

**Testimony of Kevin Cronin, Global Head of Equity Trading, Invesco
on Behalf of the Investment Company Institute**

**“Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive
Markets for Issuers and Investors”**

**Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives**

June 20, 2012

Thank you Chairman Garrett, Ranking Member Waters and members of the Subcommittee for the opportunity to speak here today. My name is Kevin Cronin; I am Global Head of Equity Trading for Invesco. Invesco is a leading independent global asset management firm with operations in more than 20 countries and assets under management of over \$632 billion.

I am pleased to participate on behalf of the Investment Company Institute at this hearing examining the structure of the U.S. securities markets. 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”). The structure of the securities markets has a significant impact on ICI members, who are investors of over \$13 trillion of assets and who held 29 percent of the value of publicly traded U.S. equity outstanding at the end of 2011. ICI members are institutional investors, but invest on behalf of over 90 million individual shareholders.¹

Funds and their shareholders therefore have a strong interest in ensuring that the securities markets are highly competitive, transparent and efficient, and that the regulatory structure that governs the securities markets encourages, rather than impedes, liquidity, transparency, and price discovery. Consistent with these goals, ICI has strongly supported efforts to address issues that may impact the fair and orderly operation of the securities markets and investor confidence in those markets and has long advocated for regulatory changes that would result in

¹ Households are the largest group of investors in mutual funds. Altogether, 52.3 million households, or 44 percent of all U.S. households, owned mutual funds as of 2011. Mutual funds also managed 55 percent of the assets in 401(k) and other defined contribution retirement plans and 45 percent of the assets in IRAs at the end of 2011. For more information on the U.S. fund industry, see 2012 Investment Company Institute Fact Book at www.icifactbook.org.

more efficient markets for investors.² We commend the Subcommittee for holding this hearing to examine these critical issues.³

As the title of the hearing suggests, orderly, efficient, innovative and competitive securities markets are essential for both issuers and investors. Achieving such markets requires fundamental elements such as: robust price discovery; transparency and fairness; sensible regulation with diligent oversight and enforcement; competition which fosters innovation and efficiencies; broad-based and diverse participation; and most critically, the participation of long-term investors. Long-term investors are the cornerstone of the capital formation process and their participation in the primary markets and secondary trading markets is fundamental to well-functioning securities markets overall. As such, it is critically important that the markets operate in the best interests, and foster the confidence, of long-term investors.

Unfortunately, over the past several years, long-term investor confidence has been challenged by a series of scandals, financial crises, and technological mishaps affecting the operations of exchanges, broker-dealers and automated trading systems -- including, most recently, the problems surrounding the Facebook IPO.

To ensure long-term investor confidence, it is incumbent upon regulators to address issues raised by developments in the structure and operation of the securities markets and the impact of those developments on investors. ICI believes that regulators have fallen short of this important objective, most likely because the implementation of the Dodd-Frank Act has diverted SEC resources to mandated rulemaking. Significantly, numerous issues raised by the SEC's concept release examining the structure of the U.S. securities markets have not been addressed, including issues surrounding high frequency trading and undisplayed liquidity, as well as the adequacy of information provided to investors about their orders.⁴

² For a comprehensive list of, and links to, ICI's key comment letters on trading and market structure issues, see Appendix.

³ While our statement focuses on the impact of market structure changes in the equity markets, ICI members also are active participants in the derivatives and fixed-income markets. Ongoing 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.

⁴ See 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>.

In addition, the events of May 6, 2010 brought to the forefront several inefficiencies in the current market structure. Several of these issues have been addressed by regulators; nevertheless, issues relating to the role of market makers and high frequency traders during the “flash crash” remain unresolved.

As discussed further below, ICI believes it is time for regulators and market participants alike to address, and take action on, many of the difficult and complex issues that have concerned investors for several years, including:

- Issues surrounding automated trading and high frequency trading, including the number of cancelled orders in the markets;
- The need for enhanced surveillance capabilities to detect potentially abusive and manipulative trading practices;
- Conflicts of interest that exist in the markets, particularly those surrounding liquidity rebates and the creation of new and complex order types;
- The need for increased transparency of order routing and execution practices;
- Difficulties surrounding capital formation, particularly for small and mid-sized companies, and the need to examine the implementation of higher minimum quote variations (*i.e.*, greater than \$.01) for certain securities; and
- Issues associated with undisplayed liquidity, particularly those related to broker-dealer internalization.

Regulators state that they have been reluctant to act on many of these issues, citing the insufficiency of data to ensure that any new or revised regulations will not adversely impact the securities markets. In our judgment, if the data currently available is insufficient to make these determinations, steps should be taken to obtain such data. As discussed further below, this might be done by instituting pilot programs to generate data, such as in the areas of liquidity rebates and minimum spreads.⁵

Impact of Automated Trading and High Frequency Trading on Funds

One of the primary drivers of changes to the structure of the securities markets over the past several years has been the rapid evolution of technologies for generating, routing and executing orders and related improvements to the

⁵ Pilot programs allow regulators to gather the data necessary to take a measured approach to reforms. If regulations are too restrictive, they may unintentionally limit the use of evolving market practices and technological developments and thus impede funds' use of new and innovative trading tools and trading venues. If regulations are too onerous or costly for some market participants, those participants may decide not to offer certain products or services to investors.

speed, capacity and sophistication of the trading functions available to investors. Funds rely heavily on technology for the efficient execution of their trades.

To be clear, we believe that investors, both retail and institutional, are in many respects better off now than they were just a few years ago. Investors have much greater control over how their trades are executed. The increased number and variety of trading tools also has resulted in less dependence on “high touch” trading and has contributed to lower overall trading costs and improved efficiency, certainly for the most liquid securities. On the other hand, the rise of automated trading and high frequency trading has forced funds and other institutional investors to modify the manner in which they trade to protect their proprietary trading strategies. Funds also have become more diligent in choosing their counterparties and in understanding where their orders are routed and the consequences of those routing decisions.

Clearly, high frequency trading has dominated the debate over the virtues of automated trading. ICI believes certain high frequency trading strategies arguably bring several benefits to the securities markets and to investors, including providing liquidity and tightening spreads in certain types of stocks. At the same time, several practices that have become associated with high frequency trading have created concerns, as discussed below.

Cancelled Orders

We believe that regulators and market participants must act to address the increasing number of order cancellations in the securities markets, particularly those that are cancelled shortly after submission. While order cancellations related to making markets is one thing, orders sent to the market with no intention of being executed before cancellation is quite another. These orders tax the markets’ technological infrastructure, and under the right circumstances, could interrupt the ability to process trades in an orderly fashion. In addition, ICI members report that certain of the practices and strategies surrounding cancellations often are designed to detect fund trading of large blocks of securities and to trade with or ahead of those blocks to the detriment of investors.

We have recommended on several occasions that regulators examine whether a fee should be imposed on cancelled orders above a certain ratio of orders to executed transactions, designed to discourage the current risk free use of certain types of orders and to protect the integrity of the markets’ infrastructure. While several exchanges have recently proposed such fees, we believe those proposals will be ineffectual; they will impact only the most extreme outliers, and the fee associated with the proposals is so small that it would not act as a deterrent. We therefore urge regulators and market participants to address

concerns regarding cancelled orders and consider truly meaningful fees or other deterrents that would adequately address this behavior.

Addressing Market Manipulation and Abuse

Recent technological advances in trading have allowed practices that are improper or manipulative in nature to be employed more easily and cheaply. This, in turn, has made trading more challenging for funds. The varied and complex trading practices used by market participants today also often makes it difficult to distinguish between legitimate and disruptive trading practices in a number of situations. We support action by regulators to clearly define practices involving automated trading strategies and high frequency trading strategies that may constitute market manipulation. In addition, we strongly support regulators having access to accurate, timely and detailed information about market participants and trades that are executed and the establishment of a more robust transaction reporting regime to enable regulators to monitor the activities of firms, ensure compliance with regulations, and monitor for market abuses.⁶

Addressing Potential Conflicts of Interest

Liquidity Rebates

The benefits and drawbacks of so-called “liquidity rebates” must be examined.⁷ Brokers are incentivized to make routing decisions based on the availability and amount of liquidity rebates offered by an exchange. Further, liquidity rebates subsidize certain of the high frequency trading strategies discussed above. At the same time, the benefits of liquidity rebates to investors are doubtful -- investors do not receive these rebates directly and arguably also do not receive the benefits of rebates indirectly.

We firmly believe that more must be learned about the effects of this practice on investors and the markets. We therefore recommend that the SEC 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

⁶ ICI provided recommendations on certain aspects of the SEC’s proposal to develop, implement, and maintain a consolidated audit trail (“CAT”) and a central repository for the CAT data regarding the trading of listed equities and options. 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>

⁷ The practice of providing liquidity rebates is associated with what is often referred to as the “maker/taker” model. In the maker/taker model, trading venues typically charge fees to market participants who “take” liquidity and pay rebates to market participants who “make” liquidity by placing orders.

to liquidity rebates. In this manner, the SEC can examine the data generated about liquidity rebate practices and determine whether rulemaking is necessary to address concerns in this area.

ICI does not believe that prohibiting liquidity rebates would negatively impact competition between markets. All trading venues should compete first on the basis of innovation, differentiation of services and ultimately, on the value their model of trading presents to investors; not on the amount of money rebated to market participants.

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, ICI 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.

Transparency of Order Routing and Execution Practices

More transparency is needed regarding the order routing and execution practices of market participants. 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 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 (whether an execution was received or not). 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.

Tick Sizes and Minimum Quote Variations

The difficulties for small companies coming to market in the United States have been well documented over the last several years. Various proposals have been set forth to stimulate capital formation and to provide support for small companies that desire to come to market. One of these proposals is to widen spreads (*i.e.*, minimum quote variations), particularly for less liquid stocks.

Since penny spreads were implemented, the average trade size has been significantly reduced, making it more difficult for funds to trade large blocks of securities, particularly in small-cap and less liquid stocks. We therefore believe it is necessary to examine ways to increase market liquidity and the depth of markets in securities that have not benefited from the move to penny spreads. Specifically, we recommend that a pilot program be established to examine wider spreads in certain stocks.⁸ We believe this pilot should be wide ranging, with different minimum spreads established for different types of stocks. A pilot program would generate valuable data on the impact on liquidity in these stocks, allowing the SEC to determine whether changes to the minimum quoting variation should be implemented.

Undisplayed Liquidity

While technological developments have resulted in improvements for investors, these changes also have shifted the dynamics of trading for funds, driving more fund orders away from the “lit” markets, such as the traditional exchanges, towards the use of undisplayed liquidity.

Funds have long been significant users of undisplayed liquidity. For ICI members that frequently execute large orders, undisplayed liquidity, and the venues that provide such liquidity (*i.e.*, dark pools), lessen the cost of implementing trading ideas and mitigate the risk of information leakage. Protecting orders from information leakage is a primary component of a fund’s day-to-day trading responsibilities; dark pools allow institutional investors, 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.

We recognize that while the use of undisplayed liquidity brings certain benefits to funds, there are concerns about its impact on the price discovery process. Ideally, funds would like as many orders as possible to be executed in the

⁸ The recent JOBS Act requires the SEC to conduct a study regarding the impact that quoting in penny increments has had on the securities markets, including on liquidity for the securities of small and mid-cap issuers and on market makers in those securities. The JOBS Act also gives the SEC authority, based upon the results of its study, to implement rules that would increase the minimum trading increment for securities of “emerging growth companies.”

lit markets. ICI therefore has strongly supported efforts to provide incentives for market participants to use transparent orders. Until we create a more efficient market structure for the execution of institutional sized orders, however, it is imperative that venues providing undisplayed liquidity remain available to funds and that the regulations overseeing these venues facilitate their continued use.

Broker-Dealer Internalization

Broker-dealer internalization (*i.e.*, where a broker internally executes against its own customer orders, taking the other side of trade) accounts for a significant percentage of the total share volume of stocks, and therefore undisplayed liquidity - more than the share volume attributed to dark pools as a whole. Internalized order flow also represents liquidity that funds do not have an opportunity, for the most part, to trade against.

Internalization raises a variety of concerns. For example, internalization may increase market fragmentation because it can result in customer orders not being publicly exposed to the market. In addition, it may raise conflicts of interest between broker-dealers and their customers because broker-dealers may execute customer orders at the displayed quotations, foregoing the opportunity for price improvement in order to maximize their profits.

We recommend that the SEC take action to ensure that internalized orders receive best execution. Specifically, any internalized order should be provided with “significant” price improvement.⁹ This requirement could result in more customer orders being exposed to the market if the amount of internalized orders is reduced, thus furthering public display of orders and potentially improving price discovery.

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Thank you and I look forward to answering any questions.

⁹ We question whether providing price improvement to internalized orders in, for example, increments of hundredths of a penny is providing meaningful price improvement.

Appendix

Key ICI Comment Letters and Statements 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_atc.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

Disclosure of Short Sales and Short Positions: Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Florence Harmon, Acting Secretary, Securities and Exchange Commission, dated December 16, 2008; available at <http://www.ici.org/pdf/23128.pdf>

Amendments to Regulation SHO (Short Selling): Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 19, 2009; available at http://www.ici.org/policy/comments/cov_comment/09_sec_short_sale_com

U.S. Senate Market Structure Hearing: Statement of the Investment Company Institute, Hearing on “Dark Pools, Flash Orders, High Frequency Trading, and Other Market Structure Issues,” Securities, Insurance, and Investment Subcommittee, Committee on Banking, Housing & Urban Affairs, U.S. Senate, October 28, 2009; available at <http://www.ici.org/pdf/23925.pdf>

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>

European Commission Review of MiFID: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Directorate General, European Commission, dated February 2, 2011; available at <http://www.ici.org/pdf/24946.pdf>

IOSCO Consultation on Dark Liquidity: 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>

Limit Up-Limit Down System: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 22, 2011; available at <http://www.ici.org/pdf/25295.pdf>

Dodd-Frank Act Short Sale Reporting Study: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 23, 2011; available at <http://www.ici.org/pdf/25297.pdf>

IOSCO Consultation on Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Werner Bijkerk, Senior Policy Advisor, IOSCO, dated August 12, 2011; available at <http://www.ici.org/pdf/25408.pdf>

Regulatory Action on Short Selling in the European Union: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Steven Maijoor, Chair, European Securities and Markets Authority, dated August 17, 2011; available at <http://www.ici.org/pdf/25428.pdf>

ESMA Consultation on Guidelines on Systems and Controls in a Highly Automated Trading Environment: Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Steven Maijoor, Chair, European Securities and Markets Authority, dated October 3, 2011; available at <http://www.ici.org/pdf/25546.pdf>

NASDAQ Market Quality Program: Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated May 3, 2012; available at <http://www.ici.org/pdf/26142.pdf>

NYSE Arca Fixed Incentive Program: Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 7, 2012; available at <http://www.ici.org/pdf/26227.pdf>