MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

April 15, 2011

Via Electronic Mail: Jointcommittee@cftc.gov; rule-comments@sec.gov

Mr. David Stawick	Ms. Elizabeth M. Murphy
Secretary	Secretary
Commodity Futures Trading Commission	Securities and Exchange Commission
Three Lafayette Centre	100 F St., NE
1155 21st Street, NW	Washington, DC 20549
Washington, DC 20581	

Re: Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010 by the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues ("Advisory Committee")

Dear Mr. Stawick and Ms. Murphy:

Managed Funds Association ("MFA")[1] appreciates the solicitation of investor perspectives by the Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC") (together, the "Commissions") on the "Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010 by the Advisory Committee ("Report").[2] MFA represents the views of institutional investors, including registered investment advisers and private investment pools, whose investors include pensions, endowments, foundations and insurance companies. We would like to share our views on several of the market structure recommendations made by the Advisory Committee relating to the events of May 6, 2010.

We appreciate the Advisory Committee's thoughtful Report. As investors, we have directly experienced the benefits from the U.S. equity market structure developments over the past decade as transaction costs, fees, execution speed, efficiency, and pricing transparency/reliability have steadily and drastically improved. Accordingly, we have aligned interests in a market structure in which investors will continue to have confidence and liquidity will continue to flourish. Below, we provide our thoughts on some of the recommendations in the Report.

I. Market Maker Obligations

MFA agrees with the Report that during times of extreme volatility, market maker obligations are of only limited effectiveness as a solution to reduced market liquidity.[3] This is because in times of such

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Report *available at:* http://www.sec.gov/spotlight/sec-cftcjointcommittee/021811-report.pdf.

[3] *See* Report at p. 10.

stress the economic risks to the designated market makers are simply too great for them to absorb. In general, from our experience, when specialists and market makers dominated trading, investors paid much higher costs due to lack of competition and lower liquidity. Accordingly, we are concerned with any proposals to the Commission that recommends incentivizing only market makers as a liquidity solution and not trying to promote more active market participants, market-wide, via more efficiency, tighter spreads and greater confidence.

We are primarily concerned that providing subsidies in the form of special trading privileges or fees to entice market making will only provide a false sense of security to investors. Investors, as a result, will incur unnecessary costs continuously as a result of these special privileges but won't benefit when markets are extremely volatile. As noted, during periods of great volatility, the risks are simply too great for a market maker to continue making markets. We feel strongly that the recently implemented circuit breakers and the proposed "limit-up/limit-down" constraints are appropriate steps for addressing extreme volatility, and bolstering investor confidence. Actions such as these constitute a more rational approach to dealing with falling markets, which benefit all market participants including market-makers. Such measures provide all market participants with a pause to digest and react appropriately to timely information. Mandatory market-making does not mitigate, nor will it ever prevent market dislocations or even instill confidence.

II. Circuit Breakers and Limit Up/Limit Down Process

MFA supports the Report's recommendations one,[4] two,[5] three[6] and five[7] relating to circuit breakers and the concept of a "limit up/limit down" process. We believe these recommendations will create symmetry in the treatment of securities during uncertain times as well as reduce the lack of uncertainty when a trading error occurs. We also support the expansion of the circuit breaker rules based on the interconnected relationship of derivatives and their respective underlying securities. Along with the pause or halt of an underlying security, any related exchange-traded derivative instruments (*i.e.*, futures or options) should also be paused or halted. In this respect, the Commissions may want to consider establishing a threshold number of issuers or a weighting percentage as it pertains to underlying securities of an index that must be paused or halted before the related index is also paused or halted. In

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[4] The Report supports:

"a. Creating single stock pauses/circuit breakers for the Russell 1000 stocks and actively traded ETFs
b. Enacting rules that provide greater certainty as to which trades will be broken when there are multi stock aberrant price movements, and
c. Implement minimum quoting requirements by primary and supplemental market makers that effectively eliminate the ability of market makers to employ "stub quotes""

[5] The Report recommends that the Commissions require that the pause rules of the Exchanges and FINRA be expanded to cover all but the most inactively traded listed equity securities, ETFs, and options and single stock futures on those securities.

[6] The Report recommends that the SEC work with the Exchanges and FINRA to implement a "limit up/limit down" process to supplement the existing Pause rules and that the Commissions clarify whether securities options exchanges and single stock futures exchanges should continue to trade during any equity limit up/down periods.

[7] The Report recommends that the Commissions evaluate the present system-wide circuit breakers and consider:

"i. reducing, at least, the initial trading halt to a period of time as short as ten minutes
ii. allowing the halt to be triggered as late as 3:30 pm **and**
iii. using the S&P 500 Index as the triggering mechanism."

our view, a limit up/limit down process will be less disruptive as it will greatly reduce market disruption from erroneous (unintentional or intentional) transaction reporting prints.

III. Pre-Trade Risk Controls

MFA supports the elimination of "naked sponsored access" and believes that broker-dealers must have appropriate and pragmatic risk management controls to prevent trading errors and to ensure compliance with applicable regulatory requirements; and that these controls should apply to both proprietary and customer business.[8] We refer the Commissions to our comments on the SEC's proposed rule 15c3-5 under the Securities Exchange Act of 1934.[9]

IV. Disruptive Trading with Respect to Extremely Large Orders or Strategies

MFA has concerns with some of the Advisory Committee members' statements with respect to disruptive trading and large order flows. As the Commissions consider defining "disruptive trading",[10] we strongly believe that any rule or guidance of the Commissions' should have as primary considerations the "intent and pattern" of the market participant in deciding what is abusive, manipulative or simply erroneous. Otherwise, rules with overly broad definitions may inadvertently catch many legitimate investment strategies or execution techniques.

Unfortunately, mistakes and errors are inevitable; regulation should not make it unlawful or even criminal for a market participant to make an unintended trading error. We fully support regulators actively pursuing market participants that intentionally engage in disruptive trading practices. However, where a market participant disrupts the markets through a technical glitch or unintentional error, we recommend that the Commissions require the market participant/investment firm and its sponsoring broker-dealer to demonstrate that they have: (1) rectified any lapse in their processes; (2) updated their risk-management protocols; and (3) resolved any programming glitches.

MFA strongly believes that any regulatory guidance or policies on "disruptive trading" should not be specific to electronic or automated orders. Algorithmic order routing strategies or particular types of investment firms should not be singled-out; rather, guidance on disruptive trading should be applicable to all firms and strategies as each has the potential to disrupt markets. We will take this opportunity to highlight that supervision and controls should not be static, and that supervisory measures should be appropriate and implemented for all investment strategies. We recommend that the Commissions delegate to individual trading venues the responsibility of determining whether an order is potentially disruptive or should be blocked by broker-dealers through their risk management controls.[11]

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[8] *See* 75 FR 4007 (January 26, 3010), Proposing Release on Risk Management Controls for Broker or Dealers with Market Access; *and* 75 FR 69792 (November 15, 2010), Final Rule on Risk Management Controls for Broker or Dealers with Market Access.

[9] *See* letter from Stuart J. Kaswell, Executive Vice President & Managing Director, MFA, to Elizabeth M. Murhpy, Secretary, SEC, dated March 29, 2010, file no. S7-03-10, *available at:* http://www.managedfunds.org/downloads/MFA%20Comments%20on%20BD%20Risk%20Mgmt.3.29.10.pdf.

[10] *See* Section 747 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Antidisruptive Trading Practices Authority.

[11] We note that Rule 15c3-5 requires broker-dealers to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds. 75 FR 69792, 67975.

MFA welcomes the opportunity to work with the Commissions to devise market structure techniques or guidelines that would reduce the disruptive power of errors and disruptive trading in general.

V. Liquidity and Order Cancellations

MFA appreciates the Report's consideration of alternative ways to enhance liquidity. However, we raise two issues with the Report's discussion points with respect to the proposition of "peak load" pricing:[12] (1) during periods of market distress—not volatile periods, but crash periods—raising rebates and access fees likely will be ineffective at restoring liquidity and investor confidence; and (2) history has shown that even when bid/offer spreads were wider and costs were higher, the wider spreads were not reason enough for market makers to provide liquidity during systemic events. For example, despite the wide bid ask spreads during the October 1987 crash, market makers acted in what they believed to be self- preservation,[13] and could not be incentivized enough to provide liquidity. During periods of market stress, rebates at pennies or tenths of pennies per share will be unlikely to provide the necessary incentive for liquidity providers to take on additional monetary risks when faced with the financial jeopardy of their businesses.

The Report proposes the use of access fees and rebates in turbulent markets to encourage liquidity, but states that Regulation NMS limits access fees but not rebates.[14] We believe it is important to recognize the rationale behind limiting access fees—it was to discourage trading venues from pricing orders at or just inside the national best bid or offer ("NBBO") and then charging seemingly outrageous access fees (*e.g.*, 2 cents/share), making those prices illusory. As the Report acknowledges, the trade through rule of Regulation NMS does not take into account access fees or rebates in determining the NBBO. Thus, to provide market participants with the "true cost" of an investment, the Commission would have to consider incorporating access fees into the quoted price so market participants appreciate the out-of-pocket expense of the investment. We believe, on one hand, that such pricing system may enhance price/cost transparency, but, on the other hand, it may create a number of unforeseeable, unintended consequences.

The Report recommends that the Commissions explore ways to fairly allocate and externalize the costs imposed by high levels of order cancellations.[15] We raise two concerns with this recommendation. First, each type of market participant creates externalized costs on the trading venues. It is extremely difficult to complete an accurate cost comparison; for example, those market participants that are best served by a physical trading floor require the New York Stock Exchange to maintain a physical building and a high level of outside security, including permanent road blockades of several lower Manhattan streets. We believe it is unfair to assess certain types of investors for "externalized" costs and not others. Second, a market participant or fiduciary may separately trade different strategies for different beneficial owners. We are concerned that an assessment on a manager would create conflicts with respect to divvying up the assessment among managed funds, especially when one strategy may carry a high cancellation rate while another strategy may not require a high cancellation rate.

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[12] Report at p. 9. The Report recommends consideration of "peak load" pricing strategies of charging higher fees for traffic at peak hours as it states that "[u]ntil recently, the fluctuations in the bid ask spread regulated the demand and supply of liquidity in financial markets. Now, it appears that in a world of HFT, bid ask spreads no longer provide sufficient incentives to offer liquidity in periods of high volatility."

[13] The Report of the Presidential Task Force on Market Mechanisms (the "Brady Report") January 1988, at 50-53.

[14] Report at p. 9.

[15] Report at p. 11.

We believe the Report may have some inconsistencies in approach and potential solutions—raising trading costs will not have the effect of enhancing or encouraging greater liquidity. A market participant's ability to manage risk prudently has to be linked to that market participant's ability to adjust risk exposure at the same rate as information is made available. A regulatory regime that makes it more costly for market participants to transact business will cause market participants and investors to trade less, which will directly impact liquidity when it is needed most—during times of extreme uncertainty. As we experienced during the "flash crash," information and the speed of information become more critical during times of perceived uncertainty, and any delays will only cause market participants to withdraw from the markets. To prevent information delays, we encourage regulators to mandate that trading venues meet a minimum standard for supporting data capacity, as well as maintain a certain level of redundancy to ensure that timely information is promptly available to market participants. What seems necessary is not requiring market participants to commit capital or disregard their fiduciary responsibilities during times of uncertainty but to create a window so market participants can receive and evaluate information on a timely basis and implement a thoughtful investment approach. Without time to evaluate information the natural and prudent reaction of a market participant is to reduce its exposure and to limit its trading activity. We think the remedies we've discussed above address this issue and would enhance market confidence, even during times of dislocations.

VI. Conclusion

MFA appreciates the opportunity to provide comments on the Report. We would be happy to meet with the Commission or its staff to discuss any of the comments in this letter or other aspects of the Report. Please do not hesitate to contact Jennifer Han or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
General Counsel

Cc:

The Hon. Mary Schapiro, Chairman
The Hon. Kathleen L. Casey, Commissioner
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
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