MEMO# 25408

August 12, 2011

ICI Letter on IOSCO Consultation on the Impact of Technological Changes on Market Integrity and Efficiency

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 53-11
INTERNATIONAL MEMBERS No. 35-11
INTERNATIONAL INVESTING SUBCOMMITTEE No. 13-11
SEC RULES MEMBERS No. 101-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 36-11
ETF ADVISORY COMMITTEE No. 57-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 66-11 RE: ICI LETTER ON IOSCO CONSULTATION ON THE IMPACT OF TECHNOLOGICAL CHANGES ON MARKET INTEGRITY AND EFFICIENCY

As we previously informed you, the International Organization of Securities Commissions' ("IOSCO") issued a consultation requesting comment on a number of issues raised by the impact of technological changes on market integrity and efficiency ("Consultation"). Attached is ICI's letter on the Consultation. The letter strongly supports IOSCO's review and provides comments on a wide variety of issues including high frequency trading ("HFT"), pre- and post-trade risk controls, trading control mechanisms, regulators' surveillance capabilities, and minimum requirements for market makers.

Impact of Technological Developments on Fund Trading

The letter notes that funds rely heavily on technology for the efficient execution of their trades and that technological developments have had a significant impact on the manner in which funds trade. Specifically, when determining the most efficient approach to executing a trade, the letter states that funds must take into account the impact of: the increase in volume of trading attributed to high frequency traders and the significant amount of automated trading in general; fragmentation in the markets and the number and types of alternative trading venues available; and new tools available to funds when trading.

The letter states that funds also have become more diligent in choosing their counterparties and the venues to which they route their orders to protect the confidentiality of information regarding their trades. Technological developments also have contributed to the reduction of posted liquidity and average execution size while increasing the difficulty of trading large blocks of stock, driving more fund orders away from the lit markets and towards the use of dark liquidity.

Regulatory Obligations on Proprietary Trading Firms/ Minimum Criteria for Market Makers

The letter states that the Consultation's suggestion that all proprietary trading firms that are not currently subject to registration or oversight by a regulator be required to obtain such registration or oversight could prove beneficial. Subjecting these firms to further regulation, at least those over a specified minimum quantitative threshold, would ensure that they are subject to systems and risk management requirements and critical regulatory oversight, as well as provide regulators with better access to information about proprietary firms. Given the critical role of liquidity, and liquidity providers, in the markets, the letter also recommends that regulators examine whether more stringent obligations are necessary for traditional market makers in times of market stress.

Pre- and Post-Trade Risk Controls/ Trading Control Mechanisms

The letter states that the establishment of robust pre- and post-trade risk controls for the markets is critical given the prevalence of algorithmic trading and high frequency trading. The letter notes that ICI strongly supported proposals by the SEC to implement risk management controls and supervisory procedures designed to manage the risks associated with market access. The letter also notes that ICI strongly supported the establishment of a limit up-limit down system to replace the single-stock circuit breaker pilot. The letter supports the implementation of similar rules by other jurisdictions.

Regulators' Surveillance Capabilities

The letter states that to be able to monitor trends in trading and trading behavior, it is important that regulators have access to accurate, timely and detailed information about market participants and the trades that are executed in the markets. The letter strongly supports an examination by regulators of transaction reporting regimes similar to the consolidated audit trail and large trader reporting initiatives in the United States.

Conflicts of Interest

The letter states that the incentives that currently exist for market participants to route orders to particular venues (e.g., liquidity rebates), and any related conflicts of interest that may arise due to these incentives, need to be examined. The letter recommends that, at the very least, there should be more transparency surrounding conflicts of interest.

Rules on Market Abuse and Disorderly Trading/High Frequency Trading Practices

The letter strongly supports an examination by regulators whether any new regulations are necessary to address certain trading strategies that should be considered as improper or manipulative and urges regulators to address issues relating to abusive or disruptive trading on an expedited basis. The letter states that some of the trading practices utilized by HFT firms may pose problems for long-term investors. The letter notes that there is nothing illegal per se about many of these practices but that merely because this behavior is not per se illegal does not mean that these practices are beneficial to the markets or to investors. The letter supports action to clearly define practices that may constitute market abuse.

Charges or Fees on Cancellations

The letter recommends that regulators act to address the increasing number of order cancellations in the financial markets and examine whether a fee should be imposed on cancelled orders.; The letter also expresses concerns about suggestions for a minimum “time in force” for orders and recommends that regulators further study the impact of a minimum time in force requirement prior to putting forth a proposal for such a requirement.

Co-Location Services

The letter notes that in the United States, the SEC has taken the position that the terms of co-location services offered by exchanges must not be unfairly discriminatory and that fees must be equitably allocated and reasonable. The letter states that these represent standards by which regulators can judge co-location services offered by trading venues.

Stress Testing Algorithms

The letter states that the increased use of algorithms has raised several regulatory concerns including algorithms that may act in an unexpected or unintended manner. The letter supports subjecting algorithms to appropriate rules and controls but cautions that, at the same time, regulators must be careful not to impede funds’ use of new and innovative trading tools.

Need for Increased Information Regarding Order Routing and Execution Practices

The letter recommends that regulators examine the sufficiency of information provided by brokers and other trading venues to investors about trade execution, including whether brokers are providing adequate and accurate information about how orders are handled and routed.

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Attachment