



May 10, 2013

International Organization of Securities Commissions  
c/o Teresa Rodriguez Arias  
Calle Oquendo 12  
28006 Madrid  
Spain

Re: Public Comment on Consultation Report: Regulatory Issues Raised by Changes in Market Structure

Dear Sir or Madam:

The Investment Company Institute (“ICI”) and ICI Global support the International Organization of Securities Commissions’ (“IOSCO”) review of issues raised by changes in market structure, particularly those raised by market fragmentation. The consultation report (“Consultation”) issued by IOSCO raises a number of issues of importance to ICI and ICI Global members.<sup>1</sup>

ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (“ETFs”), and unit investment trusts (“UITs”).<sup>2</sup> The structure of the global financial markets has a significant impact on ICI members, who are investors of approximately \$15 trillion of assets on behalf of over 90 million individual shareholders.<sup>3</sup>

ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public

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<sup>1</sup> *Regulatory Issues Raised by Changes in Market Structure*, International Organization of Securities Commissions (March 2013). The Consultation can be found on IOSCO’s website at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD407.pdf>.

<sup>2</sup> ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

<sup>3</sup> For more information on the U.S. registered investment company industry, see Investment Company Institute Fact Book at [www.icifactbook.org](http://www.icifactbook.org).

understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of over \$1 trillion in non-U.S. funds.

ICI and ICI Global members, and their shareholders, have a strong interest in ensuring that the global financial markets are highly competitive, transparent and efficient, and that the regulatory structure that governs the financial markets encourages, rather than impedes, liquidity, transparency, and price discovery. Consistent with these goals, we have strongly supported efforts to address issues that may impact the fair and orderly operation of the global financial markets and investor confidence in those markets, including issues surrounding fragmentation, and have long advocated for appropriate regulatory changes.

Some of the issues raised by the Consultation related to fragmentation have already been raised in previous IOSCO consultations. Our comments on the Consultation therefore reiterate many of the comments made in prior ICI and ICI Global letters related to market structure issues.<sup>4</sup>

## **I. General Comments**

The structure of the global financial markets has undergone significant changes over the past several years. Clearly, a primary driver and enabler of these changes has been the continual evolution of technologies for generating, routing and executing orders and related improvements to the speed, capacity and sophistication of the trading functions available to investors.

We believe these changes have benefited investors, both retail and institutional, and that investors are better off than they were just a few years ago, particularly when trading large-cap securities. Most significantly, trading costs have been reduced, more trading tools are available to investors with which to execute trades, and technology arguably has increased the overall efficiency of trading. Nevertheless, as discussed in further detail below, funds remain concerned about issues raised by fragmentation, including declines in posted liquidity and average execution size and the increased difficulty of trading large blocks of stock, as well as other challenges created by recent technological developments. When determining the most efficient approach to executing a trade, funds must now take into account, among other things, fragmentation in the markets and the number and types of

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<sup>4</sup> See Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Greg Tanzer, Secretary General, IOSCO, dated May 20, 2009, available at <http://www.ici.org/pdf/23474.pdf> (IOSCO Direct Electronic Access Consultation); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Werner Bijkerk, Senior Policy Advisor, IOSCO, dated February 11, 2011, available at <http://www.ici.org/pdf/24968.pdf> (IOSCO Dark Liquidity Consultation); Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Werner Bijkerk, Senior Policy Advisor, IOSCO, dated August 12, 2011 (IOSCO Consultation on Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency), available at <http://www.ici.org/pdf/25408.pdf>; and Letter from Karrie McMillan, General Counsel, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to Teresa Rodriguez Arias, IOSCO, dated October 11, 2012 (IOSCO Consultation on Technological Challenges to Effective Market Surveillance), available at <http://www.ici.org/pdf/26598.pdf>.

alternative trading venues available. We are therefore pleased that IOSCO has determined to take a comprehensive look at fragmentation and strongly support the goals of the Consultation, *i.e.*, to address the impact of fragmentation on market integrity and efficiency.

## II. Proposed Recommendations

### Recommendation 1

- Regulators should regularly monitor the impact of fragmentation on market integrity and efficiency across different trading spaces and seek to ensure that the applicable regulatory requirements are still appropriate to protect investors and ensure market integrity and efficiency, including with regard to price formation, bearing in mind the different functions that each trading space performs.
- Regulators should regularly evaluate the regulatory requirements imposed on different trading spaces and seek to ensure that they are consistent (but not necessarily identical) across spaces that offer similar services for similar instruments.

ICI and ICI Global believe that the current structure of the securities markets is unduly complex, attributable in large part to the sheer number of execution venues that exist. We therefore strongly agree with the Consultation's proposed recommendations that regulators should monitor the impact of fragmentation on the markets and seek to ensure that regulations are still appropriate to protect investors and to ensure market integrity and efficiency. It is clear that regulations governing the securities markets have not kept pace with the significant changes in trading practices and market structure in general.

Many of the issues surrounding fragmentation relate to the impact of undisplayed liquidity in the markets; the balance between promoting competition among trading venues and negatively impacting price efficiency is delicate. As discussed in detail in our letter on IOSCO's dark liquidity consultation,<sup>5</sup> we recognize that while having choice in the number of trading venues available, particularly those that facilitate the use of undisplayed liquidity, brings certain benefits to funds, there are concerns about the associated impact on the price discovery process, the potential for fragmentation of information and liquidity searches, and implications for market integrity due to possible differences in access to markets and information. Ideally, funds would like to reduce fragmentation and have as many orders as possible executed in the "lit" markets. We therefore strongly support efforts to provide incentives for market participants to use transparent orders; for many years we have recommended changes that would facilitate greater order interaction and, in turn, more efficient trading.

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<sup>5</sup> See Letter on IOSCO Dark Liquidity Consultation, *supra* note 4.

Nevertheless, we believe it is important that the diverse types of trading venues that exist today, including those providing dark liquidity, remain available to funds and that the regulations overseeing these venues facilitate their continued use. We would be concerned if any regulatory reforms impeded funds as they trade securities in venues providing undisplayed liquidity. Undisplayed liquidity provides an important mechanism 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.

We also believe that fragmentation and the submission of large numbers of orders and trades across multiple venues have created difficulties for regulators to effectively monitor the markets. We have therefore strongly supported efforts by regulators to obtain more information about transactions in the markets. In the United States, ICI supported the U.S. Securities and Exchange Commission's ("SEC") initiative to develop, implement, and maintain a consolidated audit trail ("CAT").<sup>6</sup> We also have supported similar efforts in Europe in conjunction with the reform of MiFID.

Allowing regulators access to accurate, timely and detailed information about market participants and trades that are executed in different trading venues will allow regulators to better assess the current regulatory requirements governing different trading venues on a continuous and ongoing basis. We believe regulators in jurisdictions around the globe should examine transaction reporting regimes similar to CAT to facilitate monitoring of trends in trading and trading behavior.<sup>7</sup>

Finally, we support regulatory initiatives to address differences in regulatory requirements between different types of trading venues that can impact competition and the efficiency of trading. In the United States, we recommended that the SEC examine the regulatory requirements overseeing exchanges and non-exchange trading venues to determine whether they make sense under the current market structure given the significant changes since many of the rules were adopted and to revisit many of the issues related to fragmentation raised in the SEC's equity market structure concept release. In Europe, we support the desire under the MiFID reform initiative to create a level playing field for all trading venues as well as the need to capture future trading models under the current regulatory framework. We have expressed concern, however, about the continuing uncertainty of the use of, and difficulties complying with parameters surrounding, the proposed Organized Trading Facility ("OTF") category and the resulting potential negative impact on the availability of trading venues for investors if firms are forced to change their business models in light of the new regulatory requirements. We

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<sup>6</sup> See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated August 9, 2010; available at <http://www.ici.org/pdf/24477.pdf>.

<sup>7</sup> While we supported the development of CAT, we expressed concern about the initiative's significant costs and the potential for these costs to be passed onto investors. We therefore urge regulators to be cognizant of this possibility as they consider the costs and burdens of adopting similar transaction reporting regimes.

therefore urge regulators, as they examine new or amended regulations, to take a measured approach in any response to fragmentation.

## **Recommendation 2**

- In an environment where trading is fragmented across multiple trading spaces, regulators should seek to ensure that proper arrangements are in place in order to facilitate the consolidation and dissemination of information as close to real time as it is technically possible and reasonable.

We agree with the Consultation that the availability and transparency of market information is key to both the fairness and efficiency of a market, and in particular to its liquidity and quality of price formation; therefore, regulation that ensures the widest access to trade data and that promotes comprehensive data consolidation and timely dissemination is significant to mitigate the potential adverse effects of market fragmentation on price discovery.

As investors in the markets, we strongly support ensuring the consolidation and dissemination of market information on a timely basis. In the U.S., pre and post-trade information is already required to be provided to a single consolidated tape. We also have strongly supported efforts in Europe, through the reform of MiFID, to similarly establish a consolidated tape.

The Consultation notes that, in a great number of jurisdictions, there remains no mandatory consolidated tape. Instead there are multiple providers offering consolidation services that may not be regulated or authorized or subject to specific regulatory oversight. We urge regulators to work towards requiring more robust data consolidation in their respective jurisdictions.

In addition to the consolidation of data, we also have generally supported regulatory efforts to increase the transparency of information, both on a pre- and post-trade basis. A robust transparency regime provides investors with access to information about trading opportunities, facilitates price formation and assists investment firms in providing best execution to their clients. Similarly, we support the reduction of delays in the publication of post-trade market data.

Nevertheless, we recognize that there are limits to the benefits of trade transparency if it results in negative consequences for the manner in which funds and other investors execute transactions. We therefore strongly support the exceptions provided in various jurisdictions to pre- and post-trade transparency for large orders. These exceptions are critical to funds and other institutional investors. We believe, however, that regulators should ensure that the exceptions are applied consistently and coherently, that their use is not being abused, and that there is legal certainty regarding the interpretation of the rules applying to the exceptions.

Finally, we believe concerns about the latency for investors receiving market data should be addressed. In the United States, we have recommended that the SEC consider eliminating the two-tiered distribution of consolidated quote and tape information so that there is no time advantage based on the choice of data feed.<sup>8</sup> In particular, given the extra step required for market centers to transmit data to plan processors, and for plan processors to consolidate the information and distribute the information to the public, the information in individual data feeds of trading venues generally reach market participants faster than the same information in the consolidated data feeds.

To address concerns about the latency for investors receiving market data, we recommended that the SEC consider eliminating the two-tiered distribution of consolidated quote and tape information. Specifically, we recommended that all market participants receive market data feeds from the same source, so that there is no time advantage available to some market participants from the choice of data feed. We recognize that some market participants will still have access to faster data transmission through more powerful computer capabilities on their end after distribution of the data, but that is merely a function of the participant's choice of resources to devote to their own internal computer processing.

### **Recommendation 3**

- Where markets are fragmented, regulators should consider the potential impact of fragmentation on the ability of intermediaries to comply with applicable order handling rules including, where relevant, best execution obligations, and take the necessary steps.

The manner in which institutions route and execute orders is critical to best execution. We therefore believe that regulators should consider the impact of fragmentation on order handling rules and we would support a broad examination of these rules in the context of fragmented markets.

In general, we believe there is a need for more transparency in the markets regarding how orders are routed and executed. Transparency of such information is vital to making informed investment decisions; robust transparency provides investors with access to information about current trading opportunities, facilitates price discovery and assists firms in providing best execution to their clients. In many cases, our members are in a position to obtain the necessary routing and execution data from broker-dealers and trading venues. We are concerned, however, that many investors are not privy to this level of transparency.

At a minimum, we recommend that brokers, upon request from a customer, be required to provide certain standardized information about an execution, including the type of execution venue

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<sup>8</sup> See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated April 21, 2010 (SEC Concept Release on Equity Market Structure); available at <http://www.ici.org/pdf/24266.pdf>

used (*i.e.*, an exchange or an alternative trading venue), the capacity in which the trade was executed (*i.e.*, agency vs. principal), and each destination to which an order was routed. Increased information regarding payments and other incentives provided or received to direct order flow to particular trading venues also would be valuable. Such increased transparency should assist in better understanding conflicts of interest that exist and would allow investors to make better informed investment decisions.

We also have supported efforts in conjunction with the reform of MiFID to improve information provided to investors about execution quality. MiFID currently does not require venues to publish harmonized data on execution quality. Potentially relevant information for best execution evaluation is therefore not generally available in a readily comparable format. We therefore support the provisions that would improve the availability of information to investors, such as the requirement for execution venues to make available to the public data relating to the quality of execution of transactions on that venue on at least an annual basis and for investment firms to provide appropriate information to their clients on their order execution policy.

The Consultation notes that, in the United States, best execution might be facilitated by providing for trade-through protection for transparent orders. When Regulation NMS was proposed in the United States, we supported the establishment of a uniform trade-through rule for all market centers.<sup>9</sup> By affirming the principle of price priority, we believed a trade-through rule would, among other things, encourage the display of limit orders, which in turn would improve the price discovery process and contribute to increased market depth and liquidity. While Regulation NMS has resulted in several improvements to the operation of the securities markets in the United States, it arguably has not resulted in the increased display of orders as intended.

We also considered further rules to facilitate order interaction and to address fragmentation. Specifically, we did not support the adoption of a “trade-at” rule for the securities markets.<sup>10</sup> While the same arguments set forth in support of the trade-through rule would apply to a trade-at rule, we believe a trade-at rule would be difficult to implement and operate under the current market environment. Published quotes today may not reliably indicate the true prices that are actually available to investors due to the disparities that exist in the fees charged by market participants. In particular, many trading venues that display their quotes in the public quotation system typically charge per share “access fees” to

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<sup>9</sup> See Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 30, 2004 (Regulation NMS); available at [http://www.ici.org/policy/markets/domestic/04\\_sec\\_nms\\_com](http://www.ici.org/policy/markets/domestic/04_sec_nms_com).

<sup>10</sup> A “trade-at” rule would prohibit any trading center from executing a trade at the price of the “national best bid and offer” (NBBO) unless the trading center was displaying that price at the time it received the incoming contra-side order. Under this type of rule, a trading center that was not displaying the NBBO at the time it received an incoming marketable order could either: (1) execute the order with significant price improvement (such as the minimum allowable quoting increment (generally one cent)); or (2) route intermarket sweep orders (“ISOs”) to execute against the full displayed size of NBBO quotations and then execute the balance of the order at the NBBO price.

non-subscriber market participants that trade with the orders that the venues display. We do not believe that access fees should be reflected in the displayed quote because this would lead to subpenny pricing, which we oppose.

#### **Recommendation 4**

- Regulators should regularly monitor the impact of fragmentation on liquidity across trading spaces.
- Regulators should seek to ensure that applicable regulatory requirements provide for fair and reasonable access to significant sources of market liquidity on the exchange and non-exchange trading market systems.

We strongly believe that fair access to the securities markets is a fundamental element of an efficient market structure. Therefore, as the Consultation recognizes, regulators should ensure that there are no unreasonable barriers to accessing different types of trading venues. Our members report that they typically have fair and reasonable access to both exchange and non-exchange trading systems, whether directly or through trading intermediaries. Technological advancements have facilitated such access in recent years.

In the United States, robust rules exist to ensure that investors have fair and reasonable access to sources of liquidity. Europe and other jurisdictions have similar rules in place. We would encourage other jurisdictions to examine implementing rules to ensure fair and reasonable access to liquidity on all trading venues.

#### **Monitoring the impact of fragmentation on market efficiency and resilience – Previous IOSCO Recommendations**

- Regulators should continue to assess the impact on market integrity and efficiency of technological developments and market structure changes, including algorithmic and high frequency trading. Based on this, regulators should seek to ensure that suitable measures are taken to mitigate any related risks to market integrity and efficiency, including any risks to price formation or to the resiliency and stability of markets, to which such developments give rise.
- Market authorities should monitor for novel forms or variations of market abuse that may arise as a result of technological developments and take action as necessary. They should also review their arrangements (including cross-border information sharing arrangements) and capabilities for the continuous monitoring of trading (including transactions, orders entered or orders cancelled) to help ensure that they remain effective.

ICI and ICI Global have spent a significant amount of time examining the impact of technological developments on investors and the markets in general including those related to



algorithmic and high frequency trading and related issues of market abuse.<sup>11</sup> We believe these developments have played a role in the amount of fragmentation in the markets and, to this end, we have provided a number of recommendations to address concerns in this area. We believe that several issues remain unresolved and should be examined by regulators in the context of any examination of fragmentation.

### Liquidity Rebates

We believe that market structure developments over the past several years have created a number of conflicts of interest. For example, incentives that currently exist for market participants to route orders to particular venues, and any related conflicts of interest that may arise due to these incentives, need to be examined. Significantly, the benefits and drawbacks of liquidity rebates used by brokers and high frequency trading firms need to be addressed; brokers may refrain from posting limit orders on a particular exchange because it offers lower liquidity rebates than other markets, even though that exchange offers the best possibility of an execution for those limit orders. At the same time, the benefits liquidity rebates may provide to investors is unclear. We do not recommend that liquidity rebates be prohibited at this time but we suggest that regulators, at the very least, require more transparency surrounding rebates and the revenue to market participants generated by rebates, as well as other incentives provided to route orders.<sup>12</sup>

### Order Types

In the race for increased market share, exchanges and alternative trading venues continue to create various types of orders to cater to market participants who create strategies and desire a vehicle through which to implement those strategies. Many of these order types facilitate strategies that can benefit market participants at the expense of long-term investors or that are potentially abusive or manipulative. In addition, members report that the transparency surrounding these order types is severely lacking. We therefore recommend that regulators vigorously examine the specific order types that exchanges and other trading venues offer and any conflicts of interest raised by the use of these order types. Sufficient transparency of the details of order types offered by exchanges and other trading venues also must be ensured and such information must be readily and easily available to investors.

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<sup>11</sup> See, e.g., ICI and ICI Global letters on market structure, *supra* note 4.

<sup>12</sup> We firmly believe that further examination is needed about the effects of this practice on investors and the markets. We therefore recommended to the SEC that it work with the exchanges and other market participants to establish a pilot program where a certain set of securities would be prohibited from being subject to liquidity rebates. In this manner, the SEC could examine the data generated about liquidity rebate practices and determine whether rulemaking is necessary to address concerns in this area. Other regulators also may wish to consider such action.

Ms. Teresa Rodriguez Arias

May 10, 2013

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We offer our assistance as the issues under the Consultation continue to be examined. If you have any questions on our comments, please feel free to contact the undersigned, or Ari Burstein at 1-202-371-5408 or [aburstein@ici.org](mailto:aburstein@ici.org).

Sincerely,

/s/ Karrie McMillan

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