

**MEMO# 26278**

June 29, 2012

## **ICI Testimony for Congressional Hearing on Market Structure Issues**

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 13-12  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 22-12  
ETF ADVISORY COMMITTEE No. 21-12  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 26-12  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 37-12  
SEC RULES MEMBERS No. 56-12  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 27-12  
FIXED-INCOME ADVISORY COMMITTEE No. 13-12  
FEDERAL LEGISLATION MEMBERS No. 3-12 RE: ICI TESTIMONY FOR CONGRESSIONAL HEARING ON MARKET STRUCTURE ISSUES

On June 20, Kevin Cronin, Global Head of Equity Trading for Invesco, testified on behalf of ICI at a hearing examining the structure of the U.S. securities markets held by the House Committee on Financial Services' Subcommittee on Capital Markets and Government Sponsored Enterprises. ICI's testimony, a copy of which is attached, covers a wide range of market structure issues including the impact of automated trading and high frequency trading on funds, potential conflicts of interest in the securities markets, tick sizes and minimum quote variations, and undisplayed liquidity. [\[1\]](#) The most significant aspects of the testimony are summarized below.

### **Impact of Automated Trading and High Frequency Trading on Funds**

#### **Cancelled Orders**

The testimony states that regulators and market participants must act to address the increasing number of order cancellations in the securities markets, particularly those that are cancelled shortly after submission. The testimony notes that ICI has recommended on several occasions that regulators examine whether a fee should be imposed on cancelled orders above a certain ratio of orders to executed transactions. While several exchanges have recently proposed such fees, the testimony states that those proposals will be

ineffectual; they will impact only the most extreme outliers, and the fee associated with the proposals is so small that it would not act as a deterrent. The testimony therefore urges regulators and market participants to consider truly meaningful fees or other deterrents that would adequately address this behavior.

## **Addressing Market Manipulation and Abuse**

The testimony supports action by regulators to clearly define practices involving automated trading strategies and high frequency trading strategies that may constitute market manipulation. The testimony also strongly supports regulators having access to accurate, timely and detailed information about market participants and trades that are executed and the establishment of a more robust transaction reporting regime to enable regulators to monitor the activities of firms, ensure compliance with regulations, and monitor for market abuses.

## **Addressing Potential Conflicts of Interest**

### **Liquidity Rebates**

The testimony states that more must be learned about the effects of so-called “liquidity rebates” on investors and the markets. The testimony therefore recommends that the SEC work with the exchanges and other market participants to establish a pilot program where a certain set of securities would be prohibited from being subject to liquidity rebates. In this manner, the SEC can examine the data generated about liquidity rebate practices and determine whether rulemaking is necessary to address concerns in this area.

### **Order Types**

The testimony recommends that regulators vigorously examine the specific order types that exchanges and other trading venues offer and any conflicts of interest raised by the use of these order types. The testimony notes that many of these order types facilitate strategies that can benefit market participants at the expense of long-term investors or that are potentially abusive or manipulative. In addition, transparency surrounding these order types is severely lacking. The testimony therefore states that sufficient transparency of the details of order types offered by exchanges and other trading venues must be ensured and that such information must be readily and easily available to investors.

### **Transparency of Order Routing and Execution Practices**

The testimony states that more transparency is needed regarding the order routing and execution practices of market participants. At a minimum, brokers, upon request from a customer, must be required to provide certain standardized information about an execution including the type of execution venue used, the capacity in which the trade was executed, and each destination to which an order was routed. Increased information regarding payments and other incentives provided or received to direct order flow to particular trading venues also would be valuable as such increased transparency should assist in better understanding conflicts of interest that exist and would allow investors to make better informed investment decisions.

## **Tick Sizes and Minimum Quote Variations**

The testimony states that it is necessary to examine ways to increase market liquidity and the depth of markets in securities that have not benefited from the move to penny spreads. The testimony therefore recommends that a pilot program be established to examine wider

spreads in certain stocks; a pilot program would generate valuable data on the impact on liquidity in these stocks, allowing the SEC to determine whether changes to the minimum quoting variation should be implemented.

## Undisplayed Liquidity

### Broker-Dealer Internalization

The testimony states that broker-dealer internalization (i.e., where a broker internally executes against its own customer orders, taking the other side of trade) raises a variety of concerns. The testimony therefore recommends that the SEC take action to ensure that internalized orders receive best execution. Specifically, any internalized order should be provided with “significant” price improvement. This requirement could result in more customer orders being exposed to the market if the amount of internalized orders is reduced, thus furthering public display of orders and potentially improving price discovery.

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[Attachment](#)

#### endnotes

[1] Testimony of all of the witnesses at the hearing, entitled “Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors,” can be found at <http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=299413>.

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