INVESTMENT COMPANY INSTITUTE

ICI Global

September 24, 2012

The Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong

Re: *Consultation Paper on the Regulation of Electronic Trading*

Dear Sir or Madam:

The Investment Company Institute ("ICI") and ICI Global strongly support the Securities and Futures Commission's ("SFC") issuance of a consultation seeking comment on proposals relating to the regulation of electronic trading.[1] The Consultation raises a number of issues of importance to ICI and ICI Global members.

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 financial markets has a significant impact on ICI members, who are investors of over $13 trillion of assets. We are institutional investors, but invest on behalf of over 90 million individual shareholders.[3]

ICI Global is a global fund trade organization based in London; members include regulated U.S. and non-U.S. based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of over $1 trillion in non-U.S. funds.

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[1] *Consultation Paper on the Regulation of Electronic Trading,* Securities and Futures Commission, (24 July 2012) ("Consultation").

[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* 2012 Investment Company Institute Fact Book at www.icifactbook.org.

ICI and ICI Global members, and their shareholders, have a strong interest in ensuring that the global financial markets are highly competitive, transparent and efficient, and that the regulatory structure that governs the financial markets encourages, rather than impedes, liquidity, transparency, and price discovery. Consistent with these goals, we have strongly supported the examination of issues related to electronic trading as well as other issues that may impact the fair and orderly operation of the global financial markets and investor confidence in those markets. We have long advocated for appropriate regulatory changes to address investor concerns; our comments on the Consultation reiterate many of the comments made in prior ICI and ICI Global letters on other proposals and consultations related to electronic trading.[4]

We are filing this response jointly as the issues surrounding the trading of securities by funds clearly are of global importance. Many funds utilize intricately linked global trading desks and are concerned about the regulation and structure of the financial markets in all jurisdictions in which they trade. In particular, our members are very active in the Hong Kong markets and are therefore particularly interested in the SFC consultation.

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

I. Summary of Comments and Recommendations

Scope of the Proposals (Question 1)

- We believe the scope of the regulation of electronic trading should be broad with respect to the types of electronic trading and products covered by the proposals and agree with the focus of the Consultation on intermediaries.

- We recommend that the SFC clarify the specific provisions in the proposal that would apply to fund managers, the scope of those provisions, and how fund managers would comply with such provisions; as proposed, it is unclear how fund managers would comply with many of the proposals due to the nature in which funds trade and use electronic trading systems.

General Requirements on Electronic Trading (Questions 2-6)

- We believe an intermediary should have the ultimate responsibility for the orders sent to the market through its electronic trading system and for the compliance of the orders with applicable regulatory requirements.

[4] For a comprehensive list of, and links to, ICI and ICI Global comment letters and statements on trading and market structure issues, *see* Appendix.

- We believe the establishment of robust pre- and post-trade risk controls is critical given the prevalence of electronic trading and support proposed measures that would require an intermediary to ensure the integrity and adequacy of the electronic trading system.

- We strongly support requiring an intermediary to employ adequate and appropriate security controls to protect the electronic trading system it uses or provides to clients from being abused, including effective techniques to protect the confidentiality and integrity of information stored in the system and passed between internal and external networks.

Specific Requirements on Internet Trading and DMA (Questions 7-10)

- We strongly support subjecting DMA orders to robust pre- and post-trade controls.

Specific Requirements on Algorithmic Trading (Questions 11-15)

- We support subjecting algorithms to appropriate rules and controls, such as requirements for policies and procedures aimed at preventing algorithms from operating in an unintended manner and the use of clearly delineated development and testing methodologies.

Electronic Trading System not Developed by Licensed or Registered Person (Questions 16-17)

- We believe an intermediary should remain responsible for the electronic trading system and/or trading algorithms provided to it by a service provider.

II. General Comments

The global equity market structure has undergone significant changes over the past several years. Clearly, a primary driver and enabler of these changes has been the continual evolution of technologies for generating, routing and executing orders and related improvements to the speed, capacity and sophistication of the trading functions available to investors. Funds rely heavily on technology for the efficient execution of their trades. We are therefore pleased that the SFC has determined to take a comprehensive look at systems and controls necessary for the current electronic trading environment.

In addition, as the Consultation recognizes, jurisdictions around the world are already addressing the issues discussed in the Consultation, and we believe it is therefore desirable to achieve a broad consistency of approach to issues surrounding electronic trading across different jurisdictions given the links between the financial markets in Hong Kong and the rest of the world. As the SFC considers initiatives relating to the reform of the regulation of the Hong Kong financial markets, we urge it to work closely with regulators around the globe to create consistent and sensible cross-border regulations.

Finally, we urge the SFC to take a measured approach in any responses it feels appropriate and necessary to address the impact of electronic trading on market efficiency and integrity. 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, such as algorithms. In addition, if regulations are too onerous or costly for some market participants, those participants may decide not to 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 therefore urge the SFC to carefully balance these potential costs with the benefits any new regulations would provide to investors.

III. Proposals on the Regulation of Electronic Trading

ICI and ICI Global have spent a significant amount of time examining the impact of electronic trading on the financial markets and on investors. The proliferation of electronic trading has forced funds and other institutional investors to modify their own trading strategies. When determining the most efficient approach to executing a trade, funds must now take into account: (1) the impact of the increase in volume of trading attributed to certain market participants such as high frequency traders and the significant amount of electronic trading in general; (2) fragmentation in the markets and the number and types of alternative trading venues available; and (3) the new technology and tools available to funds when trading.

We therefore strongly support establishing principles and requirements for intermediaries regarding electronic trading, internet trading and direct market access, and algorithmic trading that address key issues such as systems capacity, testing, staffing, and recordkeeping. We believe a robust compliance and risk management program is critical given the prominence of electronic trading.

The Consultation notes several benefits of a highly automated trading environment. One of the benefits of technological developments for funds and other institutional investors clearly has been improvements in the sophistication of the trading functions available to investors. The increased number and variety of electronic trading tools and systems available to funds has resulted in less dependence on "high touch" trading and has contributed to lower overall trading costs and higher overall efficiency of trading.

At the same time, as the Consultation recognizes, there are challenges raised by technological developments, including the need to ensure the integrity of the market and that trading via direct market access or by the use of trading algorithms is conducted in a fair and orderly manner. As discussed further below, the increased use of electronic trading has raised several valid regulatory concerns.

A. Scope of the Proposals (Question 1)

Given the proliferation of the types of electronic trading and the presence of electronic trading across all types of asset classes, ICI and ICI Global believe that the scope of the regulation of electronic trading should be broad with respect to the types of electronic trading and products covered by the proposals. In addition, we agree with the focus of the Consultation on intermediaries and on the regulatory requirements for intermediaries to manage and mitigate the risks that arise from using or providing an electronic trading system and from trading in an electronic trading environment overall.

The Consultation, however, also proposes that the principles and requirements be incorporated into the Fund Manager Code of Conduct.[5] ICI and ICI Global members, therefore, would be subject to the majority of the proposed principles and requirements (except for those applicable to DMA) in their trading as funds often would be conducting "electronic trading" as defined in the proposal.

While we support the need to address risks to the markets from electronic trading, as proposed, it is unclear how fund managers would comply with many of the principles and requirements due to the nature in which funds trade and use electronic trading systems, as well as the nature of the relationships between funds and intermediaries. For example, many of the general requirements on electronic trading are written with respect to systems that are normally operated solely by an intermediary or provided by an intermediary to a customer, not systems that are used by a fund manager to conduct trading for a fund. Similarly, some proposed principles and requirements (*e.g.*, proposed requirements regarding system capacity and contingencies) clearly could not apply to fund managers as funds do not provide electronic trading systems for use by clients in the manner contemplated by the proposals.

In addition, Section 9.2 of Draft Part IV of the Fund Manager Code of Conduct states that "A Fund Manager should comply with the following principles and requirements, **where applicable**, when conducting electronic trading on behalf of collective investment scheme managed by it." (emphasis added). We believe this section adds to the ambiguity of how the proposed principles and requirements would apply to a fund manager and may create a risk of differing interpretations of the principles and requirements between a fund manager and the SFC.

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[5] Specifically, the Consultation would add Part IV to the Fund Manager Code of Conduct and require that a Fund Manager comply with certain principles and requirements when conducting electronic trading on behalf of a collective investment scheme managed by it, in particular, paragraphs 18.3 to 18.7 and 18.9 to 18.11 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission and paragraphs 1.1 to 2.1 and 3.1 to 3.4 of Schedule 7 to that Code.

We therefore recommend that the SFC clarify the specific provisions in the proposal that would apply to fund managers, the scope of those provisions, and how fund managers would comply with such provisions. In doing so, the proposals can be better tailored to the manner in which funds and other institutional investors conduct electronic trading.

B. General Requirements on Electronic Trading (Questions 2-6)

As discussed above, a primary driver of many of the changes to the structure of the financial markets has been the evolution of technology and electronic trading. It is clear, however, that regulations governing the financial markets have not kept pace with the proliferation of electronic trading or the significant changes in market participants' trading practices overall.

We believe, as the Consultation proposes, that an intermediary should have the ultimate responsibility for the orders sent to the market through its electronic trading system and for the compliance of the orders with applicable regulatory requirements. This responsibility should include all aspects of the electronic trading system including: the design, development, deployment and operation of the system it uses or provides to clients for use; the system's reliability, security and capacity; and the maintenance of proper records regarding the operation of the system.

We also believe the establishment of robust pre- and post-trade risk controls is critical given the prevalence of electronic trading. We therefore support proposed measures that would require an intermediary to ensure the integrity and adequacy of the electronic trading system. As the Consultation notes, these include control measures to prevent the system from generating and sending orders to the market that may be erroneous or not compliant with the applicable regulatory requirements and effective controls to enable an intermediary to cancel unexecuted orders in the markets, so that it can intervene or halt outstanding trades when necessary. Recent "market disruption" events, such as the flash crash in the United States, have highlighted the need for such mechanisms.

Similarly, we support proposed requirements for an intermediary to ensure that the electronic trading system and all modifications to the system are adequately tested before deployment and are regularly reviewed to ensure that the system and modifications are reliable. We also support requiring an intermediary to promptly report any material service interruption or other significant issues related to the system. Given the potential impact on the financial markets as a whole of a significant incident related to an electronic trading system, it is crucial that regulators have access to accurate and timely information and are aware of any significant risks to the sound operation of electronic trading systems that arise to ensure a robust regulatory scheme.

Finally, we strongly support requiring an intermediary to employ adequate and appropriate security controls to protect the electronic trading system it uses or provides to clients from being abused including, among other things, effective techniques to protect the confidentiality and integrity of information stored in the system and passed between internal and external networks. The confidentiality of information regarding orders is arguably the most significant consideration for funds when trading. As we have stated in several letters to the U.S. Securities and Exchange Commission ("SEC"),[6] 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.

C. Specific Requirements on Internet Trading and DMA (Questions 7-10)

ICI and ICI Global strongly support subjecting DMA orders to robust pre- and post-trade controls. Much of the focus in the United States and Europe around pre- and post-trade risk controls has been on the establishment of requirements relating to sponsored access and other types of market access arrangements. Risks related to automated trading can arise when an automated trader uses the facilities of another firm to access the market. For example, when firms allow their trading IDs to be used by other firms, it can pose potential risks not only to the intermediary firm, but to other firms throughout the trading chain.

ICI strongly supported the adoption by the SEC of rules to require broker-dealers to implement risk management controls and supervisory procedures reasonably designed to manage the risks associated with market access.[7] Similarly, we supported efforts by IOSCO in its consultation report on direct electronic access to provide a framework for crafting regulations on these arrangements.[8] At the same time, we have urged regulators to ensure that the scope of any regulations in this area does not unnecessarily affect 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.[9]

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[6] *See, e.g.*, Letters from Paul Schott Stevens, President, Investment Company Institute, to Christopher Cox, Chairman, Securities and Exchange Commission, dated September 14, 2005 (available at http://www.ici.org/pdf/comment_leakage_05.pdf); August 29, 2006 (available at http://www.ici.org/pdf/comment_leakage_06.pdf); and September 19, 2008 (available at http://www.ici.org/pdf/comment_leakage_08.pdf).

[7] *See* 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. Specifically, the controls and procedures adopted by the SEC will, among other things, prevent the entry of orders unless there has been compliance with regulatory requirements that must be satisfied on a pre-order entry basis.

[8] *See* 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.

[9] To address these concerns in the United States, ICI recommended that, at the very least: (1) unless expressly authorized to the contrary by a customer, access to information regarding a market access customer's orders and trades be limited to broker-dealer compliance personnel directly associated with overseeing market access controls and procedures; (2) that information required to be disclosed must be relevant to specific risk concerns created by market access; and (3) that the

D. Specific Requirements on Algorithmic Trading (Questions 11-15)

The use of algorithmic trading has significantly increased over just the past several years and is an important part of the ways fund trade. The increased use of algorithms, however, raises important questions regarding the risks to the markets of algorithmic trading. These risks include algorithms that may act in an unexpected or unintended manner leading to sudden liquidity imbalances that quickly drive prices up or down.

ICI and ICI Global therefore support subjecting algorithms to appropriate rules and controls, such as requirements for policies and procedures aimed at preventing algorithms from operating in an unintended manner. We also support draft guidelines related to the use of clearly delineated development and testing methodologies to seek to ensure that, among other things, the operation of trading algorithms is compatible with an intermediary's obligations under relevant regulations, that the compliance and risk management controls embedded in the system or algorithm work as intended, and that the algorithm can continue to work effectively in stressed market conditions.

We also believe it is reasonable that persons involved in the design and development of, or approved to use, an intermediary's algorithmic trading system and trading algorithms are suitably qualified. Similarly, an intermediary should ensure that the algorithmic trading system and trading algorithms it uses or provides to clients for use are adequately tested to ensure that they operate as designed at all times and should have effective controls to ensure the integrity of its algorithmic trading system and trading algorithms and that they operate in the interest of the integrity of the market. Finally, proper recordkeeping will be important regarding the design, development, deployment and operation of its algorithmic trading system and trading algorithms.

E. Electronic Trading System not Developed by the Licensed or Registered Person (Questions 16-17)

We agree that an intermediary should remain responsible for the electronic trading system and/or trading algorithms provided to it by a service provider and perform appropriate due diligence to ensure that the service provider meets the proposed requirements in its use of the system or algorithms.

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SEC make clear that broker-dealers who obtain information also have adequate confidentiality safeguards and controls in place to protect such information and that the information be used exclusively for regulatory purposes.

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

Sincerely,

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APPENDIX

KEY ICI AND ICI GLOBAL 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_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

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

IOSCO Consultation on Regulation of Short Selling: Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Greg Tanzer, Secretary General, IOSCO, dated May 18, 2009; available at http://www.ici.org/pdf/comment_051809_iosco_consult.pdf

IOSCO Consultation on Direct Electronic Access: 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

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

U.S. House of Representatives Market Structure Hearing: Testimony of Kevin Cronin, Global Head of Equity Trading, Invesco, on Behalf of the Investment Company Institute, Hearing on "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; available at http://www.ici.org/pdf/12_house_cap_mkts.pdf

NASDAQ and NYSE Arca Market Maker Incentive Programs: Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated August 16, 2012; available at http://www.ici.org/pdf/26400.pdf