

May 20th, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

RE: File Numbers:

SR-BATS-2010-014

SR-BX-2010-037

SR-NASDAQ-2010-061

SR-NSX-2010-05

SR-NYSE-2010-39

SR-NYSEArca-2010-41

SR-NYSEAmex-2010-46

SR-ISE-2010-48

SR-EDGA-2010-01

SR-EDGX-2010-01

SR-CBOE-2010-047

SR-FINRA-2010-025

Dear Ms. Murphy:

Molinete Trading Inc. appreciates the opportunity to comment on the Securities and Exchange Commission's proposed 'Stock-by-Stock Circuit Breaker Rule'.

Summary:

- A well defined and temporary market wide halt in certain securities during periods of extreme volatility is a reasonable approach towards attempting to tame volatile markets.
- The **proposed rules may exacerbate market volatility** rather than reduce it due to the inter-play of stock circuit breaker rules, erroneous trade rules, and market participants reactions to securities nearing either threshold. **Minor modifications to the proposed rule are required.**
- Circuit breakers **designed off of the NBBO would be more effective controls than circuit breakers which utilize last trading price.**
- The current proposal omits certain edge cases leaving the possibility of different rule interpretations and implementations at listing exchanges.
- The implementation of a circuit breaker **triggered off of a rolling 5 minute window** of last trade prices may **create performance issues at listing exchanges** during periods of peak volatility. That **in turn would increase market quote latency which discourages further liquidity from entering the market.**

- **The short comment period and implementation period greatly increases the risks that our markets will experience a failure.** The desire to shore up our securities markets is understandable, but a rushed job is more likely to help recreate elements of the May 6th “Flash Crash” rather than prevent them.
- **Clarification regarding broken trade policies is at least as important towards maintaining orderly markets as stock circuit breakers.**

The SEC is to be commended for their excellent work to date on the analysis of the May 6th “Flash Crash”. As an active participant in ETF arbitrage, Molinete Trading Inc. is interested in preventing a repeat of the events of that day.

On May 6th, a combination of factors led many providers of liquidity in both ETFs and stocks to withdraw from the markets. While the SEC has already identified many of these elements in the Joint Report, two additional elements are important to consider:

1. The ARCA exchange, as noted by the SEC already was having difficulty before the major break in the markets. Either prior to or contemporaneous with Nasdaq declaring “self help” against ARCA, the latency on quotes from ARCA were routinely over 100ms delayed (Molinete Trading Inc. measures latency by analyzing the internal timestamp in the ARCA generated quotes vs. delivery time, and noted approximately 100ms delays in quotes at approximately 2:41PM). As the listing exchange and the most active trading venue for many ETFs and stocks, this loss of visibility into the ARCA order books for ETFs and their components during a period of very rapid price changes led to uncertainty in fair value price determination, which greatly discouraged participants from adding liquidity to order books for ETFs.
2. Uncertainty regarding when trades will be broken prevents the most sophisticated market participants from attempting to arbitrage the most egregious price dislocations for fear of having a single leg of a hedged transaction be broken. This uncertainty helps create a tipping point at which large market movements very far away from fair value are left uncorrected by usually active market participants for fear of adverse financial impact stemming from broken trades, further reinforcing movement of asset prices away from fair value.

As the joint commission has already noted, the rapid drop in prices seen on certain issues starting after 2:40PM on May 6th was caused by market orders and stop loss orders (which are in turn market orders) sweeping through thin order books. There are many reasons why the bid side of the markets dried up on May 6th, including the above 2 points as well as those covered in the Joint Report (in particular, the mismatch between the NYSE LRP and other exchanges, and the declaration of self help against ARCA), however **it is not possible to foresee every possible set of conditions which might create similar gaps in consolidated order books in the future.**

The successful operation of last trade price based circuit breakers in other markets is encouraging, however the multiple trading centers operating under reg-NMS in the United States makes those foreign

examples materially different from their US counterparts. Given the breadth of US market centers and the enormous efforts placed on determining the national best bid and ask for a security, the NBBO in the US markets serves as the most obvious choice for a US equity market based trade halt. **Circuit breakers built off of the NBBO importantly could prevent trading when there is a lack of liquidity** for a security before any errant trades (which might need to be broken) crossed the tape.

In the stock circuit breaker proposal, the burden of declaring a temporary trading halt for a security lies with the listing exchange after noting a trade that is 10% or further away from other trades over a rolling 5 minute window. As such, **the commission's proposal enacts a trading halt after a trade has already crossed the consolidated tape driving down (or up) a stock price.** Given the inter-linkage between various stocks and derivative products (stock options, stock and index futures, ETFs), a stock halted at an artificially low (or high) price will have other ripple effects throughout the market. It is therefore highly desirable to prevent such low (or high) priced trades from crossing the tape.

The commission also requires the **listing exchange to filter the consolidated trades such that erroneous trades do not accidentally trigger a trading halt, without however providing further clarification or harmonization about such erroneous trade rules.** The inability of market participants other than the listing exchange to determine the conditions under which a trading halt will be called will surely cause some participants watching the consolidated tape to pull out of markets prematurely, under the mistaken belief that a halt is imminent. That withdrawal of liquidity may create a self fulfilling prophecy of a trading halt. As such, **it is in the best interest of the securities markets for all participants to be able to accurately and independently determine when a stock will be subject to a trading halt, without having to wait for a determination** (perhaps human in nature) **about an erroneous trade** to be made.

With the new circuit breaker proposal in place and in the absence of an automatic filter for erroneous trades, it is possible that a wave of market orders sweeping through thin order books will once again execute against stub quotes. If for instance there were tightly coupled bids in the consolidated order book for a security all within 10% of the last trading price over the last 5 minutes, followed by a gap in bids down to very low levels (i.e. stub quotes or other very low price points), it is easy to envision a wave of market orders moving through the existing bids, causing an orderly drop in a security price, followed by a trade at an exceedingly low price (i.e. perhaps 1 penny). **The current proposal would not prevent such a trade from occurring, and would instead halt trading immediately after the execution** against a stub quote, "painting" the tape **at an extremely low (or high) level** for the duration of a trading halt. In fact, **the knowledge that a trade halt will be instigated after a price movement of 10% or more in a 5 minute window will likely cause such a gap in the order books to be common place,** as liquidity providers seek to not add liquidity near or over circuit breaker points for fear of being left with an illiquid position.

In a market where large price movements are caused in part by a loss of liquidity, **discouraging liquidity providers from actively participating in the markets due to uncertainty of future trading halt determinations and erroneous trade rulings exacerbates the problems caused by a lack of liquidity.** The proposal contemplates that the listing exchange could determine whether a trade was erroneous

and not subject to triggering a trade halt, but given the lack of uniformity (and well defined automatable process) with regard to errant trade determinations, this carve out creates further confusion for market participants. The inability of market participants other than the listing exchange to determine whether and when a trading halt will be called for a security will prevent sophisticated market makers and arbitrageurs from trading securities as they approach (or exceed) the 10% price movement window defined in the proposal, as many market participants will not choose to trade in a security that is subject to becoming illiquid at the exchange's sole determination.

The current proposal does not specify following a temporary trading halt as to whether the previous trading window of a security is to be used in determining new circuit breaker points on release from a halt. While the proposal does specify that trades prior to the start of potential circuit breakers (i.e. at market open) do not contribute to the rolling 5 minute window of trades, the proposal is silent with respect to the time period directly before a trading halt (i.e. **do the 5 minutes before a halt get utilized upon a resumption, or is no history initially gathered on trading resumption similar to the morning's opening process?**). This further lack of clarity produces edge cases (only one of which I have explored here) which will further detract from market participants willingness to enter illiquid markets. **All of the potential edge cases could clearly be resolved and well defined, however the time period allowed for comment on this proposal, and the rapid pace of development by exchanges will possibly lead to unexpected outcomes.**

The desire to act swiftly following the events of May 6th is understandable, however a rush to complete complex tasks that have not been properly vetted may further exacerbate market structure issues. According to the SRO filings, the initial roll-out of stock based circuit breakers will take place on June 7th. As a software engineers (with greater than 20 years of professional experience) and a developer of complex trading algorithms, this timeline seems overly aggressive. A rolling 5 minute trade price window off of which potential trade halts are declared is conceptually simple, however performing such a check following each trade is computationally very challenging. This increased load could potentially slow down matching engines or quote dissemination to the point where market participants choose to withdraw from the markets (as happened on May 6th with ARCA). **A poorly designed algorithm to implement the proposed circuit breaker logic could materially slow down the exchange servers during periods of peak volatility further causing a withdrawal of liquidity, and the rapid deployment timeline for the proposed circuit breakers may very well lead to sub-optimal technology implementations.**

The current proposal in conjunction with anticipated clarity over erroneous trade determinations leads open the possibility of manipulation of a stock price. Suppose a trader with a large short position in a related asset (stock option, index containing a particular stock etc.) sees a stock trading down with a thin order book. If that stock has moved downward in an orderly process (i.e. no great gaps in trading price triggering an erroneous trade determination) and the stock had moved down by 9% (i.e. less than the circuit break amount) and has effectively cleared the bids from the consolidated order books, it would be trivial to:

- Place a small order to buy shares at a price just above the maximum price that would be considered an erroneous trade.

- Wait for an order to execute against that bid
- Establish a new price much lower than the previous last trading price
- Effect a halt of the security
- Profit from the market recalculation of related assets, which would likely move down as well.

For the above reasons, Molinete Trading Inc. believes that while the concept of stock circuit breakers is valid, they must be implemented such that they are based off of a withdrawal of liquidity (as measured by the spreads on the NBBO) – which precedes a trade crossing the tape, rather than immediately after a trade has been executed.

Molinete Trading Inc. believes that **circuit breakers triggered off of moves in the NBBO prices in conjunction with well defined erroneous trade rules would lead to more stable markets**. By allowing all participants with access to the consolidated NBBO equity feeds to make determinations about the likelihood of future trading halts and broken trades, liquidity providers would not prematurely be discouraged from participating in highly volatile markets.

As many commenters noted in discussion of various short-sale restrictions, it is easier to coordinate action in today's fragmented marketplace by utilizing NBBO prices rather than relying on potentially delayed or otherwise inaccurate last-trade prices.

Many different approaches with regard to NBBO triggered circuit breakers could be applied. Examples include:

- 10% movement in the NBBO midpoint over a 5 minute window
- A 10% movement in either the NBBO bid or ask over a 5 minute window.
- A 10% movement in either the NBBO bid or ask from the last trading price, triggering something akin to a morning auction process.

I encourage the SEC, FINRA and the SROs involved to all take the required time to analyze the implications of various circuit breaker implementations on the fragmented US markets, and to give ample time for the public to comment on said structures and the software development and quality assurance teams at the various SROs to safely implement these non-trivial changes.

Sincerely,

Peter Skopp
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