From: Tim Quast <timquast@modernir.com>
Sent: Thursday, February 24, 2011 11:18 PM
To: DisruptiveTrading <DisruptiveTrading@CFTC.gov>
Subject: Re: Disruptive trading and monitoring algorithms
Attach: cftc_commentletter.pdf

Letter attached. If you need to text, please let us know.

Thanks,

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2/25/2011

US Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Disruptive Trading Practices, Monitoring Algorithms

Dear Staff and Commissioners:

I commend the Commission for its herculean effort to tackle that to which no collection of human beings should be tasked: monitoring and regulating the imponderable interactions of millions of sentient beings engaged in commerce.

We want to comment specifically on disruptive trading practices and considerations regarding monitoring algorithmic trading. We track trading patterns for public companies, applying sophisticated database and software tools to separate speculative and rational behaviors.

The shares of our constituents underpin a meaningful portion of trading through interconnected securities markets today. While our constituents are not producers of commodities alone but span the spectrum of industries, the various trading markets, as USC 15 Sec 78b(1)c says, "involve in large part the securities of issuers engaged in interstate commerce."

In addition, the structure of the various capital markets are increasingly conformed today such that classes of securities are intertwined through automated trading strategies and via swap agreements, and the incentive fees for the production and consumption of securities at exchanges continue to spread across asset classes.

<u>Disruptive Trading Practices</u>

Aren't we revisiting turf trod by legislatures and rule makers seventy-seven years ago? 15 USC 78b(3) says: "Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities…"

We have already prohibited "disruptive trading practices" through the Securities and Exchange Acts of 1933 and 1934, now codified as 15 USC 78b. Do we expect that redefining "disruptive" – and the principal

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complaint with the effort is that no one knows what that means – will accomplish what 77 years of experience hasn't? Might we be guilty of repeating the same exercise in vain hope of different results?

Second and of paramount importance, these "disruptive" practices to which the Dodd-Frank legislation referred are largely a byproduct of rules created to ensure liquid, efficient markets. The only way trades can be disruptive is if the rule structure is so rigid that in effect, all the trades that might be contrary to the disruptive ones must follow the same pattern. One need look no farther than the rule filings for the CFTC, FINRA, BATS Exchange, Direct Edge, and most importantly NYSE Euronext and NASDAQ OMX – which number in the hundreds each year – to understand why we have disruptive trades.

Each and every one of these rule filings must be approved by the Securities and Exchange Commission before the order types and their concomitant fees for matching trades or routing them can become effective. And this tirade of rules is what has produced a cornucopia of opportunity for disruption, most of it wrought by the very broker-dealers upon which the market relies for efficient functioning. This "maker/taker" construct has now spread from equities, to options, and increasingly to bonds and commodities.

In effect, if the CFTC is to implement rules to prevent "disruptive trading practices," it must contradict the SEC. Sociologists refer to this problem as "cognitive dissonance." An analogy: Suppose that a group assembles around an engine and drivetrain to address the problem of excessive rattling and the solution the group arrives at is to replace the chain driving the axels with a belt. A whine then develops, and another group determines that what must be done to solve the problem is to remove the belt.

This is a fitting analogy for our current market dilemma. Perhaps regulators should have the temerity to tell legislators that the enormity of regulatory redundancy is transforming our capital markets into a confederacy of dunces.

Monitoring Algorithms

Algorithms are a product of regulation. Traders did not simply decide one day, "Let's start trading with algorithms." First came the Order Handling Rules in 1997, through which the SEC hoped to "improve competition" by requiring exchanges to display electronic prices. If we want to retrace to the root cause of our distress, this is a good starting point. Don't mix "electronic trading" with other forms. Their purposes and time horizons differ.

But moving on, we came next to decimalization, an effort to constrain intermediary profits that should have been left to the markets. Regulations prestidigitated one hundred price points per dollar where there were previously sixteen. Now with electronic prices and narrow spreads, how were traders to keep pace? With computers.

Then came the Global Settlement of 2003, eliminating the capital-forming function of the sellside, predicated on valuable information. The sellside transformed in short order, through billions of dollars of investment, into information-technology and risk-management experts to the buyside, and principal traders. The algorithmic gold rush was on.

And that's why we have algorithms. To now suppose that we need to examine each for some form of compliance is once more, cognitive dissonance. Why not instead redress the flawed structure that has given rise to transient trading and the greedy pursuit of fleeting gaps? What's happened is that regulators and human nature have conspired to form the worst possible breed from intermingled DNA.

The Purpose of Capital Markets Regulation

Why do we regulate markets? For the same reason we referee sporting events: To perfect a free, fair and open interaction between creative and driven human beings.

Who are the players in the capital markets game? Number one, enterprising, creative businesses (particularly in equity markets but also true in commodity markets) in search of capital. Number two, the investors who want to take the risk to support them, for profit.

CFTC Commissioner Scott Omalia lamented February 24: "As of today, the Commission will have put out over forty various proposals since August, totaling around 975 Federal Register pages. If you were to lay those pages end-to-end lengthwise, they would stretch for 892 feet. That is more than the height of the Statue of Liberty from its base to the tip of the torch, with the Washington Monument balanced on top. I remain concerned that we are moving at a pace that makes it very difficult, if not impossible, for the public to dig out of that mountain of paper and piece together all of these new requirements in a meaningful way."

Has anyone, anywhere, considered whether a market with literally miles of rules is free, fair and open? Does it promote capital formation? Risk management? Is it attractive to the parties it's supposed to serve?

Look around. Two of every three public companies choose a foreign market. Our data show that but 10% of daily volume for companies from micro-cap to mega cap is driven by investment. The remaining 90% is a product of rules. Artificial, incentivized liquidity with little purpose but to automate transactions, profit from brief gaps and intermediate the intermediaries.

Why are we creating more rules to further the divide between a synthetic construct and reality? One of the problems regulators in 1934 hoped to address is codified in 15 USC 78b(3)b: to reduce the things that "hinder the proper appraisal of the value of securities."

Yet here we are, obfuscating the proper value of securities, discouraging "real" participants and turning all securities markets into places of such rigid, rules-driven conformity that risks are truly catastrophic. Risk diminishes through vibrant nonconformity and the decentralization of purpose. We're doing the opposite.

If we want to solve the problems plaguing our markets, we need to remove price controls and constraints that advantage machines, remove incentives the distort natural prices, and release market function from the cloistered minds of the few back into the proper hands of millions of energetic, bright, creative, profit-seekers. This alone is an infinitely sustainable construct.

Who will have the guts to stand up, speak the truth and do the right thing?

Yours truly,

Tim Quast
Managing Director