MEMO# 24266

April 26, 2010

ICI Comment Letter on SEC Concept Release on Equity Market Structure

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 14-10
SEC RULES MEMBERS No. 38-10
CLOSED-END INVESTMENT COMPANY MEMBERS No. 23-10
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 9-10
ETF ADVISORY COMMITTEE No. 16-10
RISK MANAGEMENT COMMITTEE No. 10-10
SMALL FUNDS MEMBERS No. 28-10 RE: ICI COMMENT LETTER ON SEC CONCEPT RELEASE ON EQUITY MARKET STRUCTURE

The Institute has filed the attached comment letter on the SEC's 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.

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 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 letter recommends that, at a minimum, the SEC consider means to require new disclosure or to improve existing disclosure of certain information, either to the customer involved or the public, as is most appropriate, regarding order routing and execution practices. The letter then recommends several specific disclosures in this area.

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 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 letter states that the SEC should not explicitly define a “long-term investor” for purposes of trading and market structure issues and should instead consider who is not a long-term investor if it determines the need to distinguish between types of investors in this manner. As a starting point, the letter suggests that the SEC could look to the characteristics of a proprietary firm engaged in high frequency trading identified in the Release.

II. Undisplayed Liquidity

The 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. The letter also states that we would be concerned if any SEC proposal resulted in unintended consequences that impeded funds as they trade securities in venues providing undisplayed liquidity. At the same time, the 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 requests comment on undisplayed liquidity handled by market makers through internalization. The letter states that internalization raises a variety of concerns. For example, such arrangements may increase market fragmentation because it can result in customer orders not being publicly exposed to the market. In addition, internalization 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 letter does not suggest that internalization should be prohibited. It recommends, however, that the SEC take further action to ensure that internalized orders receive meaningful benefits from being internalized. Specifically, any order executed through internalization should be provided with “significant” price improvement.

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. The 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 and a trade-through rule with depth of book protection could, to some extent, turn the markets into a consolidated limit order book, which some Institute members believe could negatively impact the execution of large orders.

Finally, the Release requests comment on whether it should consider reducing the minimum pricing increment for lower priced stocks (i.e., allow for “subpennies”). The letter states that permitting the entry of orders and the quoting of securities in subpennies would exacerbate many of the unintended consequences that have arisen in the securities markets since decimalization, most significantly, the potential increase in instances of stepping-ahead of investor orders and the effect on market transparency and depth. The letter therefore opposes any reduction in the minimum pricing increment for Regulation NMS stocks.

III. High Frequency Trading

The 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, the letter notes that there are potential concerns associated with HFT. 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.” The letter states that 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 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. 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 letter does not recommend that liquidity rebates be prohibited. The letter recommends, however, that the SEC require more transparency surrounding rebates and the revenue to market participants generated by rebates, as well as other incentives provided to route orders. The 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,” 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 letter states that while these strategies may not be in violation of any specific regulation, the SEC should consider whether certain order anticipation strategies should be considered as improper or manipulative activity.

C. Tools Utilized by HFT to Obtain Market Access

The 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.   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 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 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.

D. Other Recommendations

The letter recommends that the SEC should act to address the increasing number of order cancellations in the equities markets. Specifically, the letter states that this is an area worthy of further Commission examination including considering whether requirements should be put in place to restrict certain types of "pinging" in specific contexts, or whether a fee or "penalty" should be imposed on cancelled orders.

The letter also recommends that the SEC examine the trading activity of HFT firms versus the liquidity they provide and consider whether HFT firms should be subjected to quoting obligations similar to that of OTC market makers or any other regulations similar to the affirmative and negative obligations of specialists and market makers.

IV. Impact of Market Structure on Other Areas

The 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 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 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 letter therefore urges the SEC to work with other groups to coordinate actions where possible.

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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.
