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February 2, 2011

European Commission
Directorate General Internal Market and Services
Unit G3
B - 1049 Bruxelles/Brussel (Belgium)

Re: Consultation on the Review of the Markets in Financial Instruments Directive (MiFID)

Dear Sir or Madam:

The Investment Company Institute ("ICI") supports the European Commission's ("Commission") review of the Markets in Financial Instruments Directive ("MiFID"). The public consultation issued by the Commission seeking comments on the review raises a number of critical issues and highlights the need for reforms to the regulatory framework for financial services within Europe to address developments since MiFID came into effect in November 2007.[1]

The 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").[2] The structure of the global securities markets has a significant impact on ICI members, who are investors of over $12 trillion of assets. We are institutional investors, but invest on behalf of over 90 million individual shareholders.[3] According to ICI data, as of September 2010, U.S. based long-term mutual funds held $2.1 trillion in non-U.S. securities, accounting for almost 25 percent of the assets of these funds. U.S. registered investment companies and their shareholders therefore 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,

[1]The public consultation ("Consultation") can be found on the European Commission's website at http://ec.europa.eu/internal_market/consultations/docs/2010/mifid/consultation_paper_en.pdf.

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

[3] For more information on the U.S. registered investment company industry, *see* 2010 Investment Company Institute Fact Book at www.icifactbook.org.

transparency, and price discovery.[4] Consistent with these goals, we have strongly supported efforts to address issues that may impact the fair and orderly operation of the financial markets and investor confidence in those markets and have long advocated for regulatory changes that would result in more efficient markets for investors.[5]

The issues surrounding the trading of securities by funds and other institutional investors are no longer purely a domestic matter. Many funds utilize intricately linked global trading desks and must be concerned not only about the regulation and structure of the financial markets in the United States but also in other jurisdictions in which they trade. In particular, many of our members are very active in the European markets and are therefore particularly interested in the MiFID review.

In addition, jurisdictions around the world are starting to, or are already facing, a number of common issues. As the Commission examines MiFID and considers further initiatives relating to the reform of the regulation of the European financial markets, we urge it to work closely with regulators around the globe to create consistent and sensible cross-border regulations. Our increasingly global markets demand such cooperation among national regulators to avoid negative consequences of incongruent regulatory requirements and to encourage regulatory efficiencies as funds pursue an increasing cross-border presence in the interest of their shareholders.

Funds' sole interest in the current debate is to ensure that any market structure changes promote efficiencies and transparency for the benefit of all market participants and not for a particular market center, exchange or trading venue business model. As we have noted in our comments on similar reform initiatives in the United States, developing a market structure that promotes the fundamental principles of efficient financial markets while considering the competing interests of all market participants is no easy task. The Commission will undoubtedly hear a wide variety of views on the structure of the current financial markets in comments received on the Consultation, many of which will claim to be representing the interests of long-term investors. We urge the Commission to examine all comments carefully and to consider where the interests of the commenters truly lie.

While our response to the Consultation reflects the initial views of ICI members on the issues discussed in the Consultation, it is clear that the debate over these issues will be lengthy and that the current consultation process is only the beginning of deliberations on the topics raised by the reform of MiFID. We therefore offer our assistance to the Commission as it continues to examine the issues raised by the Consultation and their impact on the financial markets.

At this time, we are not providing comments on each and every question posed by the Consultation. Given the breadth of the Consultation, we are limiting our comments to the most

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[4] The issues discussed in the Consultation impact all U.S. registered investment companies, including mutual funds, closed-end funds, and ETFs. For purposes of this letter, we refer to U.S. registered investment companies as "funds."

[5] For a comprehensive list of, and links to, the ICI's key comment letters in this area, *see* Appendix A.

significant issues impacting funds. We will, however, update and submit further comments as appropriate to address other issues raised by the Consultation.

Our recommendations on the issues raised in the Consultation follow below.

I. Summary of Recommendations

Scope of Proposed Changes to MiFID

- We urge the Commission to be cognizant of the potential to create unintended consequences for investors through the implementation of a wide range of changes to MiFID in a short timeframe and to carefully balance the potential costs and benefits of new regulations.

- We believe that issues relating to the "non-equity" markets are ripe for reform but caution against using the regulations overseeing the equities markets as the basis for changes to the regulation in these markets given their differences and complexity.

- We recommend that the Commission allow sufficient time to closely study the comments received by market participants on the Consultation.

Developments in Market Structures

- **Automated Trading and High Frequency Trading**

  - **Definition of Automated Trading and High Frequency Trading:** We recommend that the Commission define "automated trading" more precisely to ensure that it does not capture trading which is not the focus of the review. We believe the definition of "high frequency trading" is a good starting point for discussing high frequency traders and high frequency trading firms.

  - **Need for Increased Transparency of Automated Trading and High Frequency Trading:** We believe there is a paucity of information about high frequency trading and therefore an immediate need for transparency in several areas including the manner in which high frequency trading firms trade, the incentives for order flow received by these firms, and other potential conflicts of interest that may exist concerning their trading and routing practices. We support Commission efforts to increase transparency for this segment of the marketplace.

  - **Algorithmic Trading Strategies:** We support Commission action to clearly define practices that may constitute market abuse to ensure adequate enforcement of illegal activities.

- **Order Cancellations:** We believe the Commission should act to address the increasing number of order cancellations and consider, among other things, whether a fee or "penalty" should be imposed on cancelled orders above a certain ratio of orders to executed transactions. We are concerned about the impact of a requirement for a minimum "time in force" for orders.

- **Regulatory Obligations on High Frequency Trading Firms:** We believe the idea that all high frequency traders over a specified minimum quantitative threshold be required to be authorized is worthy of further examination. We recommend that the Commission examine the trading activity of high frequency trading firms and the liquidity they provide and then consider whether these firms should be subjected to additional obligations.

- **Co-Location:** We believe standards by which the Commission could judge co-location services are whether the terms of the services are non-discriminatory and the fees are equitably allocated and reasonable.

- **Sponsored Access:** We support requiring firms that provide sponsored access to have in place robust risk controls and filters to detect errors or attempts to misuse facilities but recommend that the scope of any regulations in this area not impair the confidentiality of fund trading information.

- **Circuit Breakers:** We support the implementation by operators of trading venues of proper risk controls and arrangements to mitigate the risk of errors generated by automated trading.

Pre- and Post-Trade Transparency

- **Pre-Trade Transparency**

    - **Pre-Trade Transparency and Waivers:** We strongly support the flexibility provided by pre-trade transparency waivers and the Commission's recognition that the reasons for allowing waivers still appear valid. We believe that any changes to waivers must be carefully crafted to not create difficulties for investors when executing orders.

    - **Pre-Trade Transparency of Undisplayed, or "Dark," Liquidity:** We appreciate concerns that the use of undisplayed liquidity may detract from market transparency but believe it is imperative that "dark pools" remain available to funds and that regulations overseeing these venues facilitate their continued use.

- **Post-Trade Transparency**

    - **Reducing Delays in Trade Reporting:** We generally support reducing delays in trade reporting but urge the Commission to ensure that adequate exceptions to post-trade transparency remain for large orders and to protect the anonymity of investors.

    - **Post-Trade Transparency of Information Regarding Trades in Dark Pools:** We do not support the real-time disclosure of the identity of an individual dark pool on trade reports but would support such disclosure on a delayed basis, specifically at the end of the trading day, on a stock-by-stock basis.

- **Equity-Like Instruments:** We support the goal of extending transparency requirements to ETFs and agree that the differences in how ETFs are structured and traded are critical in formulating specific transparency rules.

- **Need for Increased Information Regarding Order Routing and Execution Practices:** There is a need for improved information about the order routing and execution practices of broker-dealers and other trading venues and recommend that the Commission consider means to require new disclosure or to improve existing disclosure in this area.

Data Consolidation and the Need for a European Consolidated Tape

- **European Consolidated Tape:** We strongly support the establishment of a European consolidated tape but, at this time, do not have views on the most optimal means to establish a consolidated tape.

- **Trading Center Data Feeds and Market Data Distribution:** We believe that as the Commission examines the establishment of a consolidated tape, it should consider issues surrounding the fairness of the systems for market data distribution and the latency for investors receiving market data.

Transaction Reporting

- We support a more robust transaction reporting regime to enable regulators to monitor the activities of firms, ensure compliance with MiFID, and monitor for market abuses but believe the Commission should ensure the confidential treatment of any data provided to regulators and consider the costs of any new reporting regime.

Access of Third Country Firms to EU Markets

- We do not believe it is necessary to base access to EU markets on a "strict equivalence" standard and recommend that the Commission consider a more flexible regime such as a standard

determined by reference to the third country firm's supervision and regulation in its home state or an equivalence standard based on transparent, proportionate, and objective grounds.

Ban on Specific Activities, Products or Practices

- We strongly support providing regulators with the tools to ensure the fair and orderly operation of the financial markets and the protection of investors but question whether the imposition of a ban is an appropriate or proportionate response and recommend that the Commission consider alternatives that may be more measured.

Regulatory Reform in the Derivatives and Fixed-Income Markets

- We strongly support a robust examination of the current market structure in the "non-equity" markets and agree that the existing transparency regime for these markets can be strengthened to the benefit of investors.

- **Derivatives Markets Reform**

  - We agree with the goal of having derivatives trade on exchanges or other regulated trading venues but believe providing investors with options and flexibility in executing trades is critical. We therefore believe, at this time, that investors are best served by not introducing a requirement mandating where executions must take place.

  - We do not believe that hard position limits are appropriate for all categories of market participants and oppose imposing position limits on funds that invest in certain types of derivatives.

- **Review of Fixed Income Markets:** We strongly believe that more needs to be done to address concerns in the fixed-income markets but urge the Commission to proceed cautiously in recommending any new regulations given the complexity of the issues facing these markets.

II. Introduction

The issues raised by the debate over the reform of MiFID are very similar to the market structure issues currently being examined in the United States. In the intervening years since the adoption of Regulation NMS, the last major reform to the laws governing the structure of the U.S. equity markets, the financial markets have changed dramatically. The market structure in the United States today is an aggregation of exchanges, broker-sponsored execution venues and alternative trading systems. Trading is fragmented with no single destination executing a significant percentage of the total U.S. equity market. These significant changes, along with the recent "flash crash" on May 6, 2010 and the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act

("Dodd-Frank Act"), have prompted the need for a broad review of the structure of the U.S. financial markets.

We are therefore pleased that the Commission has determined to take a comprehensive look at the European market structure and its impact on long-term investors, such as funds, through the Consultation. We are hopeful that this comment process will be the start of a thoughtful and measured approach to the reform of the structure of the markets to ensure that there are no unintended consequences to investors.

To that end, it is important that the specific market structure issues raised by the Consultation not be viewed in a vacuum and that any rulemaking initiatives arising from the Commission's review be harmonized globally. Individual issues raised in the Consultation and in other recent reform initiatives are closely linked and the decisions made by the Commission on one topic will impact, in one way or another, many of the other issues raised by the Consultation and other initiatives. For example, improving pre- and post-trade transparency in the financial markets will undoubtedly have a bearing on the structure of the markets as a whole. Similarly, creating a consolidated tape for Europe will have an influence on the order routing and execution decisions made by investors, and any changes to the regulation and operation of venues providing undisplayed liquidity will undoubtedly impact automated and high frequency trading. When appropriate, we will discuss the effect of the issues raised in the Consultation on one another.

As we discuss the topics raised by the Consultation and provide recommendations on improving the structure of the financial markets, it is important to note that despite the many issues that need to be resolved relating to the current market structure, the ICI believes that investors, both retail and institutional, are better off than they were just a few years ago and that overall, the markets are operating efficiently. Most significantly, trading costs have been reduced, more trading tools are available to investors with which to execute trades, and technology has increased the overall efficiency of trading.

III. Scope of Proposed Changes to MiFID

The ICI appreciates the desire of the Commission to ensure that any amendments to MiFID are broad enough to include new financial instruments and market participants that cannot be envisioned today. Similarly, we understand the desire to expand MiFID to include those instruments and market participants that are not currently covered. Nevertheless, we urge the Commission to be cognizant of the potential to create unintended consequences for funds and other investors by implementing such a wide range of changes to MiFID, particularly in such a short timeframe.

For example, if the Commission does not take a measured approach to MiFID reform, it may unintentionally limit the use of evolving market practices and technological developments in a way that impedes funds' use of new and innovative trading venues created to assist funds in executing large orders, such as so-called "dark pools." The use of algorithms and automated trading systems has become

an important tool for funds in the normal course of the routing and execution of orders. The Institute wants to ensure that any regulatory initiatives surrounding trading do not create unintended consequences for funds or impede the use of legitimate trading practices. Similarly, while we strongly support the need for a more robust pre- and post-trade transparency regime, the Commission must be careful to not create a regulatory environment that allows for the premature disclosure of critical information about fund orders to the detriment of fund shareholders.

In addition, if regulations are too onerous or costly for certain market participants, they may determine to not offer certain products or services to investors. Similarly, the cost of trading may increase as market participants shift the burden of compliance with new requirements to investors. We urge the Commission to carefully balance these potential costs with the benefits the new regulations would provide to investors.

Finally, the scope of the Consultation is ambitious and includes not only the wide range of issues impacting the equity markets, but also many complex issues affecting, among other things, the derivatives and fixed-income markets. While we strongly believe that issues relating to the "non-equity" markets are ripe for reform, we would caution against using the regulations overseeing, and the structure of, the equities markets as the basis for changes to the regulation of the non-equities markets. While the equities markets are themselves complex, many of the issues confronting the derivatives and fixed-income markets are equally, if not more, challenging.

The ICI therefore recommends that the Commission allow sufficient time to closely study the comments received by market participants on the Consultation, ensure that the principles underlying any proposed changes are sound, and perform an analysis of the costs and benefits of any proposed reforms.

IV. Developments in Market Structures (Section 2)

The Consultation correctly recognizes the significant role that alternative trading venues, advancements in trading technology and new market participants have played in the development of the structure of the financial markets and the need for regulations to be updated to keep pace with these changes.

A. Automated Trading and High Frequency Trading (Section 2.3, Questions 13-20)

The Consultation provides several recommendations and requests comment on a number of issues related to the use of automated or algorithmic trading. Automated trading has become a significant part of the global market structure and funds rely heavily on technology for the efficient execution of their trades. Clearly, a primary driver and enabler of changes to the structure of the markets 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. Despite these improvements, challenges for funds remain when trading - posted liquidity and

average execution size is lower while the difficulty of trading large blocks of stock has increased. In addition, new challenges have been created due to some of the recent technological developments discussed below.

1. Definition of Automated Trading and High Frequency Trading (Question 13)

The Consultation states that automated trading would be defined as trading involving the use of computer algorithms to determine any or all aspects of the execution of the trade such as the timing, quantity and price. We believe that given the breadth of the definition, many tools utilized by investors, such as funds, to manage or make internal investment decisions could be included in the definition of "automated trading" and, in turn, could inappropriately be included in regulations that are crafted based on this definition. It would therefore be helpful if the Commission could define "automated trading" in more precise terms so as to ensure that it does not capture any aspects of the trading process which is not the focus of this review.

The Consultation recognizes that a specific type of automated or algorithmic trading is high frequency trading ("HFT"). The ICI has spent a significant amount of time examining the impact of HFT on the markets and on investors. Estimates of HFT volume in the U.S. equity markets typically are 50%-70% of the total market volume or higher. We understand that HFT, as a percentage of the total market volume in Europe, also is increasing in significance.

Defining HFT for regulatory purposes, as compared to the broad definition of automated trading, is more difficult. There are many ways that HFT firms can be organized, including as a proprietary trading firm, as the proprietary trading desk of a multi-service broker-dealer, or as a hedge fund. In addition, high frequency traders use a wide variety of trading strategies. While there is no formal definition of HFT in the United States, the U.S. Securities and Exchange Commission's ("SEC") concept release on the structure of the U.S. equity markets[6] delineated several characteristics that are often attributed to HFT firms. These include: (1) the use of extraordinarily high-speed and sophisticated computer programs for generating, routing, and executing orders; (2) the use of co-location services[7] and individual data feeds offered by exchanges and others to minimize network and other types of latencies; (3) very short time-frames for establishing and liquidating positions; (4) the submission of numerous orders that are cancelled shortly after submission; and (5) ending the trading

[6] Securities Exchange Act Release No. 61358 (January 14, 2010), 75 FR 3594 (January 21, 2010).

[7] The SEC's concept release describes co-location as a service offered by trading centers that operate their own data centers and by third parties that host the matching engines of trading centers where these entities rent space to market participants that enables them to place their servers in close physical proximity to a trading center's matching engine. Co-location therefore helps minimize network and other types of latencies between the matching engine of a trading center and the servers of market participants.

day in as close to a flat position as possible. The definition of HFT set forth in the Consultation mirrors many of these characteristics[8] and we believe this is a good starting point for discussing HFT.[9]

2. Need for Increased Transparency of Automated Trading and High Frequency Trading

As the Consultation notes, existing evidence is inconclusive about the impact of HFT on market efficiency and there is no consensus on the overall impact of HFT on the securities markets. To be clear, ICI members do not object to HFT per se. HFT arguably brings several benefits to the markets in general and to investors in the markets, including providing liquidity and tightening spreads. At the same time, there are concerns associated with HFT, including the submission of numerous orders that are cancelled shortly after submission which can create unnecessary market traffic and misleading market "noise." Of particular concern, ICI members report that strategies employed by high frequency traders often are designed to detect the trading of large blocks of securities by funds and to trade with or ahead of those blocks.

There is a paucity of information about high frequency traders and the practices of HFT firms. There is an immediate need for transparency about HFT firms in several areas, including the manner in which HFT firms trade, the incentives for order flow received by HFT firms, and other potential conflicts of interest that may exist concerning their trading and routing practices. It would be extremely helpful for regulators and investors both to have access to this information to better understand the impact of HFT on the markets and for investors to make more efficient trading decisions. We therefore support Commission efforts to increase transparency for this segment of the marketplace.

3. Algorithmic Trading Strategies

The Consultation notes that concerns have been expressed that some algorithmic trading strategies may be contrary to the Market Abuse Directive and that the Commission believes that improvements can be introduced by better defining conduct or practices that may constitute market abuse.

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[8] The Consultation states that although there is debate about how HFT could be defined, it may be best defined as "trading that uses sophisticated technology to try to interpret signals from the market and, in response, executes high volume, automated trading strategies, usually either quasi market making or arbitraging, within very short time horizons. It usually involves execution of trades as principal (rather than for a client) and involves positions being closed out at the end of the day."

[9] We believe these characteristics also are a good way to distinguish between long-term investors, such as funds, and high frequency traders. Long-term investors are market participants who provide capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time. Unlike long-term investors, high frequency traders generally seek to establish and liquidate positions in a shorter time frame. Accordingly, these traders often have different interests than investors concerned about the long-term prospects of a company.

There are a number of strategies that automated and algorithmic traders may employ. Many of these strategies may pose problems for long-term investors. For example, an automated trading firm may seek to ascertain the existence of one or more large buyers (sellers) in the market and to buy (sell) ahead of the large orders with the goal of capturing a price movement in the direction of the large trading interest. After a profitable price movement, the firm then may attempt to sell to (buy from) the large buyer (seller) or be the counterparty to the large buyer's (seller's) trading. In addition, the HFT firm may view the trading interest of the large buyer (seller) as a free option to trade against if the price moves contrary to the HFT firm's position.

Similarly, an automated trading firm may utilize a strategy where it may initiate a series of orders and trades in an attempt to ignite a rapid price move either up or down. For example, the trader may intend that the rapid submission and cancellation of many orders, along with the execution of some trades, will "spoof," or fool, the algorithms of other traders into action and cause them to buy (sell) more aggressively.

There is nothing illegal per se about many of these strategies. Many market participants utilize sophisticated pattern recognition software to ascertain from available information the existence of a large buyer or seller or use orders to probe the markets in an attempt to locate and trade ahead of large buyers and sellers. Merely because this behavior is not per se illegal, however, does not mean that this type of strategy is beneficial to the markets or to investors, or that it does not interfere with efficient price discovery.

Funds have been concerned about these types of market practices for years. Many market participants in the United States, including floor brokers and market makers, utilized these techniques in the past to obtain an advantage over funds. What has changed, however, is the technology available to automated trading firms that has allowed them to better identify and execute these trading strategies. Technology has made the use of these strategies much easier and cheaper to employ, thereby lowering the risk to users of these strategies. This, in turn, has made trading more difficult for funds that are interested in buying and selling large positions and that are hurt by market participants that trade in front of their orders.

We support Commission action to clearly define practices involving algorithmic trading strategies that may constitute market abuse, in order to ensure adequate regulatory consequences for these practices.[10] The varied and complex trading practices used by market participants often makes it difficult to distinguish between legitimate and disruptive trading practices in a number of situations. Lack of clarity also may have a chilling effect on legitimate practices or make enforcement of illegal activities more difficult.

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[10] *See* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated January 3, 2011; available at http://www.ici.org/pdf/24834.pdf. *See also* Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, RIN No. 3038-AD26 (October 26, 2010), 75 FR 67301 (November 2, 2010).

4. Order Cancellations (Question 20)

The Commission suggests that market operators be required to ensure that orders would rest on an order book for a minimum period before being cancelled or that the ratio of orders to transactions executed by any given market participant would not exceed a specified level.

The ICI believes that the Commission should act to address the increasing number of order cancellations in the financial markets, particularly when numerous orders are cancelled shortly after submission. Our members report that certain of the practices and strategies surrounding cancellations often are designed to detect the trading of large blocks of securities by funds and to trade with or ahead of those blocks. At the very least, this is an area worthy of further Commission examination, including whether requirements should be put in place to restrict certain types of orders in specific contexts, or whether a fee or "penalty" should be imposed on cancelled orders above a certain ratio of orders to executed transactions that would discourage the current risk free use of certain types of orders.

While we believe a fee or penalty is an idea worthy of examination, we are concerned about the impact of a requirement for a minimum "time in force" for orders. Given the speed of the markets and the differing trading tools utilized by investors, we believe a minimum time in force requirement could impede the manner in which funds currently trade. At the very least, we recommend that the Commission conduct a study of the impact of a minimum time in force requirement.

5. Regulatory Obligations on HFT Firms (Questions 14 and 19)

The Consultation suggests that all persons involved in HFT over a specified minimum quantitative threshold would be authorized as investment firms to ensure that they are subject to organizational requirements (such as systems and risk management obligations and capital requirements) and to full regulatory oversight.[11] Similarly, market operators would be required to ensure that if a high frequency trader executes significant numbers of trades in financial instruments, then the high frequency trader would continue providing liquidity in that financial instrument on an ongoing basis subject to similar conditions that apply to market makers.

In the United States, the role of HFT and traditional liquidity providers such as market makers has taken on more significance since the "flash crash," as the sudden absence of liquidity in the markets played a critical role in the severe decline in stock prices. In recent years, many HFT firms have, in effect, replaced more traditional types of liquidity providers in the equity markets. While these firms may provide liquidity to the markets, they are under no obligation to do so and pick and choose to

[11] As discussed above, the scope of the definitions of "automated trading" and "high frequency trading" is potentially very broad and could inappropriately capture for purposes of regulations many tools and strategies utilized by investors to manage or make investment decisions. We do not believe that ICI members would be considered as "persons involved in HFT" in considering regulatory obligations for high frequency traders.

provide liquidity and capture spreads when it is in their interest. HFT firms can therefore act as de facto market makers at times of their choosing without being subject to any quoting obligations.

The ICI believes that the idea that all high frequency traders over a specified minimum quantitative threshold be required to be authorized with a specific categorization is worthy of further examination. We are unsure, however, whether requirements to ensure that high frequency traders continue to provide liquidity in times of market stress in fact would bring benefits to the markets or keep them in markets in adverse market conditions. We recommend that the Commission gather additional data and examine the trading activity of HFT firms and the liquidity they provide and then consider whether HFT firms should be subjected to quoting obligations similar to those of market makers.

6. Other Issues Related to Automated Trading

There are a number of other issues raised by the Consultation relating to automated trading. These include the use of co-location, sponsored access, and circuit breakers.

a. <u>Co-Location</u> (Question 17)

The Consultation notes that some market participants have stated that they are at a disadvantage to high frequency traders as they are not able to make a similar investment in trading technology. There are a number of tools that high frequency traders use to obtain the fastest market access possible to satisfy the manner in which they need to trade. One of these tools is the use of "co-location."

As the Commission recognizes, co-location helps minimize network and other types of latencies between the matching engine of a trading center and the servers of market participants. Co-location also assists high frequency traders in that it reduces the time to access trading venues to submit orders, as well as to receive execution reports and other messages from the trading venue.

The Consultation suggests that operators of trading venues should give market participants equal and fair access to co-location services. In the United States, the SEC has taken the position that co-location services offered by exchanges are subject to the requirements in the Securities Exchange Act of 1934. The terms of co-location services therefore must not be unfairly discriminatory and the fees must be equitably allocated and reasonable. The ICI believes that these represent standards by which the Commission can judge co-location services offered by trading venues.

b. <u>Sponsored Access</u> (Question 15)

The Consultation notes that risks related to automated trading can arise when an automated trader uses the facilities of another firm to access the market. The Commission therefore suggests that

firms that provide "sponsored access" to automated traders have in place robust risk controls and filters to detect errors or attempts to misuse facilities. The ICI supports such controls.

The ICI strongly supported a similar proposal by the SEC to require broker-dealers to implement risk management controls and supervisory procedures reasonably designed to manage the risks associated with market access.[12] We shared 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. At the same time, we cautioned that regulators should ensure that the scope of any regulations in this area does not unnecessarily impact the various methods that funds use to trade securities through broker-dealers or lead to unintended consequences for funds and other institutional investors using market access arrangements, particularly regarding the confidentiality of trading information.

Similarly, in a comment letter to IOSCO on its consultation report on direct electronic access ("DEA"),[13] ICI stressed that in crafting regulations concerning DEA arrangements, regulators must be careful to protect the confidentiality of fund trading information.[14] We also recommended that regulations should provide flexibility to DEA arrangements. Numerous methods of DEA exist and operate differently from one another. In adopting and implementing DEA regulations, regulators therefore should not take a "one size fits all" approach to the regulation of DEA arrangements. We believe these recommendations are equally applicable to the Commission's proposal.

c. <u>Circuit Breakers</u> (Question 16)

The Consultation suggests that operators of trading venues have in place proper risk controls and arrangements to mitigate the risk of errors generated by automated trading leading to disorderly trading (*e.g.*, circuit breakers). We strongly support the implementation of such controls.

The events of May 6, 2010 in the United States highlighted the need to implement a trading pause across markets for individual securities in times of market stress (*i.e.*, single stock circuit breakers) to mitigate instances of sudden market volatility. Those events also made clear the need to address the inconsistent practices employed by individual exchanges to supplement the market-wide circuit

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[12] *See* ICI Market Access Letter, Appendix A.

[13] IOSCO Consultation Report: Policies on Direct Electronic Access (February 2009). *See also* 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.

[14] The consultation report contained several principles that raised concerns in this area. For example, the report stated that (1) markets should provide member firms with access to all pre- and post-trade information (on a real time basis) to enable these firms to implement appropriate monitoring and risk management controls, and (2) intermediaries should disclose to market authorities upon request and in a timely manner the identity of their DEA customers in order to facilitate market surveillance.

breakers to address major price movements in stocks. On May 6, the inconsistent trading protocols at the exchanges contributed to the severe imbalance of sell orders to buy orders and the resulting decline in stock prices (*e.g.*, NYSE "liquidity replenishment points" and the process of exchanges declaring "self help" on one another). We are pleased that the exchanges in the United States have pledged to work together to eliminate inconsistencies in trading protocols and to harmonize, to the extent possible, policies and procedures in this area. Consistency and reliability in the application of trading pauses is critical for investors to prevent or reduce any potential market uncertainty or instability.

VIII. Pre- and Post-Trade Transparency (Section 3)

The ICI shares the views of the Commission of the importance of pre- and post-trade transparency in the financial markets. As investors, transparency of market information is vital to making informed investment decisions. As the Consultation recognizes, a robust transparency regime provides investors with access to information about current trading opportunities, facilitates price formation and assists firms in providing best execution to their clients.

As discussed further below, we believe many of the Commission's recommendations would bring benefits to investors. At the same time, there are limits to the benefits of increased transparency in certain situations. We believe the Commission should therefore closely examine the potential unintended consequences of increasing transparency of certain trade information, as well as the associated costs of any new regulations.

A. Pre-Trade Transparency (Section 3.1.1)

The Consultation states that pre-trade transparency refers to the obligation to publish (in real-time) current orders and quotes (*i.e.,* prices and amounts for selling and buying interest) relating to shares.

1. <u>Pre-Trade Transparency and Waivers</u> (Questions 27-31)

Under MiFID, pre-trade disclosure may be waived in a number of situations, most significantly for transactions that are executed "by reference to prices established outside the systems" of the regulated market or multi-lateral trading facility ("MTF") and "transactions that are large in scale."

The ICI strongly supports the flexibility provided by the pre-trade transparency waivers and the Commission's recognition that the reasons for allowing waivers still appear valid. As discussed further below, we believe the waivers are critical for certain orders utilized by funds and other investors.

At the same time, the ICI supports the Commission's desire to ensure that waivers are applied consistently and coherently, that their use is not being abused, and that there is legal certainty regarding

the interpretation of the waiver rules. We believe, however, that any changes to the waivers must be carefully crafted to not create difficulties for investors when executing orders.[15]

2. **Pre-Trade Transparency of Undisplayed, or "Dark," Liquidity**

Much of the current debate over pre-trade transparency has centered on the proliferation of undisplayed, or "dark," liquidity and the venues that provide such liquidity.

As a preliminary matter, we believe it is unfortunate that such pejorative terms as "dark liquidity" and "dark pools" have now become ingrained in the terminology used by the securities markets and policymakers to describe a type of liquidity and trading venue that has brought certain benefits to all kinds of market participants, including funds and their shareholders. We therefore are reluctant to use these terms when discussing issues surrounding this part of the market structure and urge that alternative terms be established.

Undisplayed liquidity is not a new phenomenon. Funds have long been significant users of undisplayed liquidity and the trading venues that provide such liquidity. These venues provide a mechanism for transactions, particularly the large orders ICI members frequently must execute, to interact without displaying the full scale of a fund's trading interest. This, in turn, lessens the cost of implementing trading ideas and mitigates the risk of information leakage. These venues also allow funds to avoid transacting with market participants who seek to profit from the impact of the public display of large orders to the detriment of funds and their shareholders. The importance of funds being able to trade efficiently in large size cannot be discounted. As we have stated in several letters to the SEC,[16] the confidentiality of information regarding fund trades is of significant importance to ICI 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.

At the same time, we recognize that while venues providing undisplayed liquidity bring certain benefits to funds, not displaying orders detracts to some extent from market transparency. We

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[15] We understand that certain MTFs have expressed concern about several recommendations relating to pre-trade transparency and the recommendations' impact on the ability for investors to utilize their trading facilities. For example, the Commission proposes that an actionable indication of interest ("IOI") would be treated as an order and subject to applicable pre-trade transparency requirements and such indication of interest could not be made transparent to direct participants in a trading system without also being made public. Similarly, the Consultation states that it could be clarified that remaining unexecuted parts of initially large in scale orders ("stubs") which do not meet the waiver thresholds anymore could not remain dark. Finally, the Consultation discusses the possibility of establishing an appropriate minimum order size for the reference price waiver. We would be concerned if the implementation of these changes would impair the use by funds of certain trading systems or negatively impact the manner in which funds trade. We therefore recommend that the Commission carefully study these changes prior to moving forward with the proposals.

[16] *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.

therefore understand the Commission's desire to examine trading venues that do not display quotations to the public.

Ideally, funds would like as much liquidity as possible to be executed in the displayed, or "lit," markets. Nevertheless, there is real value in enabling entities that frequently trade in large amounts to have access to venues that do not disclose their trading interest. We therefore believe it is imperative that venues trading undisplayed liquidity remain available to funds and that the regulations overseeing these venues facilitate their continued use. We would be concerned if any reforms to MiFID impeded funds as they trade securities in venues providing undisplayed liquidity, whether it be through trading large blocks or through other trading methods.

It also will be important for the Commission to consider the varying business models and the trading mechanisms of venues providing undisplayed liquidity. For example, block crossing networks in the United States offer specific size discovery mechanisms that are critical for funds in the anonymous execution of large-sized orders. Other trading facilities operate in a manner more akin to broker-dealer trading venues; we believe these latter systems arguably should be treated differently from those such as block crossing networks for purposes of regulation.

Finally, we understand that questions have been raised regarding the order execution quality provided to investors and the associated costs of executing orders in venues providing undisplayed liquidity as compared to the "lit" markets. In general, the ICI believes that the quality of execution provided by these trading facilities to funds is very good and it is no more costly (and may in certain situations be less costly) for investors to trade in venues providing undisplayed liquidity. However, as with any type of trading venue, execution results will vary depending on a number of factors such as the specific business model, the type of security the fund is seeking to trade, and overall market conditions at the time of the trade. It also is important to note that given the number of different types of facilities providing undisplayed liquidity, it is difficult to provide an all encompassing view about the order execution quality provided by these types of venues.[17]

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[17] While not exactly comparable to the types of undisplayed liquidity contemplated by MiFID, the ICI also has expressed concerns about undisplayed liquidity in the United States handled by market makers, *i.e.*, internalized orders. Broker-dealer internalized order flow represents a significant portion of undisplayed liquidity in the United States that funds do not have an opportunity, for the most part, to trade against, and that therefore can make trading large orders more difficult. Internalization raises a variety of concerns for investors. For example, internalization may increase market fragmentation because it can result in customer orders not being publicly exposed to the market, and may raise conflicts between broker-dealers and their customers because it can result in broker-dealers executing customer orders at the displayed quotations, thus foregoing the opportunity for price improvement for those orders in order to maximize the profits of the broker-dealers involved in such relationships. The ICI has not suggested that internalization in the United States be prohibited. We recommended, however, that action be taken to ensure that internalized orders receive best execution. Specifically, any order executed through internalization should be provided with "significant" price improvement.

B. Post-Trade Transparency (Section 3.1.2)

The Consultation states that post-trade transparency refers to the obligation to publish a trade report every time a transaction in a share has been concluded. We agree with the Commission that post-trade transparency is important for efficient price formation and for best execution. This transparency can show which venues or firms are providing the best prices and may also be useful to enable their clients to monitor whether they are receiving best execution.

1. Reducing Delays in Trade Reporting (Question 32)

The Consultation notes that market participants have expressed concerns related to the timing of publication of trade reports and that market participants seem to agree that the maximum permitted delays in trade reporting should be reduced.

The ICI generally supports reducing delays in the publication of trade data. At the same time, we urge the Commission to ensure that adequate exceptions to post-trade transparency remain for large orders and to consider the impact on the manner in which funds trade of any reduction in the maximum permitted delays. In particular, some ICI members have expressed concerns that a reduction in the delays for publication of information about large orders could negatively impact orders traded by funds with brokers who commit capital to facilitate the trade (*i.e.*, who trade as principal on the other side of the trade). We understand that a shorter timeframe for publication of trade information in such a situation could impact the ability of brokers to conduct such trades, in turn increasing the costs for funds. Similarly, we also urge the Commission to ensure that adequate exceptions are in place to protect the anonymity of investors. As discussed above, revealing specific information about individual investors and their orders can lead to frontrunning of fund orders to the detriment of their shareholders.

2. Post-Trade Transparency of Information Regarding Trades in Dark Pools

An issue that has been widely discussed in the United States and that the Commission may wish to consider as it examines increasing post-trade transparency is the disclosure of information regarding trades that occur in dark pools. The SEC recently proposed requiring the real-time disclosure of the identity of dark pools on trade reports in the public data stream. Currently, published trade reports in the United States only identify these trades as over-the-counter trades and do not identify the particular venue or other broker-dealer that reported the trade. While the ICI supported the goal of increasing post-trade transparency for dark pools, we expressed concerns about several unintended consequences for funds.

Specifically, while the SEC included an exemption in its proposal for certain large-sized trades that is intended to mitigate concerns relating to information leakage, we believe that the real-time disclosure of the identity of the specific venue where non-exempt trades were executed will nevertheless reveal too much information about fund orders. Only a small portion of trades in dark liquidity venues

take place in pools specializing in trading large blocks of securities. More often, funds must break up their larger "parent" orders into smaller "child" orders and execute these orders in other types of venues. The ICI therefore believes that the real-time disclosure of individual venue identities would provide another crucial "piece of the puzzle" to those who intend to prey off the orders of funds and has the potential to facilitate the frontrunning of funds' security positions.

While we do not support the real-time disclosure of the identity of an individual dark pool, we do support such disclosure on a delayed basis, specifically disclosure of the identity of individual venues on trade reports at the end of the trading day, on a stock-by-stock basis. To further transparency of dark pool trades, we believe that any trades exempted from initial disclosure, *i.e.*, large block trades, also be disclosed on a delayed basis in this manner.

C. Equity-Like Instruments (Section 3.2, Questions 33-34)

The Consultation notes that the pre- and post-trade transparency requirements currently only apply to shares admitted to trading on a regulated market and that a number of instruments that are similar to shares are outside the scope of MiFID transparency requirements. The Commission therefore suggests that the transparency regime could be extended to several "equity-like" financial instruments if admitted to trading on a regulated market including, among other things, ETFs.

The ICI supports the goal of extending transparency requirements to ETFs.[18] The Consultation states that the regime would in principle be based on the regime that applies to shares but with appropriate differentiation to take into account specific differences in the nature of the instruments concerned. In the United States, ETFs are subject to same transparency requirements as individual securities. The imposition of share-like transparency requirements has not, to our knowledge, raised concerns. We agree, however, that considering the differences in how ETFs are structured and traded will be important in formulating specific transparency rules, and thresholds for applying those rules, for ETFs.

D. Need for Increased Information Regarding Order Routing and Execution Practices

Given the complexities of the current market structure and the associated difficulties in assessing market performance for investors, the ICI believes that one of the areas in which action will be critical is the need for improved information to investors and regulators about the order routing and execution practices of broker-dealers and other trading venues. Improved information would allow investors to make better informed investment decisions and, in turn, facilitate best execution, as well as assisting regulators in assessing current market performance.

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[18] The ICI does not have specific comments on extending transparency requirements to the other equity-like instruments noted in the Consultation.

Currently, although MiFID requires that investment firms provide information to clients about their execution and conflicts of interest policies, institutional investors feel that they do not have ready access to complete information about the orders provided to brokers and other trading venues. We therefore recommend that, at a minimum, the Commission consider means to require new disclosure or to improve the existing disclosure of certain information regarding the order routing and execution practices of brokers and other trading venues including: payments and other incentives provided or received to direct order flow to particular trading venues; specific information regarding the routing and execution of orders, for example, the trading venues to which an order was routed and did not get filled prior to being executed;[19] external venues to which a broker routes orders, the percentage of shares executed at each external venue, and any ownership and other affiliations between the broker and any venues to which the broker routes orders; policies and procedures regarding the dissemination of information about a customer's order and trade information to facilitate a trade; and policies and procedures to control leakage of information regarding a customer's order and other confidential information.

V. Data Consolidation and the Need for a European Consolidated Tape (Section 4)

As the Consultation notes, besides requiring market data to be reliable, timely and available at a reasonable cost, investors also require the information to be brought together in a way that allows comparison of prices across different venues.

A. European Consolidated Tape (Section 4.3, Questions 51-59)

ICI members consistently state that one of their primary concerns about the current European market structure is the lack of a consolidated tape. The lack of a consolidated tape makes it difficult for investors to get a complete picture of available liquidity and accurate price and volume information.

The ICI therefore strongly supports bringing together market data through a consolidated tape. We believe, however, that many of the conditions listed in the Consultation for a consolidated tape must first be satisfied, including requirements relating to the information that must be included in the consolidated tape, its format, accessibility, latency and cost, and the period for which data must be kept. At this time, the ICI does not have views on the most optimal means to establish a consolidated tape.[20]

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[19] ICI members report that while they receive information about the venue at which an order was executed, they often do not receive information about what occurred prior to execution. For example, an order could have been routed to several different venues prior to execution for a brief period of time and rested on those venues until the order was routed elsewhere. Such information can help provide a more complete picture of the quality of execution provided by a broker and other execution venues as well as provide insight into the potential leakage of information about an order that may have occurred during the time it was exposed at the trading venues that did not execute the order.

[20] The three options noted in the Consultation are: (1) mandate that the formal consolidated tape would be operated by a single, non-profit seeking entity, established and appointed by a legal act, similar to the system that is used in the United States; (2) mandate that the consolidated tape would be operated by a single commercial entity, appointed following a public tender upon the merit of its bid submitted to the European Commission; or (3) prescribe in MiFID conditions that must be

B. Trading Center Data Feeds and Market Data Distribution

As the Commission examines the establishment of a consolidated tape, it also may want to consider an issue currently being debated in the United States surrounding the fairness of the systems for market data distribution. In the United States, many exchanges and other trading venues offer individual data feeds that are important for certain market participants to avoid the latency of consolidated data feeds. When the SEC adopted Regulation NMS, it did not require a market center to synchronize the delivery of its data to end-users with delivery of data to end-users through the consolidated tape and eliminated the provisions in the Exchange Act that prohibited the independent distribution of market data. In making this change, the SEC only required that market data be distributed on terms that are "fair and reasonable" and "not unreasonably discriminatory."

Given the extra step necessary for the distribution of market data to the public, the information in individual data feeds of exchanges and other trading venues in the United States generally reaches market participants faster than the same information in the consolidated data feeds.

To address concerns about the latency for investors receiving market data, many ICI members believe that the United States should consider eliminating the two-tiered distribution of consolidated quote and tape information. Specifically, all market participants should 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 under such a model 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.

VI. Transaction Reporting (Section 6)

The ICI welcomes the discussion in the Consultation regarding the benefits of transaction reporting to regulators. Specifically, a robust transaction reporting regime enables regulators to monitor the activities of firms and ensure compliance with MiFID and to monitor for market abuses. The ICI has provided recommendations to the SEC on certain aspects of trade reporting with respect to efforts by the SEC to develop, implement, and maintain a consolidated audit trail ("CAT") and a central repository for the CAT data for the trading of listed equities and options.[21]

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met for the provision of a consolidated tape and then allow competing commercial providers to provide the consolidated tape if they meet those conditions.

[21] *See* ICI Consolidated Audit Trail Letter, Appendix A. *See also* SEC Release No. 62174 (May 26, 2010), 75 FR 32555 (June 8, 2010), available at http://www.sec.gov/rules/proposed/2010/34-62174.pdf. The SEC's proposal would require "self-regulatory organizations" ("SRO") and their members to provide detailed information regarding an order to a proposed repository on a real-time basis, including information sufficient to identify the customer. Each SRO and the SEC would have unlimited access to this information for purposes of performing their regulatory and oversight responsibilities.

The ICI supported the establishment of a CAT. As the flash crash illustrated, the SEC currently is unable to gather the information necessary to quickly and efficiently assess market events and trading activity. We expressed, however, significant concerns over the confidential treatment of CAT data, certain costs of transaction reporting regimes, and any requirement for providing data in real time.[22] Specifically, we noted concerns regarding the confidentiality of the use of client-type identifiers and specific information about fund orders, particularly since this information would pass through and potentially be exposed to several market participants before reaching regulators. The ICI believes our recommendations in this area can be useful to the Commission as it examines methods to enhance trade reporting.

VII. Access of Third Country Firms to EU Markets (Section 8.3, Questions 138-140)

The Consultation requests comment on whether it is necessary to introduce a new regime in MiFID to address access by third country firms to EU markets. The new regime would be based on the principle of exemptive relief for "equivalent jurisdictions" which would be subject to a strict equivalence standard.

Given the global nature of trading and the markets in general, the ICI does not believe that it is necessary to base access to EU markets on a strict equivalence standard. We are concerned that such a standard would not provide any flexibility for allowing investors (both in the EU and in third countries) to access different types of markets or to be provided with investment opportunities where a third country may not meet the strict equivalence standard. We therefore recommend that the Commission consider a more flexible regime.

For example, the standard could be determined by reference to the third country firm's supervision and regulation in its home state and not by reference to precise criteria and parameters. Alternatively, an equivalence standard could be based on transparent, proportionate, and objective grounds, recognizing that jurisdictions have different legal and regulatory structures. In any event, the standards imposed on third country firms and markets should not be higher than those imposed on EU firms and equivalence should not be used as a barrier to entry.

VIII. Ban on Specific Activities, Products or Practices (Section 9.1, Question 142)

The Consultation requests comment on the possibility of banning products, practices or operations that raise significant investor protection concerns, generate market disorder or create serious systemic risk. The Consultation also states that national regulators would be given the power to

[22] The SEC also has proposed the creation of a large trader reporting system that would enhance the SEC's ability to identify the effects of certain large trader activity on the markets, reconstruct trading activity following periods of unusual market activity, and analyze market events and trading activity for regulatory purposes. *See* ICI Large Trader Reporting Letter, Appendix A. *See also* SEC Release No. 61908 (April 14, 2010), 75 FR 21456 (April 23, 2010).

temporarily ban or restrict the trading or the distribution of a product by one or more investment firms or the provision of an activity in case of exceptional adverse developments which constitute a serious threat to financial stability or to market confidence in a Member State or the European Union.

The ICI strongly supports providing regulators with the tools necessary to ensure the fair and orderly operation of the financial markets and the protection of investors in those markets. We question, however, whether the imposition of a ban is an appropriate or proportionate response and believe that the decision to ban a particular product, practice or operation, if taken, should only be taken in the most dire of circumstances, and then only after a thorough examination of the implications of a ban on market participants and the markets as a whole.

We also recommend that the Commission consider alternatives that may be more measured and effective in managing risks and protecting investors. In any case, if the proposals to ban products or practices proceed, we strongly recommend the adoption of sufficient safeguards such as requirements for consultation and coordination among regulators and the provision of sufficient notice of any ban to market participants to prevent or reduce any potential market instability. In addition, the process for reinstating the trading or distribution of a product or the provision of an activity would have to be clarified.

IX. Regulatory Reform in the Derivatives and Fixed-Income Markets

The ICI's comments are focused on the impact of market structure changes in the equity markets. The Consultation, however, asks a series of questions relating to changes in the structure of markets for other types of instruments, including derivatives and fixed-income securities.

ICI members are active participants in the derivatives and fixed-income markets and changes to the structure of those markets will have an impact on the manner in which funds execute trades and interact with other market participants. We therefore strongly support a robust examination of the current market structure in the non-equity markets. In particular, we agree that the existing transparency regime for these markets can be strengthened to the benefit of investors.

A. Derivatives Markets Reform

The reform of the regulations overseeing the derivatives markets is of significant interest to ICI members. Funds use derivatives as a means to pursue their stated investment objectives, often by hedging their investments from a decline in value, for efficient portfolio management purposes, and for securing at low cost assets they wish to acquire.[23] ICI members therefore have a strong interest in the safety and soundness of the derivatives markets.

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[23] *See* Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law, July 6, 2010.

In response to efforts in the United States to implement the Dodd-Frank Act, the ICI has been extremely active in commenting on a series of proposals by the SEC and CFTC to reform the regulation of the swaps markets. To date, ICI has filed comment letters on a wide range of issues including those related to the governance structure of swap clearing entities, the protection of customer collateral for cleared and uncleared swaps, the real-time reporting of swap transaction data, and the status of foreign exchange swaps and forwards as "swaps" under the Commodity Exchange Act.[24]

The Consultation requests comment on a number of derivatives related issues. In general, given the complexity of the derivatives markets and the broad range of proposals to change the structure and oversight of these markets, the ICI strongly urges the Commission to take a careful and measured approach to the reform of regulations in this area. Moving expeditiously without considering the implications, costs and risks of reforms could lead to regulations that may, at the end of the day, dissuade market participants from using the derivatives markets, thereby impairing liquidity and increasing risks.

Among other things, the Consultation requests comment whether a requirement should be introduced that all clearing-eligible and sufficiently liquid derivatives should trade exclusively on regulated markets, MTFs, or organized trading facilities. The ICI agrees with the goal of having derivatives trade on exchanges or other regulated trading venues, which could bring certain benefits in terms of increased transparency and better price discovery. At the same time, we believe ensuring that investors have options and flexibility in the manner in which they execute trades in derivatives is critical. We therefore believe, at this time, that investors are best served by not introducing a requirement mandating where executions must take place.

The Consultation also requests comment on stronger oversight of positions in derivatives. The ICI does not believe that hard position limits are appropriate for all categories of market participants.[25] Specifically, we do not think that imposing position limits on funds that invest in certain types of derivatives (*e.g.*, futures contracts or fully collateralized swaps in various commodities to replicate the performance of commodity indices) would advance the goals of preventing market manipulation and disorderly markets. Further, we believe that the failure to carefully craft position limits could have an adverse impact on certain fund investors, which is problematic in that funds are one of the primary vehicles for small investors to access the commodities markets.[26]

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[24] For a list of, and links to, ICI comment letters in this area, *see* Appendix B.

[25] *See* ICI Position Limits Letter, Appendix B.

[26] We note that the idea of imposing hard position limits, to this point, has not gained much traction in Europe. *See, e.g.,* CESR Response to European Commission Request for Additional Information in Relation to the Review of MiFID, October 2010 and Financial Services Authority & HM Treasury, Reforming OTC Derivative Markets, A UK Perspective, December 2009.

In the United States, the ICI has recommended that diversified, registered funds that comply with the leverage requirements of the Investment Company Act of 1940 and that take passive, long-only positions should not be subject to position limits. These funds, among other things, do not selectively target particular physical commodities or amass significant positions in any one commodity such that their selling decisions could affect market pricing. Yet, imposing position limits on such diversified, registered funds could harm the futures and swaps markets as well as fund investors in those markets. Position limits could reduce the liquidity available to commodity producers and end-users that rely on these funds to take the other side of their trades. By reducing liquidity, price discovery would be impaired as well. Fewer traders, and consequently transactions, in the commodities derivatives markets would result in less transparency and information to identify the true market price of a contract. The imposition of position limits would also impair an important portfolio diversification tool for fund investors.

B. Review of Fixed Income Markets

Many of the issues discussed above with respect to the equity markets, such as the need for increased transparency by certain market participants, addressing conflicts of interest that may be present, and whether regulation in general has kept pace with how securities are traded, are all present in the fixed income markets, perhaps to an even greater degree. The Institute has long advocated for reform in this area.[27]

We strongly believe that more needs to be done to address concerns in the fixed-income markets and that an examination of these markets is long overdue. Nevertheless, while we strongly believe that issues relating to the fixed-income markets are ripe to address, as discussed above, we would urge the Commission to proceed cautiously in recommending any new regulations given the complexity of the issues facing these markets. We therefore believe that investors would be well served by a Commission study of developments in this area.

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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

[27] For a list of, and links to, ICI comment letters in this area, *see* Appendix B.

Appendix A
Key ICI Comment Letters on Market Structure Issues

Order Execution Obligations: Letter from Craig S. Tyle, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated January 16, 1996; available at http://www.ici.org/pdf/7561.pdf

Regulation of Exchanges and Alternative Trading Systems: Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated July 28, 1998; available at http://www.ici.org/pdf/comment98_reg_exch_ats.pdf

Market Fragmentation Concept Release: Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 12, 2000; available at http://www.ici.org/pdf/11894.pdf

Subpenny Concept Release: Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated November 20, 2001; available at http://www.ici.org/policy/comments/01_SEC_SUBPENNY_COM

Regulation NMS: Letter from Ari Burstein, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 30, 2004; available at http://www.ici.org/policy/markets/domestic/04_sec_nms_com

Flash Orders: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated November 23, 2009; available at http://www.ici.org/pdf/23973.pdf

Non-Public Trading Interest: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 22, 2010; available at http://www.ici.org/pdf/24142.pdf

Market Access: Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated March 29, 2010; available at http://www.ici.org/pdf/24210.pdf

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

SEC Market Structure Roundtables: Letters from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 1, 2010 and June 23, 2010; available at http://www.ici.org/pdf/24361.pdf and http://www.ici.org/pdf/24384.pdf

Circuit Breakers: Letters from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 3, 2010 and July 19, 2010; available at http://www.ici.org/pdf/24364.pdf and http://www.ici.org/pdf/24438.pdf

Large Trader Reporting System: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 22, 2010; available at http://www.ici.org/pdf/24381.pdf

Clearly Erroneous Executions: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated July 19, 2010; available at http://www.ici.org/pdf/24437.pdf

Consolidated Audit Trail: 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

Appendix B
ICI Comment Letters on Derivatives and Fixed-Income Issues

Derivatives Issues

Definitions Related to Regulation of Swaps: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated September 20, 2010; available at http://www.ici.org/pdf/24551.pdf

SEC and CFTC Proposals to Mitigate Conflicts of Interest at Swap Entities: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission and David A. Stawick, Secretary, Commodity Futures Trading Commission, dated November 17, 2010; available at http://www.ici.org/pdf/24715.pdf

Status of FX Swaps and Forwards as "Swaps": Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Mary J. Miller, Assistant Secretary for Financial Markets, United States Department of the Treasury, dated November 29, 2010; available at http://www.ici.org/pdf/24751.pdf

Protection of Customer Collateral for Cleared Swaps: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated January 18, 2011; available at http://www.ici.org/pdf/24882.pdf

Position Limits: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, CFTC, dated January 11, 2011; available at http://www.ici.org/pdf/24867.pdf

Protection of Collateral of Counterparties to Uncleared Swaps: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated February 1, 2011; available at http://www.ici.org/pdf/24931.pdf

Fixed-Income Issues

SEC Amendments to NRSRO Rules: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated July 25, 2008; available at http://www.ici.org/pdf/22740.pdf

SEC and MSRB Proposals to Amend Municipal Securities Disclosure: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, U.S. Securities and Exchange Commission, dated September 22, 2008; available at http://www.ici.org/pdf/22899.pdf