

COMMENT LETTER

March 29, 2010

ICI Comment Letter on SEC Proposal Relating to Market Access Arrangements (pdf)

March 29, 2010 Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission
100 F Street, N.E. Washington, D.C. 20549 Re: Risk Management Controls for Brokers or
Dealers with Market Access (File No. S7-03-10) Dear Ms. Murphy: The Investment Company
Institute¹ supports the Commission's examination of practices surrounding market access,
i.e., broker-dealer access to trading directly on an exchange or alternative trading system
("ATS").² Registered investment companies ("funds") and their shareholders have a strong
interest in ensuring that the regulatory structure that governs the securities markets
promotes both the efficiency of trading on the markets and the maintenance of fair and
orderly markets. The Institute therefore shares the Commission's concerns regarding the
various financial, market, and regulatory risks that could arise in connection with market
access when it is not subject to appropriate and effective procedures and controls by
broker-dealers providing such access. I. Market Access Proposal The proposal would require
broker-dealers to implement risk management controls and supervisory procedures
reasonably designed to manage the risks associated with market access. Specifically, the
controls and procedures would address pre-trade and post-trade risks and would be
designed to, among other things, prevent the entry of orders unless there has been
compliance with all regulatory requirements that must be satisfied on a pre-order entry
basis and assure that appropriate

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.55 trillion and serve almost 90 million shareholders. ² SEC Release No. 34-61379 (January 19, 2010), 75 FR 4007 (January 26, 2010) ("Release"). Ms. Elizabeth M. Murphy March 29, 2010 Page 2 of 4 surveillance personnel receive immediate post-trade execution reports that identify the applicable customer associated with each execution. Concerns relating to "sponsored access arrangements," where market participants that are not themselves broker-dealers obtain direct access to markets through a broker-dealer's trading identifier, were the genesis of the Commission's proposal. As we have previously noted,³ 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. High-speed electronic access arrangements, whether they be direct market access arrangements or sponsored access

arrangements, raise a series of supervision, compliance and risk-management issues that could impact the efficient and orderly operation of the securities markets upon which funds rely. We therefore supported proper controls over high speed electronic access arrangements. The scope of the current proposal, however, is broader than just direct market access arrangements or sponsored access arrangements and would impact all types of arrangements where a broker-dealer provides access to trading directly on an exchange or ATS. The proposal therefore could impact the various methods that funds use to trade securities through broker-dealers. II. Potential Unintended Consequences for Fund Users of Market Access While the Institute supports the goals of the Commission's proposals, we are concerned that certain requirements of the proposal, if implemented (in the manner discussed below) without certain changes or clarification, could lead to unintended consequences for funds and other institutional investors using market access arrangements, particularly regarding the confidentiality of trading information. We have written on numerous occasions to the Commission about the importance of maintaining trade confidentiality. When funds use market access arrangements they, like other market participants, do so, in large part, to avoid the handling of their orders by the trading desks of broker-dealers so as not to impart trading information to these desks and, in general, to seek anonymity of their trading interest. This anonymity could be damaged by the pre-trade and post-trade controls and procedures mandated by the rule. For example, the proposed rule would require that broker-dealer controls and procedures assure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access. The Release states that the Commission expects that broker-dealers would be able to identify the applicable customer associated with each such execution report. The Release also states that immediate reports of executions would provide surveillance personnel with important information about potential regulatory violations, and better enable them to investigate, report, or halt suspicious or manipulative trading activity.

3 See, e.g., Statement of the Investment Company Institute, Hearing on "Dark Pools, Flash Orders, High Frequency Trading, and Other Market Structure Issues," Securities, Insurance, and Investment Subcommittee Committee on Banking, Housing & Urban Affairs, U.S. Senate, October 28, 2009. Ms. Elizabeth M. Murphy March 29, 2010 Page 3 of 4 The Institute is concerned that requirements of this kind could impair the confidentiality of fund trading information and could enable the trading personnel of a broker-dealer to deconstruct the trading methodologies of funds provided with market access. For example, it is unclear who would be considered "appropriate surveillance personnel" and the specific information that must be included in post execution reports. It is our understanding that customers generally do not currently provide the detailed information to broker-dealers that would be required under this aspect of the proposal. A similar concern arises with respect to the pre-trade controls required by the rule where a broker-dealer's controls must prevent the entry of orders that exceed pre-set credit or capital thresholds for each customer. We understand the need to implement such controls, but are concerned about the potential for leakage of information to non-compliance staff at broker-dealers who establish the required controls. Any access to information about the identity of funds submitting orders to the sales or trading personnel of a broker-dealer, on what is intended to be a direct submission of an order to an execution venue through the market access arrangement, would be of concern as it could lead to an improper information advantage for a broker-dealer. To address these concerns, we recommend that, at the very least: (1) unless expressly authorized to the contrary by a customer, access to information regarding a market access customer's orders and trades necessary to comply with the rule be limited to broker-dealer compliance personnel directly associated with overseeing market access controls and procedures; (2) that the information required to be disclosed must be relevant to specific risk concerns

created by market access; and (3) that the Commission make clear that broker-dealers who obtain information to comply with the rule also have adequate confidentiality safeguards and controls in place to protect such information and that the information be used exclusively for regulatory purposes.⁴ The Institute raised similar concerns and recommendations regarding provisions of the recently adopted Nasdaq proposal addressing market access arrangements.⁵ * * * * *

4 The Institute also has concerns about the suggestion that each market access customer be provided with a separate MPID. We believe that identifying orders as coming from a specific customer, even if the identity of the customer is apparent, would disclose sensitive and confidential information that could enable market participants to discover the trading techniques and methodologies of the customer. 5 SEC Release No. 34-61345 (January 13, 2010). The final Nasdaq rule limits access to the books and records of a sponsored participant that are necessary to allow the sponsoring member to comply with its regulatory obligations with respect to activity within the sponsored access arrangement and requires that the information received by the sponsoring member be maintained as confidential, but available to Nasdaq upon request for regulatory purposes. See also Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Greg Tanzer, Secretary General, IOSCO, dated May 20, 2009 (IOSCO consultation report on direct electronic access). Ms. Elizabeth M. Murphy March 29, 2010 Page 4 of 4 If you have any questions on our comment letter, please feel free to contact me directly at (202) 371-5408. Sincerely, /s/ Ari Burstein Ari Burstein Senior Counsel cc: The Honorable Mary L. Schapiro The Honorable Kathleen L. Casey The Honorable Elisse B. Walter The Honorable Luis A. Aguilar The Honorable Troy A. Paredes Robert W. Cook, Director James Brigagliano, Deputy Director Division of Trading and Markets Andrew "Buddy" Donohue, Director Division of Investment Management U.S. Securities and Exchange Commission

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