFT firms to ensure that these firms are not violating any regulatory duties when conducting an order anticipation strategy.

C. Tools Utilized by HFT to Obtain Market Access

The draft letter discusses a number of tools that HFT firms use to obtain the fastest market access possible to satisfy the manner in which they need to trade including “co-location” and using certain advantages arising from the current structure of trading center data feeds and market data distribution. Specifically, the Release requests comment on the fairness of co-location services and whether they benefit or harm long-term investors and market quality, including whether they provide HFT firms with an unfair advantage. The Release notes that the SEC has taken the position that the terms of co-location services must not be unfairly discriminatory and the fees must be equitably allocated and reasonable. The draft letter states that these are the appropriate standards by which the SEC should judge co-location services offered by exchanges and, rather than banning such services, the SEC should subject them to standards that ensure fairness and equity in their allocation.

The Release states that another important tool used by HFT firms is the individual data feeds offered by many exchanges and ECNs. Specifically, some HFT firms opt to use individual data feeds to avoid the latency between consolidated data feeds and individual trading center data feeds. To address concerns about the latency for investors receiving market data, the draft letter states that the SEC should consider eliminating the two-tiered distribution of consolidated quote and tape information. Specifically, the letter recommends that all market participants receive market data feeds from the same source, so that there is no time advantage available to some market participants from the choice of data feed.

IV. Impact of Market Structure on Other Areas

The draft letter states that while the equity markets have received the bulk of attention by regulators and Congress relating to regulatory reform, there has been a relative lack of attention given to the fixed-income markets. The draft letter urges the SEC to issue a comprehensive concept release examining the fixed-income markets to gather comments from a wide variety of market participants to assist in determining what regulatory changes are needed to best serve investors.

The draft letter also states that the issues surrounding the trading of securities by funds and other institutional investors are no longer purely a domestic matter. Many funds have intricately linked global trading desks and must be concerned not only about the regulation and structure of the securities markets in the United States but also in other jurisdictions in which they trade. The draft letter therefore urges the SEC to work with other groups to coordinate actions where possible.

Ari Burstein
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Attachment

endnotes

[1] Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010) ("Release"). The Release can be found on the SEC's website at http://www.sec.gov/rules/concept/2010/34-61358.pdf.
