MEMO# 23925

November 4, 2009

ICI Submits Statement for Senate Market Structure Hearing

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TO: SEC RULES MEMBERS No. 119-09
EQUITY MARKETS ADVISORY COMMITTEE No. 48-09
CLOSED-END INVESTMENT COMPANY MEMBERS No. 49-09
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 10-09
ETF ADVISORY COMMITTEE No. 38-09
SMALL FUNDS MEMBERS No. 64-09 RE: ICI SUBMITS STATEMENT FOR SENATE MARKET STRUCTURE HEARING

The Institute submitted a statement for the record, a copy of which is attached, in connection with a hearing by the Senate Banking Committee's Subcommittee on Securities, Insurance and Investment on several market structure issues, with emphasis on issues surrounding dark pools, high frequency trading, and flash orders.

Current U.S. Market Structure

The statement discusses some of the issues facing the current U.S. market structure and notes that many of the issues discussed during the last major review of the structure of the securities markets, specifically during the adoption of the SEC's Regulation NMS, continues to be of great importance to mutual funds.

The statement notes that while changes in the structure of our markets the last few years have not addressed all of the components we believe necessary for a fully efficient market structure, great strides that benefit all investors have been made. For example, trading costs have been reduced, more trading tools are available to investors with which to execute trades, and technology has increased the overall efficiency of trading. Nevertheless, the statement notes that challenges remain - posted liquidity and average execution size is dramatically lower while volatility and the difficulty of trading large blocks of stock have increased.

Dark Pools

The statement notes that mutual funds are significant users of dark pools, i.e., automated trading systems that do not display quotes in the public quote stream. Dark pools provide a solution to problems facing funds when trading large blocks of securities, particularly those relating to the frontrunning of mutual fund orders. The issue with dark pools, however, is that the benefits of not displaying orders also lead to concerns for the structure of the securities markets, most significantly, that sheltering orders from the marketplace can impede price discovery and transparency.

The statement discusses the SEC's proposals to increase transparency relating to dark pools and to address concerns about the development of a two-tiered market that could deprive certain public investors from information regarding stock prices and liquidity. Specifically, it expresses support for the government's desire to examine trading venues that do not display quotations to the public. At the same time, it stresses that policymakers should take a measured approach to making trading through dark pools more transparent and urges policymakers to ensure that there are no unintended consequences for mutual funds, which must execute large blocks of securities through dark pools on a daily basis on behalf of their shareholders.

High Frequency Trading and Related Market Structure Issues

The statement also discusses issues relating to high frequency trading. The statement notes that there are many benefits to high frequency trading that have been cited, including providing liquidity to the securities markets, tightening spreads, and playing a role as the "new market makers" but that high frequency trading also raises a number of regulatory issues. The statement notes that mutual funds do not object to high frequency trading per se but that given the growing amount of the daily trading volume that high frequency trading now constitutes, many of the issues surrounding this trading practice are worthy of further examination.

Flash Orders

The statement notes that the SEC already has proposed to prohibit “flash orders, i.e., orders that trading venues disseminate, often for only milliseconds, to a select group of market participants before they are displayed or traded against displayed bids or offers. Most mutual funds do not allow their orders to be flashed, primarily because the process of displaying orders to a select group of market participants could result in information leakage. Given the “free look” that flash orders provide and the informational advantage given to certain market participants, the statement recommends that flash orders be immediately banned.

Co-Location

The statement notes that “co-location,” i.e., providing space for the servers of market participants in the same data center housing the matching engines of an exchange, raises fair access issues. It states that while the Institute does not have an issue with the concept of co-location, all investors should have an equal and reasonable opportunity for access to a co-location facility.

Sponsored Access

Sponsored access is the practice of market participants that are not themselves broker-dealers obtaining direct access to markets through a broker-dealer’s trading identifier. Certain types of sponsored access arrangements provide access to markets without any broker-dealer pre-trade risk management system reviewing orders being transmitted. The statement notes that mutual funds do not often use sponsored access arrangements, as the speed that these arrangements provide is not critical to the type of trades funds typically execute. The statement recognizes, however, that unfettered sponsored access arrangements raise a series of supervision, compliance and risk-management issues that could impact the efficiency of the securities markets and therefore supports proper controls over these arrangements.

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Attachment
