

COMMENT LETTER

June 3, 2010

ICI Comment Letter on Single Stock Circuit Breakers (pdf)

June 3, 2010 Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission 100 F Street, N.E. Washington, D.C. 20549 Re: SRO Single Stock Circuit Breaker Proposals (File Nos. SR-BATS-2010-014, SR-BX-2010-037, SR- NASDAQ-2010-061, SR-NSX-2010-05, SR-NYSE-2010-39, SR-NYSEArca-2010-41, SR- NYSEAmex-2010-46, SR-ISE-2010-48, SR-EDGA-2010-01, SR-EDGX-2010-01, SR-CBOE-2010- 047, SR-FINRA-2010-025) Dear Ms. Murphy: The Investment Company Institute¹ is writing to provide comments on the proposed single stock circuit breakers filed by the national securities exchanges and the Financial Industry Regulatory Authority ("FINRA") in response to the market events of May 6. The events of May 6 highlighted the need to implement a trading pause for individual securities in times of market stress to mitigate instances of sudden market volatility. The proposed circuit breakers are designed to implement such a pause. The Institute strongly supports single stock circuit breakers. The proper functioning of the securities markets is critical for Institute members, who are investors of over \$11 trillion of assets on behalf of almost 90 million individual shareholders. Registered investment companies and their shareholders have a strong interest in ensuring that the securities markets are highly efficient and that the regulatory structure that governs the securities markets promotes such efficiency. 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 \$11.97 trillion and serve almost 90 million shareholders. Ms. Elizabeth M. Murphy June 3, 2010 Page 2 of 4 While the proposed circuit breakers are a meaningful first step, other inefficiencies in our current market structure highlighted by the events of May 6 also must be addressed without delay. Specifically, there is an immediate need to examine: (1) procedures for resolving clearly erroneous trades; (2) the use of market orders; (3) the inconsistent practices employed by exchanges to address major price movements in stocks; and (4) the lack of coordination across markets in the event of a market disruption. In addition to these specific issues, the issues addressed by the Commission's concept release on the current U.S. equity market structure should be examined to further improve our markets.² I. Circuit Breaker Proposals Under the proposed rules, trading in a stock would pause across U.S. equity markets for a five- minute period in the event that a stock experiences a ten percent change in price over the preceding five minutes. The circuit breaker would be in effect only from 9:45 a.m. to 3:35 p.m. Eastern Time. The circuit breakers would first be implemented via a pilot program consisting of the stocks comprising the S&P 500 index. We understand, however, that the parameters of the pilot are subject to

change and that the scope of the pilot will expand beyond S&P 500 securities to include other securities such as exchange-traded funds ("ETFs") (discussed below). The pilot program would last until December 10, 2010. At this time, and without sufficient data or experience to fully assess the operation of the proposed circuit breaker in times of market stress, we do not have a definitive view whether the proposed parameters will accomplish the Commission's goal of addressing temporary and severe dislocations in the securities markets. We support the Commission's approach of using the pilot period "to make appropriate adjustments to the parameters or operation of the circuit breaker as warranted based on ... experience."³ It is clear that the implementation of the circuit breakers will entail addressing several complex issues regarding its operation.⁴ We therefore urge the Commission to work closely with all market participants throughout the pilot program to resolve any issues that may arise. To that end, the Institute will supplement our views on the pilot program as necessary. ² See SEC Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010) (Concept Release on Equity Market Structure), available at <http://www.sec.gov/rules/concept/2010/34-61358.pdf>. See also Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated April 21, 2010. ³ See, e.g., Testimony of Chairman Mary L. Schapiro, Examining the Causes and Lessons of the May 6th Market Plunge, before the Subcommittee on Securities, Insurance, and Investment of the United States Senate Committee on Banking, Housing, and Urban Affairs, May 20, 2010, available at <http://www.sec.gov/news/testimony/2010/ts052010mls.htm> ⁴ For example, the opening and re-opening processes for securities after a pause, the status of existing orders once a pause goes into effect, and how information about imbalances will be disseminated, among other things, all have yet to be fully resolved. Ms. Elizabeth M. Murphy June 3, 2010 Page 3 of 4 II. Inclusion of Exchange-Traded Funds in Circuit Breaker Pilot The May 6 market event impacted both individual securities and ETFs. As a result of the severe market decline, many trades were cancelled according to the securities markets' "clearly erroneous rules," which provide the various securities exchanges with the ability to cancel trades effected at prices that were sharply divergent from prevailing market prices. For trades effected on May 6, the exchanges determined to cancel any trades effected from 2:40 p.m. to 3:00 p.m. at prices 60 percent away from the last trade at or before 2:40 p.m. ETF trades comprised a majority of the cancelled trades - approximately seventy percent of the trades according to the joint CFTC-SEC preliminary report on the May 6 events.⁵ Given the impact on ETFs of the market events on May 6, we believe it is imperative that ETFs be included in the circuit breaker pilot program as soon as possible. We are encouraged by the Commission's recognition that ETFs should soon be part of the pilot.⁶ We are concerned, however, that if circuit breakers exist for individual securities contained in an ETF's basket, but not for the ETFs themselves, ETFs could again suffer disproportionately during a market event similar to that of May 6. Of immediate concern is the initial pilot program's failure to include ETFs that track the S&P 500 or other indices with substantially overlapping securities.⁷ The market price of an ETF is typically highly correlated to the market price of its basket of component securities. Under normal circumstances, ETFs will maintain this correlation even when trading has been halted for one or two component securities. An ETF may experience a slight deviation from the price of its basket because of the challenge of pricing the non-trading security; the ETF's market makers may also slightly widen the spread on the ETF to account for the risk associated with uncertain pricing of the non-trading security. Once the security begins trading again, the ETF price will typically realign with its basket in short order. As illustrated on May 6, however, when multiple underlying securities experience trading halts or slowdowns (i.e., the NYSE going into "slow mode"), the correlation between the prices of an ETF and its underlying basket may experience more severe dislocation.⁸ This scenario could repeat itself if circuit breakers on several S&P 500 securities are

triggered before ETFs containing those securities are 5 See Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, Preliminary Findings Regarding the Market Events of May 6, 2010, dated May 18, 2010, available at <http://www.sec.gov/sec-cftc-prelimreport.pdf>. 6 See, e.g., Testimony of Chairman Mary L. Schapiro, *supra* note 2 (stating that the pilot program's scope should "expand ... to securities beyond the S&P 500 (including ETFs) as soon as practicable."). 7 A related concern is that the proposed circuit breaker pilot is not coordinated across other exchange-traded instruments whose value is correlated to securities included in the pilot, such as futures and options. 8 See Appendix, "Effect of Aberrant Trading on May 6 on ETFs," for a more detailed discussion of ETF performance on May 6. Ms. Elizabeth M. Murphy June 3, 2010 Page 4 of 4 included in the pilot program. We therefore urge the Commission to include in the pilot program, as soon as possible, ETFs that track the S&P 500 or indices with substantially overlapping securities. As additional stocks are added to the circuit breaker pilot, ETFs containing those securities also should be added at the same time.⁹ Additionally, while we believe it is appropriate for the pilot program to apply the same circuit breaker triggers to ETFs initially (i.e., ten percent change in price over the preceding five minutes), we urge the Commission and exchanges to use the pilot program to consider whether a different trigger is appropriate for ETFs. * * * * * If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Ari Burstein at (202) 371-5408, or Mara Shreck at (202) 326-5923. Sincerely, /s/ Karrie McMillan Karrie McMillan General 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 J. Donohue, Director Division of Investment Management U.S. Securities and Exchange Commission Appendix 9 Consistent with this approach, because closed-end funds are also exchange traded products, as securities in which they invest are added to the pilot, closed-end funds whose portfolios are substantially comprised of these securities also should be added to the pilot. Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec TWA Bid Depth Size Up to Level 10 of 120 ETFs 0 50,000 100,000 150,000 200,000 250,000 300,000 350,000 400,000 14 :40 :00 14 :41 :00 14 :42 :00 14 :43 :00 14 :44 :00 14 :45 :00 14 :46 :00 14 :47 :00 14 :48 :00 14 :49 :00 14 :50 :00 14 :51 :00 14 :52 :00 14 :53 :00 14 :54 :00 14 :55 :00 14 :56 :00 14 :57 :00 14 :58 :00 14 :59 :00 15 :00 :00 Bid De pt h S ize U p t o L ev el 10 Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec Trade Imbalances of 120 ETFs -25000 -20000 -15000 -10000 -5000 0 5000 10000 15000 14 :40 :00 14 :41 :00 14 :42 :00 14 :43 :00 14 :44 :00 14 :45 :00 14 :46 :00 14 :47 :00 14 :48 :00 14 :49 :00 14 :50 :00 14 :51 :00 14 :52 :00 14 :53 :00 14 :54 :00 14 :55 :00 14 :56 :00 14 :57 :00 14 :58 :00 14 :59 :00 15 :00 :00 Av er ag e S ha re Tr ad e I mb ala nc es Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec Midquote Volatility of 120 ETFs 0 50 100 150 200 250 14 :40 :00 14 :41 :00 14 :42 :00 14 :43 :00 14 :44 :00 14 :45 :00 14 :46 :00 14 :47 :00 14 :48 :00 14 :49 :00 14 :50 :00 14 :51 :00 14 :52 :00 14 :53 :00 14 :54 :00 14 :55 :00 14 :56 :00 14 :57 :00 14 :58 :00 14 :59 :00 15 :00 :00 6-May 7-May Avg 5/3-5/5 Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec TWA Spread of 120 ETFs 0 100 200 300 400 500 600 700 14 :40 :00 14 :41 :00 14 :42 :00 14 :43 :00 14 :44 :00 14 :45 :00 14 :46 :00 14 :47 :00 14 :48 :00 14 :49 :00 14 :50 :00 14 :51 :00 14 :52 :00 14 :53 :00 14 :54 :00 14 :55 :00 14 :56 :00 14 :57 :00 14 :58 :00 14 :59 :00 15 :00 :00 TW A Sp re ad (in bp s) Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec Hidden Order Buy Volume of 120 ETFs 0 1,000 2,000 3,000 4,000 5,000 6,000 7,000 8,000 9,000 10,000 14 :40 :00 14 :41 :00 14 :42 :00 14 :43 :00 14 :44 :00 14 :45 :00 14 :46 :00 14 :47 :00 14 :48 :00 14 :49 :00 14 :50 :00 14 :51 :00 14 :52 :00 14 :53 :00 14 :54 :00 14 :55 :00 14 :56 :00 14 :57 :00 14 :58 :00 14 :59 :00 15 :00 :00 Hi dd en O rd er Bu y V olu m e (in sh ar

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400 14 :4 0: 00 14 :4 1: 00 14 :4 2: 00 14 :4 3: 00 14 :4 4: 00 14 :4 5: 00 14 :4 6: 00 14 :4 7: 00 14 :4 8: 00 14 :4 9: 00 14 :5 0: 00 14 :5 1: 00 14 :5 2: 00 14 :5 3: 00 14 :5 4: 00 14 :5 5: 00 14 :5 6: 00 14 :5 7: 00 14 :5 8: 00 14 :5 9: 00 15 :0 0: 00 Av er ag e N um be r o f T ra de s Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: Average 15sec Midquote Volatility of 120 ETFs 0 50 100 150 200 250 9:3 0:1 5 9:4 2:1 5 9:5 4:1 5 10 :06 :15 10 :18 :15 10 :30 :15 10 :42 :15 10 :54 :15 11 :06 :15 11 :18 :15 11 :30 :15 11 :42 :15 11 :54 :15 12 :06 :15 12 :18 :15 12 :30 :15 12 :42 :15 12 :54 :15 13 :06 :15 13 :18 :15 13 :30 :15 13 :42 :15 13 :54 :15 14 :06 :15 14 :18 :15 14 :30 :15 14 :42 :15 14 :54 :15 15 :06 :15 15 :18 :15 15 :30 :15 15 :42 :15 15 :54 :15 Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec Midquote Volatility of 120 ETFs 0 50 100 150 200 250 14 :40 :00 14 :41 :00 14 :42 :00 14 :43 :00 14 :44 :00 14 :45 :00 14 :46 :00 14 :47 :00 14 :48 :00 14 :49 :00 14 :50 :00 14 :51 :00 14 :52 :00 14 :53 :00 14 :54 :00 14 :55 :00 14 :56 :00 14 :57 :00 14 :58 :00 14 :59 :00 15 :00 :00 6-May 7-May Avg 5/3-5/5 Market Plunge on May 6, 2010: Average 15sec TWA Spread of 120 ETFs 0 100 200 300 400 500 600 700 9: 30 :1 5 9: 42 :3 0 9: 54 :4 5 10 :0 7: 00 10 :1 9: 15 10 :3 1: 30 10 :4 3: 45 10 :5 6: 00 11 :0 8: 15 11 :2 0: 30 11 :3 2: 45 11 :4 5: 00 11 :5 7: 15 12 :0 9: 30 12 :2 1: 45 12 :3 4: 00 12 :4 6: 15 12 :5 8: 30 13 :1 0: 45 13 :2 3: 00 13 :3 5: 15 13 :4 7: 30 13 :5 9: 45 14 :1 2: 00 14 :2 4: 15 14 :3 6: 30 14 :4 8: 45 15 :0 1: 00 15 :1 3: 15 15 :2 5: 30 15 :3 7: 45 15 :5 0: 00 TW A Sp re ad (in bp s) Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec TWA Spread of 120 ETFs 0 100 200 30 400 5 6 7 14 :4 0: 00 14 :4 1: 00 14 :4 2: 00 14 :4 3: 00 14 :4 4: 00 14 :4 5: 00 14 :4 6: 00 14 :4 7: 00 14 :4 8: 00 14 :4 9: 00 14 :5 0: 00 14 :5 1: 00 14 :5 2: 00 14 :5 3: 00 14 :5 4: 00 14 :5 5: 00 14 :5 6: 00 14 :5 7: 00 14 :5 8: 00 14 :5 9: 00 15 :0 0: 00 TW A Sp re ad (in bp s) Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: Average 15sec Hidden Order Buy Volume of 120 ETFs 0 10,000 20,000 30,000 40,000 50,000 60,000 70,000 80,000 90,000 100,000 9: 30 :4 5 9: 43 :3 0 9: 56 :1 5 10 :0 9: 00 10 :2 1: 45 10 :3 4: 30 10 :4 7: 15 11 :0 0: 00 11 :1 2: 45 11 :2 5: 30 11 :3 8: 15 11 :5 1: 00 12 :0 3: 45 12 :1 6: 30 12 :2 9: 15 12 :4 2: 00 12 :5 4: 45 13 :0 7: 30 13 :2 0: 15 13 :3 3: 00 13 :4 5: 45 13 :5 8: 30 14 :1 1: 15 14 :2 4: 00 14 :3 6: 45 14 :4 9: 30 15 :0 2: 15 15 :1 5: 00 15 :2 7: 45 15 :4 0: 30 15 :5 3: 15 Hi dd en O rd er Bu y V olu m e (in sh ar es) Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec Hidden Order Buy Volume of 120 ETFs 0 1,000 2,000 3,000 4,000 5,000 6,000 7,000 8,000 9,000 10,000 14 :4 0: 00 14 :4 1: 00 14 :4 2: 00 14 :4 3: 00 14 :4 4: 00 14 :4 5: 00 14 :4 6: 00 14 :4 7: 00 14 :4 8: 00 14 :4 9: 00 14 :5 0: 00 14 :5 1: 00 14 :5 2: 00 14 :5 3: 00 14 :5 4: 00 14 :5 5: 00 14 :5 6: 00 14 :5 7: 00 14 :5 8: 00 14 :5 9: 00 15 :0 0: 00 Hi dd en O rd er Bu y V olu m e (in sh ar es) Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: Average 15sec Hidden Order Sell Volume of 120 ETFs 0 10,000 20,000 30,000 40,000 50,000 60,000 70,000 80,000 90,000 9:3 0:1 5 9:4 3:1 5 9:5 6:1 5 10 :09 :15 10 :22 :15 10 :35 :15 10 :48 :15 11 :01 :15 11 :14 :15 11 :27 :15 11 :40 :15 11 :53 :15 12 :06 :15 12 :19 :15 12 :32 :15 12 :45 :15 12 :58 :15 13 :11 :15 13 :24 :15 13 :37 :15 13 :50 :15 14 :03 :15 14 :16 :15 14 :29 :15 14 :42 :15 14 :55 :15 15 :08 :15 15 :21 :15 15 :34 :15 15 :47 :15 Hi dd en O rd er Se ll V olu m e (in sh are s) Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: 14:40 - 15:00 Average 15sec Hidden Order Sell Volume of 120 ETFs 0 2,000 4,000 6,000 8,000 10,000 12,00 4 16 18, 2 , 14 :40 :00 14 :41 :00 14 :42 :00 14 :43 :00 14 :44 :00 14 :45 :00 14 :46 :00 14 :47 :00 14 :48 :00 14 :49 :00 14 :50 :00 14 :51 :00 14 :52 :00 14 :53 :00 14 :54 :00 14 :55 :00 14 :56 :00 14 :57 :00 14 :58 :00 14 :59 :00 15 :00 :00 Hi dd en O rd er Se ll V olu m e (in sh are s) Avg 5/3-5/5 6-May 7-May Market Plunge on May 6, 2010: Average 15sec Hidden Order Trade Imbalances of 120 ETFs -15,000 -10,000 -5,000 0 5,000 10,000 9: 30 :1 5 9: 42 :3 0 9: 54 :4 5 10 :0 7: 00 10 :1 9: 15 10 :3 1: 30 10 :4 3: 45 10 :5 6: 00 11 :0 8: 15 11 :2 0: 30 11 :3 2: 45 11 :4 5: 00 11 :5 7: 15 12 :0 9: 30 12 :2 1: 45 12 :3 4: 00 12 :4 6: 15 12 :5 8: 30 13 :1 0: 45 13 :2 3: 00 13 :3 5: 15 13 :4 7: 30 13 :5 9: 45 14 :1 2: 00 14 :2 4: 15 14 :3 6: 30 14 :4 8: 45 15 :0 1: 00 15 :1 3: 15 15 :2 5: 30 15 :3 7: 45 15 :5 0:

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