MEMO# 24989

February 24, 2011

CFTC-SEC Advisory Committee "Flash Crash" Report

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 8-11
ETF ADVISORY COMMITTEE No. 20-11
EQUITY MARKETS ADVISORY COMMITTEE No. 18-11
CLOSED-END INVESTMENT COMPANY MEMBERS No. 26-11
SEC RULES MEMBERS No. 38-11
INVESTMENT COMPANY DIRECTORS No. 5-11 RE: CFTC-SEC ADVISORY COMMITTEE "FLASH CRASH" REPORT

The Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues has issued its final report containing a number of recommendations related to the "flash crash" of May 6, 2010 as well as other market structure issues. [1] The most significant aspects of the report are summarized below.

Issues Relating to Market Volatility

The report discusses a number of issues and makes several recommendations relating to the effect of the increase in electronic trading on the securities markets. The report states that while recent changes in the markets have increased competition and reduced transaction costs, they also have created market structure fragility in highly volatile periods. The report notes that liquidity in a "high-speed world" is not a given and that the structure of the markets must ensure that liquidity is continuously provided in a highly fragmented, highly interconnected trading environment.

- The Committee concurs with the steps the SEC has taken to: (1) create single stock pauses/circuit breakers, (2) enact rules that provide greater certainty as to which trades will be broken when there are multi-stock aberrant price movements, and (3) implement minimum quoting requirements by market makers that effectively eliminate "stub quotes."
- The Committee recommends that the SEC and CFTC require that the pause rules be expanded to cover all but the most inactively traded listed equity securities, ETFs, and

options and single stock futures on those securities.
- The Committee 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 SEC and CFTC clarify whether securities options exchanges and single stock futures exchanges should continue to trade during any equity limit up/limit down periods.
- The Committee recommends that the CFTC and the relevant derivative exchanges evaluate whether the CME's "stop logic" circuit breaker should be amended to institute a second tier of pre-trade risk safeguards with longer timeframes when the current "five second limit" does not attract contra-side liquidity.
- The Committee believes that the interconnectedness of the trading on May 6 and the fragility of electronic equity markets during periods of extreme price volatility underscore the need to review the present operation of the system-wide circuit breakers. The Committee therefore recommends that the SEC and CFTC consider: (1) reducing the initial trading halt to a period of time as short as ten minutes, (2) allowing the halt to be triggered as late as 3:30pm, and (3) using the S&P 500 Index as the triggering mechanism.

Restrictions on Co-location and Direct Access

The report makes several recommendations relating to issues associated with high frequency trading, particularly "co-location" and direct market access. The report states that one of the most notable developments which has greatly facilitated the growth and evolution of high frequency trading has been the ability of individual firms to co-locate their routing technology with the market and limit book technology of the exchanges. The report also notes that the direct market access of large numbers of unregulated, and in many ways, unsupervised entities creates risks of erroneous trades or manipulative strategies.

- The Committee supports the SEC's "naked access" rulemaking and urges the SEC to work closely with FINRA and other exchanges with examination responsibilities to develop effective testing of sponsoring broker-dealer risk management controls and supervisory procedures.
- The Committee recommends that the CFTC use its rulemaking authority to impose strict supervisory requirements on certain market participants that employ or sponsor firms implementing algorithmic order routing strategies and that the CFTC and the SEC carefully review the benefits and costs of directly restricting "disruptive trading activities" with respect to extremely large orders or strategies.

Liquidity Enhancement Issues

The report states that while the steps taken by the SEC and CFTC and the recommendations made by the Committee would improve the ability of the equity and related derivative markets to handle another event like the flash crash, there remain legitimate concerns over the absence of incentives for market participants to provide liquidity under the present market structure. The Committee therefore focused on several areas that might positively impact liquidity.

Liquidity Pricing and Liquidity Rebates

The Committee suggests that the SEC and CFTC consider permitting incentives to supply liquidity that vary with market conditions, i.e., a "peak load pricing solution" to encouraging liquidity that would involve both market access fees and rebates that would rise in volatile markets.

- The Committee recommends that the SEC evaluate the potential benefits which might be gained by changes in maker/taker pricing practices, including building in incentives for the exchanges to provide for "peak load" pricing models.

Market Maker Obligations and Order Cancellations

The report discusses several issues relating to current market maker obligations and the rise in the number of cancelled orders. Significantly, the report states that the SEC and CFTC should consider addressing the disproportionate impact that high frequency trading has on exchange message traffic and market surveillance costs. The report adds that, at a minimum, market participants employing certain strategies should properly absorb the externalized costs of their activity.

- The Committee recommends that the SEC evaluate whether incentives or regulations can be developed to encourage persons who engage in market making strategies to regularly provide buy and sell quotations that are "reasonably related to the market."
- The Committee recommends that the SEC and CFTC explore ways to fairly allocate the costs imposed by high levels of order cancellations, including perhaps requiring a uniform fee across all exchange markets that is assessed based on the average of order cancellations to actual transactions effected by a market participant.

Preferencing, Internalization, and Routing Protocols

The report states that another area which has impacted the displaced liquidity of exchange markets is the substantial expansion of order flow that is executed by individual broker-dealer firms through "internalizing" their customer's order flow or as a result of agreements with order routing firms "preferencing" their order flow to a particular broker-dealer, usually as a result of a payment for order flow agreement. The report states that the impact of the substantial growth of internalizing and preferencing activity on the incentives to submit priced order flow to public exchange limit order books deserves further examination. The report also states that a related concern has to do with the effects of the current routing protocols on the overall incentive to place orders providing liquidity in the public markets.

- The Committee recommends that the SEC conduct further analysis regarding the impact of a broker-dealer maintaining privileged execution access as a result of internalizing its customer's orders or through preferencing arrangements. The SEC's review should, at a minimum, consider whether to (1) adopt its rule proposal requiring that internalized or preferenced orders only be executed at a price materially superior to the quoted best bid or offer, and/or (2) require firms internalizing customer order flow or executing preferenced order flow to be subject to market maker obligations that requires them to execute some material portion of their order flow during volatile market periods.
- The Committee recommends that the SEC study the costs and benefits of alternative routing requirements, in particular, that the SEC consider adopting a "trade at" routing regime. The Committee further recommends analysis of the current "top of book" protection protocol and the costs and benefits of its replacement with greater protection to limit orders placed off the current quote or increased disclosure of relative liquidity in each book.

Information Provision

The report states that enhanced information provision is consistent with the long-standing view of the SEC and CFTC that market-based solutions play a preferential role in the efficient functioning of markets.

- The Committee recommends that the SEC and CFTC consider reporting requirements for measures of liquidity and market imbalances for large market venues.

Regulators' Access to Information

The report discusses the importance of access by regulators to certain information about the securities markets and participants in those markets.

- The Committee recommends that the SEC proceed with a sense of urgency, and a focus on meaningful cost/benefit analysis, to implement a consolidated audit trail for the U.S. equity markets and that the CFTC similarly enhance its existing data collection regarding orders and executions.

Ari Burstein
Senior Counsel - Securities Regulation

endnotes

[1] The report, "Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010," can be found on the SEC's website at http://www.sec.gov/spotlight/sec-cftcjointcommittee/021811-report.pdf.