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

June 21, 2011

Via Electronic Mail: rule-comments@sec.gov

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Joint Industry "Limit Up-Limit Down" Proposal; File No. 4-631

Dear Ms. Murphy:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "SEC" or "Commission") on the joint industry National Market System ("NMS") plan to address extraordinary market volatility through a market-wide limit up-limit down mechanism (the "Plan").[2] As the Commission notes:

> The Participants filed the proposed Plan in order to create a market-wide limit up-limit down mechanism that is intended to address extraordinary market volatility in ''NMS Stocks,'' as defined in Rule 600(b)(47) of Regulation NMS under the Act. The proposed Plan sets forth proposed procedures that provide for market-wide limit up-limit down requirements that would be designed to prevent trades in individual NMS Stocks from occurring outside of the specified Price Bands. These limit up-limit down requirements would be coupled with Trading Pauses, as defined in Section I(X) of the proposed Plan, to accommodate more fundamental price moves (as opposed to erroneous trades or momentary gaps in liquidity).[3]

MFA is generally supportive of a market-wide limit up-limit down mechanism. We believe the limit up-limit down mechanism has been successful in other markets and has the potential of addressing extreme market volatility in the equity markets with fewer unintended consequences than single-stock circuit breakers. In our letter, we raise some important concerns

[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 $2.0 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Joint Industry Plan, 76 *FR* 31647 (June 1, 2011) [hereinafter "Joint Industry Plan"].

[3] *Id*. at 31647 (footnotes omitted).

for the Commission and Plan Participants[4] to consider with respect to the application of a limit up-limit down mechanism to the equity markets in order to avoid market disruptions and other unintended consequences under the Plan. In particular, while the proposed trading limits[5] ("Price Bands") may operate in markets with large volumes and small spreads, we are concerned that problems may arise when the limits are applied to smaller, less-active instruments for which there is less prior experience from other markets. Further, we believe few events leading to trading pauses are likely to occur in Phase I, which will provide Participants with little experience for Phase II when more than 50 times the number of events may be expected given the broad application of the Plan.

I. Comments

1. Quotations Outside of Price Bands and Trading Pauses

The Plan provides that Participants shall establish practices that are reasonably designed to prevent the display of offers below the Lower Price Band and bids above the Upper Price Band for an NMS Stock.[6] We disagree with this aspect of the proposal, and feel that the Participants (or their members) operating trading centers should display all bids/offers not specifically marked as hidden orders that broker-dealers send to them and mark them non-executable if they are outside the limit bands.[7] We agree that the national best bid and offer ("NBBO") should be calculated based only on executable orders. However, we are concerned that censorship of valid orders can lead to unusual side effects when prices move. (*See* the WYNN example provided below where such requirement would have the effect of increasing the spread by 55%).

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[4] Plan Participants are: BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Incorporated, Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, The Nasdaq Stock Market LLC, National Stock Exchange, Inc., New York Stock Exchange LLC, NYSE Amex LLC, and NYSE Arca, Inc.

[5] The Plan provides that "Price Bands" shall be based on a Reference Price for each NMS Stock that equals the arithmetic mean price of Eligible Reported Transactions for the NMS stock over the immediately preceding five-minute period (except for periods following openings and reopenings). The Price Bands for an NMS Stock shall be calculated by applying the Percentage Parameter for such NMS Stock to the Reference Price, with the Lower Price Band being a Percentage Parameter below the Reference Price, and the Upper Price Band being a Percentage Parameter above the Reference Price. "The Price Bands shall be calculated beginning at 9:30 a.m. ET, and ending at 4:00 p.m. ET. Between 9:30 a.m. and 9:45 a.m. ET, and 3:35 p.m. and 4:00 p.m. ET, the Price Bands shall be calculated by applying double the Percentage Parameters set forth in Appendix A." *See* Joint Industry Plan at 31651.

[6] Joint Industry Plan, at 31652.

[7] *See, e.g.*, The Joint Industry Plan would provide:

> When one side of the market for an individual security is outside the applicable Price Band (i.e., when the National Best Bid is below the Lower Limit Band or the National Best Offer is above the Upper Limit Band for an NMS Stock), the Processor would be required to disseminate such National Best Bid or National Best Offer with an appropriate flag identifying it as non-executable.

76 *FR* at 31647. MFA believes that this approach is preferable for all orders, not just when one side of the market is outside of the applicable Price Band.

It is our understanding that some trading centers plan to re-price non-executable orders to a Price Band. While this may be a valuable option for some customers, others may want to place non-executable orders outside the Price Band in anticipation of the Price Band moving in order to obtain a better price and have queue priority. At a minimum, the broker-dealer entering the order on behalf of the customer should have the option of repricing or posting the order in accordance with the customer's wishes.

The plan provides that "No trades in an NMS Stock shall occur during a Trading Pause, but all bids and offers may be displayed."[8] In order for participants to have adequate information about the market, we believe that all bids and offers should be displayed during that period. Otherwise, exchanges (and perhaps some customers) will have information about the market that is not widely disseminated. Displaying such bids and offers will provide investors with real-time transparency and information on the trading interest.

2. Price Band Size Changes

The Plan provides that between 9:30 am and 9:45 am ET, and 3:35 pm and 4:00 pm ET, the Processor for each NMS stock shall calculate Price Bands by applying double the Percentage Parameters (*i.e.*, 10%).[9] We are concerned that the Plan's inconsistent calculation of Price Bands (*i.e.*, from 10% to 5% to 10%) will lead to irregularities even in orderly markets. We set forth the example of Wynn Resorts, Limited, stock on October 10, 2008, to illustrate our point.

Example: WYNN (Wynn Resorts, Limited) on October 10, 2008.

- Between 9:42 am and 9:45 am, the stock price increased from $52 to $59 – approximately a 13% move. If the Plan had been in effect, the Price Band would have been 10% before 9:45 am. Since the Reference Price was moving, the rule would not have prohibited any trades.

- At 9:45 am, the Reference Price would have been around $55.50, and the Price Bands would have shrunk to 5% – the Upper Price Band being around $58.28. The quote at that time was $58.84 by $59.85 – as a result, both the bid and ask would have become invalid (and the bid would have become un-displayable). The NBBO spread would have increased artificially by 55% (the best bid displayable would have been at the Upper Price Band), and whether a limit state is entered would have depended on whether a stale bid happened to be in the book at the upper band.

If Plan Participants believe that the wider 10% Price Bands for Tier 1 instruments are necessary in the morning and afternoon, the Plan would need to include provisions to address the Price Band transition period to avoid making a valid market price suddenly invalid. We recommend that the most straightforward approach would be to keep the Price Bands constant

[8] Joint Industry Plan, at 31652.

[9] Joint Industry Plan, at 31651, 31653.

throughout the day at the 10% level. As a general principle, open markets should be allowed to adjust to news whenever it occurs. In addition, we believe the 10% price band used by trading centers under the stock-by-stock circuit breaker program has worked well and that a 10% Price Band would generally be effective under the Plan.[10]

3. Low Volume Stocks

Under the Plan, low volume stocks present challenges where displayed spreads exceed the 10% Price Band. For such a stock, the opposite quote would become non-executable after a trade. Further, the only way to legally trade would be to wait for a dark execution inside the Price Band (and thus, changing the Reference Price). We set forth the example of Hallador Energy Company stock on April 12, 2011, to illustrate our point.

Example: HNRG (Hallador Energy Company) on April 12, 2011.

- On April 12, 2011, at 10:25 am, the NBBO was 200@10.77 by 700@11.99. There had been no trades in the last 5 minutes.

- At 10:50 am, there was an execution at the bid for 10.77. Under the Plan, 10.77 would have become the Reference Price, and the ask would no longer have been an executable quote. A buyer would be forced to either wait for an execution in a dark pool, which would move the Reference Price, or to wait for an offer at the Price Band price.

- Under the Plan, essentially, there would be no valid market in this instrument as the market-determined spread is larger than the 10% Plan Price Band.

There are many other examples of thinly-traded stocks whose markets would be disrupted under the Plan (most priced between $1-$3) as a 10% Price Band would be too tight for the instrument. We respectfully urge the Commission and Plan Participants to keep in mind that small cap stocks have different trading characteristics from large cap stocks. Accordingly, the Commission and Plan Participants will not gain useful experience on the impact of a limit up-limit down mechanism on small cap stocks during Phase 1 of the Plan, as Tier 1 stocks almost all have high volumes and narrow spreads. We are concerned that the Plan would create greater market disruptions in the trading of small cap stocks as the market-determined spread for these instruments is often greater than a 10%, or even 15%, Price Band. Therefore, we believe that the Plan should be limited to Tier 1 stocks, and that Phase II (section VIII(B)) should not be implemented.[11] If the Commission and Plan Participants feel strongly that a limit up-limit down mechanism should apply to small cap stocks, then we respectfully urge it to consider reducing the number of Tier 2 NMS stocks to a small test group.

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[10] *See* Exchange Act Release No. 62252 (June 10, 2010), *available at:* http://www.sec.gov/rules/sro/bats/2010/34-62252.pdf.

[11] We believe the Plan should not apply to stocks less liquid than those in the Russell 1000.

4. Reference Price Calculation

Under the Plan, the Processor shall calculate a Pro-Forma Reference Price on a continuous basis during regular trading hours, and only if the Pro-Forma Reference Price has moved by 1% will a new Price Band be disseminated.[12] This formula for calculating the Reference Price implies that market participants who would like to know when the Reference Price will change would have to keep track, on a tick-by-tick basis, of when the moving average has changed by 1%. We recommend what we believe to be a simpler approach—calculating a new Reference Price on regular 30 second intervals, regardless of whether it has changed by 1%. This simplification also obviates the definition of a Pro-Forma Reference Price. An opening after a Trading Pause would still become the new Reference Price, and the next Reference Price would be computed at the next regular 30-second schedule.

Further, we believe a more accurate reference price could be calculated using a volume-weighted average price ("VWAP") instead of a simple average of the ticks. This removes the possibility of participants splitting orders in different ways to affect the Reference Price calculation.

5. Exiting a Limit State and Trading Pauses

The Plan provides that trading for an NMS Stock shall exit a Limit State if, within 15 seconds of entering the Limit State, the entire size of all Limit State Quotations are executed or cancelled.[13] If trading for an NMS Stock exits a Limit State within 15 seconds of entry, the Processor shall immediately calculate and disseminate updated Price Bands.[14] If trading for an NMS Stock does not exit a Limit State within 15 seconds of entry, then the Primary Listing Exchange shall declare a Trading Pause.[15] We are concerned that the exit from a Limit State is arbitrary and may be easily manipulated. Under the Plan, it's not clear to market participants from moment to moment whether a trading pause will be declared or whether the Price Bands will suddenly be adjusted. Exiting a Limit State would depend upon the timing of an order that could clear out the Limit State quotation and when a new limit order arrives at the Limit State quotation.

A market where only one side of the book is executable (*e.g.*, ask is legal but bid is not, or vice-versa) is not a viable market—as a market participant is only allowed to buy but not sell. Marketable sell orders do not exist in this environment. We believe that a simpler and more useful framework is: (1) to enter a Limit State, where there will be no executable buys or sells, or both; that is, either the best bid is outside the Price Bands, the best ask is outside the Price Bands,

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[12] Joint Industry Plan, at 31651.

[13] *Id.*

[14] *Id.* The updated Price Bands will be based on a Reference Price that equals the arithmetic mean price of Eligible Reported Transactions for the NMS Stock over the immediately preceding five-minute period (including the period of the Limit State).

[15] *Id.*

or both; and (2) declare a Trading Pause if either the bid or the ask, or both, remain outside a Price Band for 5 seconds. Also, potentially this approach may encourage displayed orders versus hidden orders in a volatile market as market participants wanting to execute orders near a Price Band would be encouraged to define a price to avoid entering a Limit State or Trading Halt.

6. Entering a Limit State

The Plan provides that all trading for an NMS Stock shall enter a Limit State if the National Best Offer equals the Lower Limit Band and does not cross the National Best Bid, or the National Best Bid equals the Upper Limit Band and does not cross the National Best Offer.[16] We are concerned that requiring the NBBO to be equal to the Upper Price Band in order to enter a Limit State may create some unusual market discrepancies. Would it be possible to not have a Limit State, but still have the market frozen? In the above example with WYNN, if there wasn't a stale order at the Upper Price Band, a buyer would have to wait for orders to come in at the Upper Price Band before being able to execute a trade. Our concern is that buyers may not submit orders if the Upper Price Band is sufficiently far away from the market. Our recommendation in the previous section addresses this issue; if either the best bid or ask is outside the Price Band, the market enters a Limit State and has 5 seconds to readjust before a Trading Halt.

7. Impact on Indexed ETFs and Derivatives

Another issue we raise for the Commission and Plan Participants to consider is that both the circuit-breaker rules and the Plan may have the unintended effect of impairing liquidity in indexed exchange-traded funds ("ETFs") or derivatives in a volatile market. If one or more components of an index have a Trading Pause while others remain open, spreads of the index products are likely to increase due to the uncertainty of the price of the underlying instrument(s). Further, traders providing index arbitrage between the derivative/ETF and the underlying basket may decline to trade entirely under such circumstances if they do not have a way to hedge their risk.

8. Bad Prints

The Plan provides little guidance on what to be done with bad prints, which have the possibility of affecting a Reference Price. We recommend that the Plan include a more explicit definition for which prints are included in calculating a Reference Price. For example, if a tick price is outside the existing Price Bands at the time, it is not included in the calculation of the Reference Price.

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[16] The Joint Industry Plan, at 31652.

MFA appreciates the opportunity to provide comments on the Plan. We would be happy to discuss our comments with the Commission or Plan Participants in further detail or answer additional questions. 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
The Hon. Troy A. Paredes, Commissioner