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What the SEC Staff Will Likely Recommend in Reaction to the May 6th Flash Crash

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Introduction

The SEC staff is likely to issue recommendations shortly for preventing another May 6th Flash Crash. Certainly, the staff has taken on a daunting task, with no shortage of critics questioning every move, but it should be congratulated for a diligent undertaking. That being said, we anticipate that the recommendations may be more on the order of temporary Band-Aids, although we still hold out hope for a pleasant surprise. While implementation of some technical fixes may decrease the likelihood of another May 6th, they will not address the root problems that have been exposed in our "Frankenmarkets." Those recommendations are likely to come later.

Ultimately, the investing public – and by that we mean traditional institutional and retail investors, managing pension, 401K and IRA money – will decide whether the committee has done enough to restore confidence. The Flash Crash erased $862 billion in equity value in 20 minutes. Since then through August, investors have withdrawn nearly $57 billion from U.S. stock mutual funds, the most during any four-month period since 2008, according to the Investment Company Institute. Third quarter average daily trading volumes are down more than 25% from the second quarter and down more than 15% year over year. Investors are as risk-averse today as at any point in the past 10 years, with the exception of the height of the financial system meltdown, according to the State Street investor confidence index.

The question is: How long can Wall Street sustain this situation?

Likely SEC Staff Recommendations

Based on the preliminary findings of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, existing SEC proposals and comments from market participants, we believe the SEC staff will make four major recommendations:

1. *Alter the existing single stock circuit breaker to include a limit up/down feature.* The SEC has implemented a single stock circuit breaker (SSCB) pilot program which halts any stock currently in the program for five minutes if the price moves 10% or more in the preceding five minute period. We commented to the SEC that the current program was triggering unnecessary halts. To improve the SSCB, we recommended that before a halt is issued, a minimum number of trades at the threshold level should have to occur. We also recommended that the National Best Bid and Offer (NBBO) should be checked before the halt is issued. Other commenters have recommended that the SEC revise the halt process to a limit up/down feature similar to what is used in the futures market. We believe the SEC will alter the existing SSCB to include a limit up/down feature, as well as some form of price check and minimum number of trades, to prevent false triggers.

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2. *Eliminate stop-loss market orders.* Many investors that lost money on May 6th did so because they thought they were protecting themselves with stop-loss market orders. As the market melted down, these orders were activated and chased prices down a vicious spiral. These orders were not the cause of the Flash Crash per se, but they resulted in enormous damage to many unsuspecting traditional investors. The SEC has indicated that it may require market order "collars," effectively converting market orders into limit orders.

3. *Eliminate stub quotes and allow one-sided quotes (a stub quote is basically a place holder that a market maker uses in order to provide a two-sided quote).* When Accenture (ACN) traded at $0.01/share on May 6th, it traded against a stub quote. When asked about stub quotes at a May 11th Congressional hearing, SEC Chairman Mary Schapiro said: "When a market order is seeking liquidity and the only liquidity available is a penny-priced stub quote, the market order, by its terms, will execute against the stub quote. In this respect, automated trading systems will follow their coded logic regardless of outcome, while human involvement likely would have prevented these orders from executing at absurd prices." Stub quotes did not cause the May 6th flash, but May 6th exposed the practice of stub quotes and now the SEC will act to eliminate them. Exchanges also recently proposed a ban on stub quotes. They requested that all market makers be mandated to quote no more than 8% away from the NBBO for stocks in the circuit breaker pilot program and during the hours that the circuit breakers are in effect (9:45am-3:35pm ET). Exchanges proposed that market makers be mandated to quote no further than 20% away from the NBBO during the 15 minutes after the opening and 25 minutes before the close. We believe the price bands proposed by the exchanges will not fix anything. There is no need to have a quote 20% away from the NBBO. Simply allowing one-sided quotes that are within 5% of the NBBO is a better proposal.

4. *Increase market maker requirements, including a minimal time for market makers to quote on the NBBO.* There is currently an internal debate within the high frequency trading (HFT) community over increased obligations for market makers. Some larger HFTs are in favor of more obligations. These larger HFTs have recommended that market makers publish two-sided quotes that are "at the inside" of the NBBO for a minimum percentage of the day and have minimum size requirements. They also believe that market makers should provide 3-5 levels of price depth below the NBBO. In addition, the larger HFTs believe that market makers should have higher capital requirements. Some smaller HFTs have not supported these proposed obligations, however. They fear that the larger HFTs will be able to meet these obligations and, in return, the larger HFTs will receive advantages from the exchanges that market makers usually enjoy. According to these smaller HFT's, these advantages would include preferential access to the markets, lower fees and informational advantages. Smaller HFTs have warned that competition could be degraded and barriers to entry could be raised. We believe the SEC will side with the larger HFTs and impose their requested obligations.

In addition, we believe the SEC will signal that it will take action in the near future on four proposals that it already has recommended:

1. *Flash Order Ban.* After much public outrage more than a year ago, the SEC proposed banning flash orders. It has since published the proposal again for comment. In the meantime, flash orders are still being used by some exchanges.

2. *Market Access Rule.* Would require effective risk management controls for broker-dealers with access to markets, including those providing customers unfiltered or naked access to the markets.

3. *Large Trader Reporting System.* Would enhance regulators' ability to identify large market participants, collect information on their trades, and analyze their activity.

4. *Consolidated Audit Trail.* Would require the SROs to jointly develop, implement and maintain a consolidated order tracking system, or consolidated audit trail.

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What Really Needs to Be Done

Unfortunately, we have a crisis of confidence in our market structure. Until real and perceived inequalities and problems are rectified, that will continue to be the case, and we may continue to see investors flee. Investors want to know that another May 6th cannot happen again. They want to know that the market is fair and equal for all. And they want to know that the market is structured in a way such that pricing of assets reflects intrinsic values.

With that in mind, we believe the SEC staff should recommend much more substantive market reform. This is obviously a major undertaking that should be well thought out and careful attention needs to be paid to potential unintended consequences. Until then, we believe the following steps will help increase investor confidence and should be taken immediately:

1. *Mandate Fiduciary Language for Exchanges and Brokers.* Money managers have a legally binding duty to place all of their clients' needs ahead of their own profitability. It seems appropriate that this obligation be extended to brokers and exchanges regulated by the SEC. An exchange that is handling a slower participant's order would have the responsibility of protecting that order's intentions to the same degree it protects a more profitable participant's (high volume/co-located) order.

2. *Market Fragmentation.* Do we need 10 exchanges and more than 40 "dark pools"? Is that desirable? What is the value added that each one brings to the investment community? Our regulators should institute a broad, yet meaningful standard, against which it weighs the approval of any new exchange or ATS. Deference should be given to the SEC's stated mandate: "…To protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."

3. *Order Cancellation Fee / Minimum Order Life.* More than 90% of orders are cancelled. This potential overload of data to market centers is a clear systemic risk. Orders entered into the marketplace without the intention to trade threaten an orderly market. To control this risk, we would like to see a fee imposed on cancellations. In addition, we would like a minimum order duration of perhaps one second or at least long enough so that the market's slowest participant can still be afforded the opportunity to act on a quote.

4. *Eliminate the Maker/Taker Model (pioneered by the Island ECN more than a decade ago).* Maker rebates encourage volume for the sake of volume. This has generated high volume among the top 100 stocks, giving the illusion of a deep, liquid market. A good percentage of this volume is from firms engaged in rebate arbitrage, however. Rebate arbitrage is highly complex, involving the arbitraging of numerous trading destinations, each with separate incentives and rates, such that participating in that game has little economic relevance and congruence with trading and investing in general. The activity is price-agnostic. The successful playing of this game does not require buying low and selling higher, or vice versa. One of the criteria that many investment managers use when evaluating which securities to purchase is average daily volume (ADV). HFT "hot potato" volume is skewing the ADV statistics and could be distorting a key piece of information upon which many investors rely.

Conclusion

We believe that the intentions of the SEC staff are noble, but we know that it does not operate in a political vacuum. This is why we have laid out what we think it will recommend (with a glimmer of hope for something more substantive), while highlighting what we think the SEC really needs to do.

To regain public trust and confidence in our equity market, the SEC must undertake major reform. Such change faces two major challenges, however. It means admitting that the past decade of regulations have had serious unintended negative consequences. And it means going up against the HFT community, which is likely to do everything in its power to slow or water down the reform process.

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The HFT community will claim that if any serious reform is implemented, they will be driven out of the market, spreads will increase and liquidity will dry up. We agree that spreads will widen, but liquidity will not vanish; only HFT volume will. And if a slightly wider spread is the cost of getting our market back into the hands of the owners who are responsible for price discovery, then that is a cost that most investors will gladly pay, we believe. While explicit costs will go up, the implicit costs of reduced market confidence will plummet.

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