

COMMENT LETTER

February 22, 2010

ICI Comment Letter on SEC Proposal Relating to Dark Pools and Other Non- Public Trading Interest (pdf)

February 22, 2010 Ms. Elizabeth M. Murphy Secretary Securities and Exchange Commission
100 F Street, N.E. Washington, D.C. 20549 Re: Regulation of Non-Public Trading Interest
(File No. S7-27-09) Dear Ms. Murphy: The Investment Company Institute¹ supports the
Commission's examination of the current regulation of non-public trading interest.² The
structure of the securities markets has a significant impact on Institute members, who are
investors of over \$11 trillion of assets and who held 28 percent of the value of publicly
traded U.S. equity outstanding at the end of the third quarter of 2009. We are institutional
investors but invest on behalf of almost 90 million individual shareholders. Mutual funds
and their shareholders therefore have a strong interest in ensuring that the securities
markets are highly competitive, transparent and efficient, and that the regulatory structure
that governs the securities markets encourages, rather than impedes, liquidity,
transparency, and price discovery. Consistent with these goals, we have strongly supported
the Commission's continuing efforts to address issues that may impact the fair and orderly
operation of the securities markets and investor confidence in those 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 \$11.82 trillion and serve almost 90
million shareholders. 2 SEC Release No. 34-60997 (November 13, 2009), 74 FR 61208
(November 23, 2009) ("Release"). Ms. Elizabeth M. Murphy February 22, 2010 Page 2 of 8
markets³ and have long advocated for regulatory changes that would result in more
publicly displayed quotes.⁴ Mutual funds' sole interest in this discussion is in ensuring that
proposed market structure changes promote competition, efficiency and transparency for
the benefit of all market participants and not for a particular market center, exchange or
trading venue business model. All trading venues should compete on the basis of
innovation, differentiation of services and ultimately on the value their model of trading
presents to investors. It will be important for regulators to be cognizant of this as they
examine the reform of the current market structure and to focus on the interests of the
markets' ultimate end-user - the investor. I. Broad Examination of Market Structure Issues
We are pleased that the Commission has determined to take a broad look at the current
U.S. equity market structure and its impact on long-term investors, such as mutual funds,
through its recently issued concept release.⁵ We are hopeful that requesting comment on a
wide variety of issues impacting the securities markets and participants in those markets

will allow the Commission to take a measured approach to the reform of the structure of the U.S. markets to ensure that there are no unintended consequences to investors. It is important that any specific market structure issue, such as the regulation of non-public trading interest, not be viewed in a vacuum and that the Commission address the many diverse methods that investors use to trade and the reasons for their use of particular trading methods or venues. For this reason, we recommend that the Commission consider whether to defer action on the current proposal until it completes its broader examination of market structure issues and has vetted these issues fully through the public comment process. At the very least, the current proposal should be viewed as just one step towards increasing transparency by venues providing execution facilities to investors. We look forward to commenting on the concept release and the issues raised by the release, such as those surrounding the performance of the current equity market structure, high frequency trading, and undisplayed liquidity. In addition to these issues, there are a number of significant (and often related) issues that we believe will be imperative for the Commission to examine and address to

3 See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated November 23, 2009 (Elimination of Flash Order Exception from Rule 602 of Regulation NMS). 4 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. 5 Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010). Ms. Elizabeth M. Murphy February 22, 2010 Page 3 of 8 ensure an efficient market for all investors. We will discuss these in much more detail in our letter on the concept release but they include, most significantly:

- Information Provided by Executing Brokers and Trading Venues to Investors – An examination of the sufficiency of the information currently provided by broker-dealers to investors about trade execution, including whether broker-dealers are providing adequate and accurate information directly to investors about how orders are handled and routed; the need for more public disclosure about how orders provided to broker-dealers are handled; and better trade reporting by all types of execution venues regarding order execution.
- Internalization – An examination of the need for increased transparency and regulation regarding broker-dealer internalization; most significantly, increased transparency surrounding internalization practices and the execution provided to internalized trades and whether midpoint execution or “significant” price improvement should be required to be provided to internalized trades.
- Incentives to Direct Order Flow – An examination of incentives currently provided to market participants (e.g., rebates) to direct order flow to certain trading venues; the impact of these incentives on execution quality; and the cause and effect of such incentives on the proliferation of certain short-term trading venues and strategies.
- Better Enforcement and Surveillance of the Markets – An examination of the need for increased focus by regulators on trade leakage, frontrunning, gaming of the markets, and any other form of abusive trading and the rigorous enforcement of cases related to these issues.
- Fragmentation – An examination of fragmentation in the markets, the impact on the ability of investors to trade efficiently, and related issues such as the lack of incentives to publicly display orders (and the priority afforded to those orders).

We offer our assistance as the Commission examines these issues and proposes further rulemaking, as necessary, to address issues that may have a detrimental effect on investors.

II. Commission Proposals and Funds’ Use of Non-Public Trading Interest

Much of the current debate over the structure of the U.S. securities markets have centered on the proliferation of non-public trading interest and the venues that provide such interest, particularly “dark pools.”⁶ Mutual funds are significant users of these trading venues, which provide a mechanism

⁶ We believe it is unfortunate that such

a pejorative term has now become ingrained in the terminology used by the securities markets and policymakers to describe a type of trading venue that has brought certain benefits to all kinds of market participants, including funds and their shareholders. We therefore are reluctant to use the term when discussing issues surrounding this part of our market structure and urge that an alternative term be established to describe such venues. However, since no alternative term has yet been formally recognized and for purposes of clarity, we will use “dark pools” in this letter to address these alternative trading venues.

Ms. Elizabeth M. Murphy February 22, 2010 Page 4 of 8 for transactions to interact without displaying the full scale of a fund’s trading interest, thereby lessening the cost of implementing trading ideas and mitigating the risk of information leakage. These venues also allow funds to shelter their large block size trading interest from market participants who seek to profit from the impact of the public display of large orders to the detriment of funds and their shareholders.⁷ As we have stated in several letters to the Commission,⁸ the confidentiality of information regarding mutual fund trades is of significant concern to Institute members. Any premature or improper disclosure of this information can lead to frontrunning of a fund’s trades, adversely impacting the price of the stock that the fund is buying or selling. We recognize that while dark pools and other alternative trading systems (“ATSS”) bring certain benefits to institutional investors, not displaying orders also leads to concerns for the structure of the securities markets. Sheltering orders from the marketplace can impede price discovery and transparency, two key elements in creating an efficient market structure. The Commission’s proposals seek to address these concerns. Specifically, the proposals address concerns about pre-trade messages sent out by dark pools and other venues that are akin to orders but that are only sent to selected market participants (so-called “actionable indications of interest” or “actionable IOIs”) and the lack of display of these venues’ best-priced orders. The proposals also address the lack of real-time disclosure of the identity of individual ATSS on public trade reports. We support, in general, the Commission’s efforts to increase transparency of non-public trading interest. We believe that increasing overall transparency in the markets would lead to a more efficient marketplace. We nevertheless have certain recommendations to ensure that the proposals do not result in unintended consequences for funds as they trade securities in venues providing non-public trading interest, whether it be through trading large blocks or through other trading methods.

III. Post-Trade Transparency for ATSS The proposal would require the real-time disclosure of the identity of individual ATSS on trade reports in the public data stream. Currently, published trade reports only identify ATS trades as over-the-counter trades and do not identify the particular ATS or other broker-dealer that reported the trade. The Release notes several potential benefits of the proposal. Specifically, the proposal would address concerns that the lack of information concerning the ATS on which trades are executed makes

⁷ It is important to note that the particular business models and trading mechanisms of dark pools and other ATSS can vary widely. For example, some dark pools, such as block crossing networks, offer specific size discovery mechanisms that are critical for institutional investors in the anonymous execution of large-sized orders. Other dark pools and ATSS operate in a manner more akin to exchanges and other broker-dealer trading venues and arguably should be treated as such for purposes of regulation. We believe it is important that the Commission consider these differences as it examines the current, and any future, rulemaking.

⁸ See, e.g., Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission, dated September 14, 2005, August 29, 2006, and September 19, 2008. Ms. Elizabeth M. Murphy February 22, 2010 Page 5 of 8 it difficult for the public to assess ATS trading in real-time and to reliably identify the volume of executions in particular stocks on individual ATSS. We agree with these concerns and support increasing post-trade transparency for ATSS. As discussed below, however, we have several

recommendations to amend the proposal to prevent unintended consequences for mutual funds.⁹

A. Real-Time Disclosure of an ATS Identity We are pleased that the proposal recognizes some of the challenges that funds face when executing large size trades and the need for funds to control the information flow concerning their transactions. In particular, the Release notes that the disclosure of the identity of an individual ATS that has executed a particular large size trade could potentially cause undue information leakage about that trading. While we support the proposed exemption for certain large-sized trades (with some recommended changes discussed below) that is intended to mitigate concerns relating to information leakage, we believe that the real-time disclosure of the identity of the specific ATS where non-exempt trades were executed will nevertheless leave too large a “footprint” of fund orders. As the Release notes, only a small portion of trades in ATSs take place in pools specializing in trading large blocks of securities. More often, mutual funds must break up their larger “parent” orders into smaller “child” orders that would not be exempted under the proposal, and execute these orders in other types of ATSs. The liquidity for the majority of fund orders often cannot be found in the specialized block ATSs. We therefore believe that the real-time disclosure of individual ATS identities would provide another crucial “piece of the puzzle” to those who intend to prey off the orders of mutual funds and has the potential to facilitate the frontrunning of funds’ security positions.

B. Disclosure of an ATS Identity on a Delayed Basis While we do not support the real-time disclosure of the identity of an individual ATS, we do support such disclosure on a delayed basis. To address concerns about the frontrunning of mutual fund trades, we recommend that the Commission require the disclosure of the identity of individual ATSs on trade reports at the end of the trading day, on a stock-by-stock basis (i.e., the volumes for each individual stock that was executed by the ATS). It is the general consensus of our members that this disclosure should apply uniformly across all types of stocks. Several members, however, remain concerned that end-of-day disclosure for certain less liquid stocks, such as small-cap and mid-cap stocks, could still lead to frontrunning of mutual fund trades. We therefore would not object to a bifurcated disclosure model where trades in large-cap, liquid stocks would be required to be disclosed at the end of the day and trades in smaller, less liquid stocks would be required to be disclosed on a further delayed basis (e.g., T+5). To further transparency of ATS trades, we believe that any trades that would have been exempted under the proposal, i.e., large block trades, also be disclosed on a delayed basis in this manner.¹⁰ We believe these changes would not impair the goals of the proposal and would address the unintended consequences that could occur if the proposal is approved in its current form.¹¹

IV. Actionable IOIs and ATS Display Obligations The proposal would address pre-trade transparency in ATSs by amending the definition of “bid” or “offer” in Exchange Act quoting requirements to apply expressly to “actionable IOIs” privately transmitted by dark pools and other trading venues to selected market participants. The proposal also would amend the display obligations of ATSs by lowering the trading volume threshold in Regulation ATS, from 5% to 0.25%, that triggers the order display and execution access requirements for an ATS.

A. The Proposal Would Bring Certain Benefits to the Markets The Release states that the effect of the proposed amendments would be that “ATSs could not privately display actionable IOIs only to select market participants and

thereby create two-tiered access to information on the best available prices” for NMS stocks and that more ATS quotes could be made available to the public by requiring their inclusion in the consolidated quotation data. While some trading venues may use actionable IOIs to find contra-side trading interest for large size orders, our members report that they do not typically permit their orders to be advertised via actionable IOIs (as those IOIs are characterized in the proposal), for the reasons discussed above relating to frontrunning. Therefore, while the proposal would, in effect, eliminate actionable IOIs and therefore reduce a choice for funds in how to facilitate the execution of their orders, we believe the benefits of pre-trade transparency noted above strongly outweigh any impact (limited as it might be) on fund trading.¹² 10 We believe this information should not be disclosed on an aggregated basis, for example, disclosure solely of the total volume for each individual ATS, as this information would not be helpful to investors in assessing ATS trading or identifying the volume of executions in particular stocks on individual ATSS. 11 While we do not support the public disclosure on a real-time basis of individual ATS identities, we strongly support requiring the reporting of this information to regulators on a real-time basis. Real-time disclosure of ATS identities should facilitate a more robust understanding by regulators of current ATS practices and enforcement of rules and regulations relating to ATSS. 12 Some commenters have contended that the pre-trade transparency proposals also would result in increased transaction costs for investors by eliminating a method used to find contra-side trading interest for large-sized orders. We do not believe this to be the case. Given the limited use by mutual funds of actionable IOIs, the proposals, in and of themselves, would not result in increased overall transaction costs. Ms. Elizabeth M. Murphy February 22, 2010 Page 7 of 8 B. Potential Unintended Consequences of Proposals While we generally support the pre-trade transparency proposals, we urge the Commission to examine any unintended consequences that may arise as a result of the new requirements prior to adoption. For example, the proposals could result in ATSS becoming more “dark” to avoid regulation and/or broker-dealers increasing their execution of orders internally, continuing the lack of transparency to investors; this would run counter to the goals of the proposal and could result in an increasingly fragmented market.¹³ Similarly, instead of sending out IOIs, a trading venue could instead use “immediate or cancel” (“IOC”) orders instead of IOIs to “ping” the market. Our members report that this would only increase the “noise” already in the markets and would make trading more difficult and less efficient by potentially distorting indications of the true liquidity in the markets. V. Exception for Institutional Sized Trades and Quotes The proposals contain an exemption from the pre-trade and post-trade requirements for large sized trades or quotes, i.e., trades and quotes with a value of at least \$200,000. The Release states that the purpose of the exemption is to provide certain large orders with an opportunity for size discovery without having to be displayed in the public quote stream or disclosed post-execution, addressing the potential for information leakage. We appreciate that the Commission attempted to narrowly draft the exemption to only cover what it considers to be a true large-sized order. Nevertheless, as drafted, the exemption would not include certain large-sized orders in small-cap and mid-cap stocks that would raise the same concerns about the frontrunning of orders and information leakage as exempted orders. We therefore recommend that the exemption be modified to include a threshold based not only on the dollar value of a trade, but also on a variety of factors, e.g., the lesser of a dollar value of a trade, the number of shares of a trade, or the percentage of the average daily volume of a stock that a trade represents. If the Commission amends the post-trade transparency proposal as recommended above, we believe the exemption will be unnecessary for this aspect of the proposal as we are recommending that all trades be disclosed uniformly on a delayed basis. On the other hand, if our recommendations are not adopted, amendments to the proposed exemption will be critical to prevent frontrunning of

mutual fund orders and allow for the continued use of dark pools in an efficient manner. The exemption also will continue to play a role in the pre-trade transparency proposals for those ATSs who are specializing in the execution of large-sized trades. 13 This potential consequence illustrates the need for an examination of related market structure issues prior to the adoption of the current proposal. While the proposal would increase transparency regarding dark pool and other ATS liquidity, investors still would not have a complete picture of the liquidity in the markets as a whole, as trade volume executed by brokers outside of their ATSs, such as internalized volume, still would not be disclosed to the public on an attributed basis. We urge the Commission to address this deficiency. Ms. Elizabeth M. Murphy February 22, 2010 Page 8 of 8 * * * * * If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, or Ari Burstein at (202) 371-5408. 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 David Shillman, Associate Director Division of Trading and Markets Andrew "Buddy" Donohue, Director Division of Investment Management U.S. Securities and Exchange Commission

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