Joint CFTC-SEC Advisory Committee Recommends Transformative Market Changes in the Wake of May 6th Flash Crash

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On February 18, 2011, the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues (the "Committee") issued a report entitled Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010 ("Report"), setting forth its recommendations for regulatory action by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") (collectively, "the Commissions") in the wake of the so-called "flash crash" of May 6th.[1] The Committee recommends substantial changes to certain widespread market practices, as well as more incremental changes to certain of the Commissions' current market regulatory initiatives. Taken together, implementation of the Committee's recommendations would have a significant, transformative effect on the operation of the U.S. markets and their participants.

I. Recommendations for Significant Regulatory Changes

The Report makes various recommendations that, if adopted, would have substantial, far-reaching effects on the current operation of the U.S. markets:

- Enhancing Liquidity Through Changes to Maker-Taker Pricing Models. The Committee notes that "incentives to display liquidity may be deficient in normal markets, and are seriously deficient in turbulent markets." Therefore, the Committee suggests that the Commissions consider incentives to supply liquidity that vary with market conditions. In particular, 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. The Committee recognizes, however, that there are reasonable counterarguments to such peak load fee changes, such as the possibility of increased internalization.
- Incentives to Regularly Provide Quotes Reasonably Related to the Market. Although the Committee is "chary of overdependence on market maker obligations as a solution to market liquidity," the Committee believes that the Commissions should consider encouraging, through incentives or regulation, persons who regularly implement market

maker strategies, such as firms engaging in high frequency trading ("HFT"), to maintain best buy and sell quotations that are reasonably related to the market. Such incentives could include differential pricing or preferential co-location provisions.

- Allocation of Costs for High Levels of Order Cancellations. The Committee expressed concern about the disproportionate impact that HFT has on exchange message traffic and market surveillance costs. The Committee recommends that the SEC and the CFTC explore ways to fairly allocate the costs associated with high levels of message traffic, including order cancellations, to market participants generating them. For example, the regulators may assess a uniform fee across all markets that is calculated based on the ratio of order cancellations to actual transactions effected by a market participant.
- Re-examination of Internalization Practices. The Committee noted 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."[2] In particular, the Committee recommends that the SEC should, at a minimum, consider whether to (1) require that internalized or preferenced orders only be executed at a price materially superior (*e.g.*, 50 mils for most securities) 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 require them to execute some material portion of their order flow during volatile market periods. The first alternative would eliminate the current practice of quote matching by requiring material price improvement for internalized orders.
- Consideration of Alternative Routing Regimes. Related to the internalization issues, the Committee also expressed concern about "the effects of the current routing protocols on the overall incentive to place orders providing liquidity in the public markets." As a result, the Committee recommends that the SEC consider adopting a "trade at" routing regime in which orders must be routed to one or more markets with the best displayed price. This contrasts with the current practice in which venues cannot "trade through" a better price displayed on another market, but can retain and execute the order by matching the current best price even if it has not displayed a publicly accessible quote order at that price. In addition, the Committee recommends analysis of the costs and benefits of replacing the current "top of book" trade-through protection protocol with "depth of book" protection. The Report recognizes, however, that such changes in routing practices may entail substantial technology and implementation costs and may adversely impact some forms of competition.
- Broader Public Dissemination of Liquidity Imbalances. The Report also supports the broader public dissemination of information regarding liquidity imbalances in larger trading venues, including information related to the state of the limit order book and the market, the current buy/sell ratio of orders on the book, the rate at which orders are sent to the respective sides of the book, or other metrics related to the current state of liquidity in the market. The Committee believes that the disclosure of this information would provide a basis for market-generated responses to liquidity imbalances.

II. Recommendations for Enhancements to Current Regulatory Initiatives

The Committee also supports certain existing regulatory initiatives by the SEC and the CFTC in the wake of May 6th, and recommends further enhancements or refinements to these initiatives:

- Expansion of Single Stock Pauses. The Committee supports the recent creation of single stock pauses/circuit breakers for the Russell 1000 stocks and actively traded ETFs, and recommends the expansion of the pause rules to cover all but the most inactively traded listed equity securities, ETFs, and options and single stock futures on those securities.
- Adoption of Limit Up/Limit Down Process. In light of concerns about the limitations of the single stock pauses, including the complete restriction on trading as well as the continued possibility of erroneous triggering trades, the Committee recommends the implementation of a "limit up/limit down" process to supplement the existing pause rules (as is currently under consideration by the SEC). In addition, the Committee recommends that the Commissions clarify whether securities options exchanges and single stock futures exchanges should continue to trade during any equity limit up/down periods.
- Evaluation of Need for Second Tier of Pre-Trade Risk Safeguards for Derivatives Markets. The Committee fully supports the CME's use of five-second circuit breakers to allow for the entry of contra-side orders to correct an imbalance. The Committee, however, questioned whether a longer timeframe would better address the need for additional liquidity in all trading scenarios (*e.g.*, news-driven scenarios). Therefore, the Report recommends that the CFTC and the relevant derivatives exchanges evaluate whether a second tier of pre-trade risk safeguards with longer timeframes should be instituted when the five-second limit does not attract contra-side liquidity.
- Updating System-Wide Circuit Breakers. In light of the electronic nature of today's trading as well as the interconnectedness of the equity and derivatives markets, the Committee recommends updating the present system-wide circuit breakers. In particular, the Committee would (1) reduce, at least, the initial trading halt to a period of time as short as 10 minutes; (2) allow the halt to be triggered as late as 3:30 p.m.; and (3) use the S&P 500 Index, instead of the Dow Jones Industrial Average, as the triggering mechanism.
- Support for SEC's Prohibition of Naked Access. The Committee supports the SEC's adoption of the direct market access rule,[3] which prohibits broker-dealers from providing customers with "unfiltered" or "naked" access to an exchange or alternative trading system ("ATS") and requires risk management controls and supervisory procedures for brokers providing market access. The Committee also urges the SEC to work closely with FINRA and the exchanges with examination responsibilities to develop effective testing of sponsoring broker-dealer risk management controls and supervisory procedures.
- CFTC Rulemaking on Anti-Disruptive Trading. The Committee recommends that the CFTC use its rulemaking authority to impose strict supervisory requirements on designated contract markets or futures commission merchants 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.[4]
- Implementation of Consolidated Audit Trail. The Report also urges the SEC to "proceed

with a sense of urgency, and a focus on meaningful cost/benefit analysis," to implement its proposed consolidated audit trail.[5] Similarly, the Committee recommends the enhancement of the CFTC's existing data collection regarding orders and executions.

[1] Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010: Summary Report of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues (Feb. 18, 2011), *available at*www.sec.gov/spotlight/sec-cftcjointcommittee/021811-report.pdf. *See also* Preliminary Findings Regarding the Market Events of May 6, 2010: Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues (May 18, 2010), *available at*www.sec.gov/sec-cftc-prelimreport.pdf; Findings Regarding the Market Events of May 6, 2010: Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues (Sept. 30, 2010), *available at*www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/staff-findings050610.pdf.

[2] The Committee states that the percentages of order flow executed in this manner has sharply risen and is believed to account for over 20% of the share volume in listed equity securities. Report at 11.

[3]*See* Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 61379, 75 Fed. Reg. 4007 (Jan. 10, 2010); SEC Proposes Broad Changes for Broker-Dealers with Direct Access to ATSs and Exchanges, WilmerHale Client Alert (Feb. 3, 2010), available at www.wilmerhale.com/publications/whPubsDetail.aspxpublication=9392. *See also* Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 63241, 75 Fed. Reg. 69792 (Nov. 15, 2010); A Return to Modesty - The SEC Clothes Naked Access: Adoption of Risk Management Controls for Broker-Dealers with Market Access, WilmerHale Client Alert (Nov. 11, 2010), *available at*www.wilmerhale.com/publications/whPubsDetail.aspx?publication=9646.

[4]*See* Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 67301 (Nov. 2, 2010).

[5] Consolidated Audit Trail, Exchange Act Release No. 62174, 75 Fed. Reg. 32556 (Jun. 8, 2010); SEC Proposes Consolidated Audit Trail, WilmerHale Client Alert (June 9, 2010), *available at*www.wilmerhale.com/files/upload/Securities_Alert_6_9_10.pdf.

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