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

August 14, 2012

Via Electronic Mail:

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Computer Trading & Risk Management Issues

Dear Chairman Schapiro:

Managed Funds Association[1] ("MFA") respectfully submits this letter to provide the Securities and Exchange Commission ("SEC" or the "Commission") with our comments and suggestions on issues that have been raised in the media and elsewhere after the events of Wednesday, August 1, 2012, concerning Knight Capital Group Inc. ("Knight Capital"). At the outset, MFA notes that it is not commenting on the specific facts surrounding Knight Capital. We appreciate that the Commission and other regulators will be examining these events from a variety of perspectives. MFA is not in possession of all of the facts surrounding Knight Capital and even if we were, we believe it would be inappropriate for us to comment specifically on Knight Capital at this juncture. Instead MFA believes that the August 1st events and other market disruptions such as the events of May 6, 2010, have begun a conversation about how to best protect the structure of our equity markets to ensure their efficient and effective functioning for investors, entities raising capital, and other market participants. Our members are investors themselves and are fiduciaries to the investors who entrust their funds to them. Accordingly, MFA members have a strong interest in markets that operate efficiently and with integrity. MFA and its members believe that the Commission should examine the recent events thoughtfully and work with all interested parties to consider what additional steps may need to be taken to enhance the integrity of our market structure as well as to improve investor confidence.

MFA consistently has supported the Commission's efforts to implement a robust regulatory framework that fosters innovations in technology and promotes greater competition among marketplaces. We are strong proponents of advancements in technology in the markets,

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

which have empowered investors, both institutional and retail, with more efficient methods to access the markets and execute their investment strategies globally. The Commission's thoughtful recent changes to regulations proved to achieve their intended purposes as demonstrated on August 1st. The circuit breakers and the certainty provided by the rules on addressing erroneous trades afforded containment as well as speedy resolution to incidents that, in the past, would have taken days to resolve.[2] Nevertheless, as the markets of the 21st century are largely, and will become ever more, interconnected and the need for technology will only increase, we believe that all market participants and regulators should take responsible steps to prepare for this continuing market evolution. Preparation in advance can only provide for increased robustness and confidence in our markets. Accordingly, we offer the below suggestions based on what we believe should be best market practices.

MFA also notes that to the extent the Commission endorses these suggestions it may wish to consider alternative approaches to implementing them. For example, the SEC may wish to consider adopting interpretive guidance, amending existing rules, encouraging self-regulatory organizations such as the Financial Industry Regulatory Authority ("FINRA") to adopt rules for broker-dealers, or encouraging industry groups to endorse sound practices. We believe the Commission should consider all of these alternatives as part of a comprehensive strategy.

1. Strong Risk Management Controls

We believe that the Commission should examine whether technology implementation controls for market participants, including brokers–dealers, need to be enhanced. We commend the Commission for its recent adoption of Rule 15c3-5 and note that MFA supported it at the time of its adoption.[3] We now believe that the Commission should reevaluate that rule to be sure that it addresses the industry's growing reliance on technology. We note that Rule 15c3-5(b) provides that:

> A broker or dealer with market access, or that provides a customer or any other person with access to an exchange or alternative trading system through use of its market participant identifier or otherwise, shall establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity.

---

[2] *See* Error by Knight Capital rips through stock market, Reuters, Aug. 1, 2012. The trading caused pauses in trading in five stocks: Corelogic Inc, China Cord Blood Corp, Kronos Worldwide, Trinity Industries and Molycorp.

[3] *See* letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, to Ms. Elizabeth M. Murphy, Secretary, SEC, March 29, 2010, File No S7-03-10, available at https://www.managedfunds.org/wp-content/uploads/2010/03/MFA-Comments-on-BD-Risk-Mgmt.3.29.10.pdf. We note that the Commission was concerned that customers, such as hedge funds, would have "naked sponsored access" to broker-dealer's trading systems without appropriate protections. MFA supported the framework of Rule 15c3-5 to address that basic concern.

Accordingly, we believe that the pre-trade risk management controls required for customer transactions, which were part of eliminating "naked sponsored access", applies equally to broker-dealers as to their customers. The rule requires broker-dealers to adopt financial risk management controls and supervisory procedures that, among other things, are reasonably designed to "prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate"[4] In light of the increasing globalization of our markets and the need for technology to support this new paradigm, the Commission may also want to consider whether a broker-dealer's pre-trade risk management controls should include checking credit or capital thresholds on an order-by-order basis or during a very short period of time.

Further, we believe the Commission may want to consider whether a broker-dealer should have a separate group within its firm, such as a technology advisory group, to review or perform its pre-technology release reviews or to develop technology risk assessments.

Finally, we believe that the Commission, in conjunction with other industry participants (exchanges, broker-dealers, and investment managers) should consider providing guidance with respect to the supervisory procedures under Rule 15c3-5 for installations of new electronic trading programs or software upgrades. For example, SEC guidelines could suggest or require that a technical manager review and confirm that the firm has taken reasonable steps in making material software changes or upgrades and that the technical manager certifies to senior management that he or she reasonably believes that the broker-dealer: (1) has undertaken appropriate testing and performed appropriate market simulations; and (2) has complied with its policies and procedures for software installations.

2. Live Simulations and Robust Systems Testing

We believe that rules or industry practice should encourage more robust and more routine testing of trading software at the exchange or liquidity centers. We understand that many, if not all, exchanges provide market participants a test facility to test trading software and algorithms, as well as offer test symbols/stocks to trade. In addition to individual testing, exchanges or liquidity centers also should offer integrated or holistic testing where a firm's software interacts with others. We believe it is important for testing of critical software to become more routine practice, especially testing the process for the suspension of a particular algorithm or trading software in the event an issue arises in a live environment. As you have wisely stated, "reliance on computers is a fact of life" in markets everywhere.[5] Given this reality, exchanges, broker-dealers and other market participants should conduct more routine testing of trading software to review for anomalies and interdependencies as markets evolve. In particular, we believe that the Commission should encourage testing from broker-dealers to market centers, which in many instances may be preferable to testing exclusively within a firm.

[4] *See* Rule 15c3-5(c)(1)(i) and (ii).

[5] Chairman Schapiro Statement on Knight Capital Group Trading Issue, SEC Press Release, August 3, 2012.

3. Control and Oversight of Electronic Trading Programs—Designated Principal

For an electronic trading program, MFA believes there should be at least one designated principal (such as a General Securities Principal at a broker-dealer) who is available and authorized at all times to suspend all or part of the firm's trading program in the event of a trading or software malfunction. Such a person should be "on duty" anytime the firm is trading and should have sufficient information flow to ensure appropriate action. MFA believes that it is important that market sponsors including broker-dealers have "plan-of-action" protocols including scenarios that include timely trading suspension based on specific software malfunctions or general disaster recovery events. Firm principals should have the ability through a "kill-switch" to turn off the trading program. Firms should periodically test the kill-switch and report such test results as part of its Rule 15c3-5(b) procedures and report the results to the relevant SRO.

4. Implement the Limit Up-Limit Down Mechanism

MFA supports the limit up-limit down mechanism as an effective means to address extreme market volatility in the equity markets with fewer unintended consequences than single-stock circuit breakers.[6] While the circuit breakers were successful in mitigating the unintended market volatility caused by Knight Trading's software implementation error, they only went into effect at 9:45 am. We know the Commission has approved on a pilot basis the limit up-limit down plan submitted by the national securities exchanges and FINRA, which is expected to become effective in February 2013.[7] We encourage the Commission to work with self-regulatory organizations to implement the limit up-limit down mechanism as soon as possible.

* * * * *

All market participants have a vested interest in keeping pace with market structure advancements including the corresponding technology requirements necessary to support these changes. These changes have made demonstrated improvements to market function in terms of lowering costs, increasing efficiency, and enhancing liquidity. MFA believes that as market structure and corresponding technology advances, we must also stay vigilant so that our reliance on technology doesn't introduce new risks that we are not prepared to manage. We are prepared to work with the Commission, its staff, and other market participants to develop guidelines, best practices and test protocols to appropriately manage risks while maintaining the progress that has been achieved in the past decades, and would look forward to discussing our comments. Please do not hesitate to contact the undersigned or Jennifer Han, Associate General Counsel, for more information at (202) 730-2600.

---

[6] *See* letter to Elizabeth M. Murphy, Secretary, SEC, from Stuart J. Kaswell, Executive Vice President & Managing Director, dated June 21, 2011 on the Joint Industry "Limit Up-Limit Down" Proposal, *available at:* http://www.managedfunds.org/wp-content/uploads/2011/06/MFA-Final-limit-up-limit-down.6.21.11.pdf.

[7] SEC Release No. 34-67091, May 31, 2012.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director
& General Counsel

CC: The Hon. Elisse B. Walter, Commissioner, SEC
The Hon. Luis A. Aguilar, Commissioner, SEC
The Hon. Troy A. Paredes, Commissioner, SEC
The Hon. Daniel M. Gallagher, Commissioner, SEC
Robert W. Cook, Director
Division of Trading and Markets
Norman B. Champ III, Director
Division of Investment Management

The Hon. Chairman Gary Gensler
The Hon. Commissioner Bart Chilton
The Hon. Commissioner Jill E. Sommers
The Hon. Commissioner Scott D. O'Malia
The Hon. Commissioner Mark P. Wetjen

Richard G. Ketchum, Chairman, Financial Industry Regulatory Authority
Daniel J. Roth, President and CEO, National Futures Association