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Via On-Line Submission

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Via Electronic Mail: rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
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Washington, D.C. 20549

RE: Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010

The Futures Industry Association (“FIA”) has long been a proponent of strong risk management practices. We commend the work of the Joint CFTC-SEC Advisory Committee (“Committee”) and wish to provide comment on the *Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010*. The FIA Market Access Working Group reviewed these recommendations in the context of the futures market on behalf of the FIA.¹

Managing the risks associated with electronic trading is a shared responsibility for executing and clearing brokers, trading firms and exchanges. FIA has published three papers to give specific guidance on various aspects of order entry and access to markets. The FIA published *Market Access Risk Management Recommendations* in April 2010. The FIA Principal Traders Group published *Risk Controls for Trading Firms* in November 2010. Most recently FIA published *Electronic Order Handling Risk Management Recommendations for Executing Brokers* in June 2011.

¹ The FIA formed the Market Access Working Group in January 2010 to address risk management issues related to direct access. The group consists of representatives from executing and clearing brokers, trading firms and both U.S. and non-U.S. exchanges.

I. Volatility

1. The Committee concurs with the steps the SEC (working with the Exchanges and FINRA) has taken to
 - a. Create single stock pauses/circuit breakers for the Russell 1000 stocks and actively traded ETFs
 - b. Enact rules that provide greater certainty as to which trades will be broken when there are multi stock aberrant price movements, and
 - c. implement minimum quoting requirements by primary and supplemental market makers that effectively eliminate the ability of market makers to employ 'stub quotes'
2. The Committee recommends that the Commissions require that the pause rules of the Exchanges and FINRA be expanded to cover all but the most inactively traded listed equity securities, ETFs, and options and single stock futures on those securities.
3. The Committee recommends that the SEC work with the Exchanges and FINRA to implement a "limit up/limit down" process to supplement the existing pause rules and that the Commissions clarify whether securities options exchanges and single stock futures exchanges should continue to trade during any equity limit up/down periods.
4. The Committee recommends that the CFTC and the relevant derivative exchanges evaluate whether a second tier of pre-trade risk safeguards with longer timeframes should be instituted when the 'five second limit' does not attract contra-side liquidity.
5. The Committee recommends that
The Commissions evaluate the present system-wide circuit breakers and consider:
 - i. reducing, at least, the initial trading halt to a period of time as short as ten minutes
 - ii. allowing the halt to be triggered as late as 3:30 p.m. and
 - iii. using the S&P 500 index as the triggering mechanism.

The FIA supports appropriate market pauses, circuit breakers and price limits as mechanisms to give market participants the opportunity to adjust to extreme market conditions. FIA, however, believes that these mechanisms should be established with the goal of keeping markets open as much as possible because, among other things, market closings may dramatically reduce market participants' ability to manage risk. These mechanisms should not be used exclusively, but rather along with appropriate risk controls, such as price banding and maximum order size limits in order to avoid outright trading halts.

Circuit Breakers, Market Pauses, and Trading Halts²

Trading halts are intended to protect against the possibility of a broader market breakdown and should not be used to compensate for weaknesses in trading processes or a temporary reduction in liquidity. As such, FIA recommends that automated risk and volatility mitigation mechanisms be implemented in place of trading halts. A single errant trade can have the effect of causing a halt in the trading of a security. Clearly, isolated events caused by human error or system malfunction are not the types of events that justify the activation of a trading halt. In addition, allowing isolated events to disrupt all trading in a security introduces the possibility of a single market actor intentionally halting markets for manipulative purposes.

Proven market mechanisms are available that mitigate volatility caused by transitory liquidity gaps and that minimize the risk of clearly erroneous trades - without the need for disruptive market halts and without the disruption associated with error trades and their cancellation. Such mechanisms allow markets to be paused for a short amount of time to allow the market to process information and recover from a transitory dearth in liquidity.

FIA recommends that all trading venues adopt automated means, similar in function to the CME Group's Stop Spike functionality or the Eurex "volatility interruption" functionality to briefly pause the market in the event that a circuit breaker is triggered. The momentary pause afforded by this type of functionality allows an opportunity for liquidity to be replenished. In a highly efficient market, the pause can reasonably be calibrated to seconds without substantive impacts on the broader market. The benefit of this type of functionality was clearly evident on May 6 as stop spike functionality on CME Globex triggered a five second pause in the E-mini S&P futures market, during which time buy orders came into the market, leading to the reversal of the broader market decline.

The Eurex volatility interruption is a specific protective mechanism to enhance price continuity and the probability of matching market orders in futures products. Eurex sets product-specific price corridors at the individual contract level based on the contract's pricing characteristics. If two prices are outside the price corridor in a predefined timeframe, the volatility interruption mechanism is triggered. The price corridors are calculated regularly and are chosen so that continuous trading is rarely interrupted even in volatile phases.

Another process that should be considered to limit volatility is "price banding." Price banding is in effect through the CME's Globex, NYSE Liffe and NYSE Liffe US systems to limit the likelihood of erroneous executions well out of range of the current market. It is essential that such a limit remain dynamic and well outside the range of the current

² For the purposes of this paper, we use "circuit breaker" to describe the mechanism that triggers a pause in execution and "market pause" to describe such a pause. "Trading halt" is any circumstance where there is an unscheduled stoppage of matching. In the futures trading environment, "Limit up-limit down" implies that there is a static price limit for a trading session.

market, as short-term volatilities cause such limits to be an artificial barrier to trading and may cause price jumps when bands are too close and then reset.

Regardless of their methodology, trading halts should take into consideration the unique characteristics of the product, should be set by the exchange at the product level and should be coordinated across trading venues as appropriate. They should perhaps be set at tighter ranges but be shorter in duration. Given today's highly efficient market structure and sophisticated information processing technology, shorter halts are sufficient to allow market participants to assimilate information, assess risk and resume trading in an orderly manner.

Special consideration should be given to trading halts during the closing period due to the risks associated with suddenly losing the ability to hedge or close open positions before the market closes for the day, or even worse, the weekend. For instance, if a significant event were to occur during the closing period on a Friday, the market could be halted due to volatility protections. If the market is halted through the exchange close, the next opportunity traders would have to hedge or close-out their open risk would be Sunday evening, 48 hours after the event.

Error Trade Policy

Trade certainty is critical to maintain electronic liquidity provider participation in volatile market conditions. Breaking trades disrupts the ability of market participants to complete combination strategies, hedge risk by offsetting trades, and trade with the proceeds or benefits of an execution with certainty. Breaking trades creates risk when one side of a closed trade is removed, results in margin calls when valid proceeds for subsequent transactions are withdrawn, and creates extreme uncertainty when trades are broken outside of market hours (which happens during market halts or as a result of a review of closing transactions). Without trade certainty, liquidity providers are less likely to remain in markets where there is an increased likelihood of broken trades.

The *FIA Market Access Risk Management Recommendations* strongly recommended that exchanges adopt error trade policies that embrace trade certainty:

“Exchanges should adopt a “Preferred Adjust-Only Policy” to ensure absolute trade certainty to all parties to an error trade. In a Preferred Adjust-Only Policy all trades inside of a product-specific “no-adjust” range are ineligible for adjustment. All trades outside of the no-adjust range potentially could be adjusted to the edge of the no-adjust range from the prevailing market at the time of execution.”

Price adjustment of trades is most efficient when coupled with other mechanisms, such as price banding, to decrease the likelihood of out-of-range erroneous executions.

II. Restrictions on Co-Location and Direct Access

7. The Committee recommends that the CFTC use its rulemaking authority to impose strict supervisory requirements on DCMs or FCMs that employ or sponsor firms implementing algorithmic order routing strategies and that the CFTC and the SEC carefully review the benefits and costs of directly restricting “disruptive trading activities” with respect to extremely large orders or strategies.

FIA strongly supports industry-wide, exchange and regulatory initiatives that seek to manage the risks associated with direct market access and algorithmic order routing strategies. FIA believes risk mitigation is a shared responsibility between trading firms, executing and clearing firms and exchanges. The approach to managing risks varies depending on the product, the trading platform and the path the order takes to the trading platform.

Risk controls are currently required and monitored in multiple places. One-size-fits-all controls are not appropriate; pre-trade controls should be appropriate for the asset class and prevention of certain types of risk that are based on characteristics of markets. Regulators should focus on ensuring these risks are managed without being prescriptive on how the risks are managed:

- When an order is entered by a client, clearing firms should establish automated controls that limit or prevent the client from placing orders that exceed certain pre-established trading and risk limits, such as credit, price and order size limits. Clearing firms should be allowed to use exchange provided pre-trade risk controls as part of an overall supervisory program.
- Because of the greater centralization of trading in the futures market, there are greater opportunities to manage these types of risk at the exchange level than there are in the securities market. In many cases, futures exchanges are best placed to establish tools for clearing firms to use in connection with clients’ order entry. Exchanges can best tailor requirements for the products and trading features offered on their markets and can establish tools for the clearing firms to apply that complement risk control measures implemented by the exchange. It is important to note that such controls are exchange-specific and not intended to be a substitute for cross-market, cross-asset credit controls which are generally implemented by the clearing firm or trading firm outside the exchange environment.

There are some key differences between futures exchanges and securities liquidity destinations that affect how pre-trade controls are implemented. Because of these differences, we make the following recommendations.

First, we recommend that certain mechanisms for pre-trade controls be placed at the exchange level instead of the individual broker infrastructure level as prescribed in SEC Rule 15c3-5. Futures trading, unlike securities trading, is mostly centralized on a single exchange instead of on a variety of liquidity destinations. This market structure makes it more practical to implement standardized risk controls in the futures markets at the

exchange level. Risk controls implemented at the exchange level ensure a comprehensive and level playing field--all trading access is subject to the same level of risk controls.

Second, exchange rules should require clearing firms to have pre-trade controls and then give the clearing firms the mechanism for controlling the credit levels used by customers accessing the exchange directly. Futures brokerage is generally divided between clearing brokers and executing brokers, with the ultimate responsibility for controlling credit and risk resting with the clearing broker. The clearing broker often does not allow a direct access client to use the clearing broker's member ID. In some cases, the direct access client must join or register with the exchange itself, and the exchange is partially responsible for enforcing client adherence to exchange rules.

Third, futures credit controls differ markedly from the notional value calculations typically used in the securities world and enable the market participants to derive appropriate controls based on product characteristics. Because futures are a leveraged product with varying levels of exposure depending on product characteristics, we recommend that the appropriate types of controls offered to customers and their clearing firms be determined by the exchange that designs the products and then administered by the clearing firms, which must calculate how much credit exposure is appropriate for a given client.

Finally, futures trading takes place across global exchanges and is not under the control of a single regulator, making it difficult to derive a uniform standard across all exchanges. We encourage the CFTC to work with its regulatory counterparts to agree upon uniform standards across the globe.

Exchange Role in Supervising Risk and Compliance

The FIA recommends that any additional supervisory requirements relating to direct market access and algorithmic order routing strategies be implemented through exchange rules. Exchange rules should require clearing firms to have credit risk management policies and procedures in place that are commensurate with the firm's size, clientele and product mix. These policies and procedures should be reviewed by the exchanges to ensure all clearing firms comply with exchange requirements.

In addition, exchanges should implement the functionality discussed in the *FIA Market Access Risk Management Recommendations* such as price banding and stop logic, in order to mitigate the potential disruptive impact of large orders. This approach limits the number of orders that might be disruptive from ever entering the market, allowing supervisory authorities to better focus their resources and attention on situations in which orders are entered intentionally or extremely recklessly for the purpose of manipulating the market.

The FIA recommends that supervisory requirements relating to direct market access and algorithmic order routing be implemented through exchange rules because each exchange has a unique rulebook, client base and product mix. For this reason, the resources and expertise of the exchange, subject to CFTC regulatory oversight, should be relied on for

frontline trade practice, market surveillance and market conduct rule enforcement. This approach would provide for robust market oversight, while not unintentionally prohibiting or impairing legitimate market behavior that contributes to liquidity and price discovery.

Clearing Firm Role in Supervising Risk and Compliance

Clearing firms have a continuing responsibility to diligently supervise all aspects of their business (NFA Rule 2-9, CME Rule 950) and generally to prevent conduct that is detrimental to the marketplace (CME Rule 432), including where a clearing firm provides customers with direct market access. Supervision of this activity can be broken down into two categories: clearing firm supervision of risk and credit for clients accessing the exchange directly and clearing firm supervision of orders for compliance with regulations.

Clearing firms typically implement pre-trade risk controls that can prevent clients from trading beyond their credit limits. These controls include order size limits, intraday cumulative order limits, margin limits, and intraday profit and loss limits. The risk department of the clearing firm typically reviews and prescribes limits for each client, and the electronic trading department typically implements these limits under documented procedures. In addition, most clearing firms conduct periodic audits of all risk limits for clients using the clearing firm's trading access to the exchange.

Clearing firms also implement order level checks to attempt to prevent inadvertent trading and trading that does not comply with regulations. These controls may include order size limits, restrictions on order types, such as market on open or close orders, intraday position limits to prevent too much trading in a particular direction, and limits on how far from the last trade price a limit order can be placed. The FCM implements controls at a customer level when an individual client has direct access.

With the increasing use of algorithms designed by clearing firms and given to clients to automate order handling, particularly in the case of large orders, it is important that clearing firms adopt controls to mitigate the potential for orders generated by their own algorithms to disrupt the market. In particular, the FIA recommends that clearing firms that provide execution algorithms apply certain best practices, as set forth in the *FIA Order Handling Risk Management Recommendations for Executing Brokers*. A clearing firm that uses its own algorithm to "work" large client orders has the responsibility to perform checks on orders generated by the algorithm before sending such orders to a market.

Supervision of Large Orders

In general, the FIA believes that the disruptive nature of excessively large orders can be controlled by applying supervisory procedures and explicit pre-trade controls on orders before they are entered into an exchange's trading platform. Unintentionally disruptive orders can be easier to monitor at a pre-trade level through clearing firms and exchanges using standard controls, as discussed above. In particular, pre-trade controls such as

realistic fat finger limits can be used to prevent large orders from being sent to the market.

Clearing firms that use execution algorithms or provide market access to clients using their own execution algorithms have the responsibility to minimize the possibility of sending orders that may be considered disruptive. A clearing firm can implement risk controls that ensure that orders generated by their algorithms are consistent with regulatory requirements. Changes to relevant systems would go through a change control process to determine whether the appropriate risk management controls remain in place and function properly.

If a client of a clearing firm accesses the exchange directly through the client's own membership on the exchange, the customer should be directly responsible to the exchange for violations of its rules, including violations that are a result of lack of, or failure to implement, proper pre-trade controls. The clearing firm remains financially responsible to the exchange for the customer's trades and continues to bear the credit risk.

III. Liquidity Enhancement Issues

8. The Committee recommends that the SEC evaluate the potential benefits which might be gained by changes in maker/taker pricing practices, including building in incentives for the Exchanges to provide for "peak load" pricing models.
9. The Committee recommends that the SEC evaluate whether incentives or regulations can be developed to encourage persons who engage in market making strategies to regularly provide buy and sell quotations that are "reasonably related to the market."

The FIA supports exchange-based initiatives—particularly those that are market-based—that encourage liquidity provision and promote the stability of those markets in which FIA members place their capital at risk. As a result, we fully support empowering each exchange to provide incentives to attract market makers and electronic liquidity providers that they deem appropriate, as long as such incentives do not disadvantage other market participants³. In the past, exchanges have devised creative methods to incentivize market makers, and they must maintain the freedom to do so.

We do not, however, believe that regulators should be creating incentives for market making or erecting unnecessary barriers to competition. The FIA was rightfully concerned about depending on market-maker obligations as a purported guarantee of liquidity during periods of market stress.

³ For example, we would not support limiting the ability to stream quotes to only designated market makers.

Overly prescriptive rules could not only inhibit innovation but become quickly outdated. Rules implemented at the federal level, if ultimately adopted, would still need to be flexible enough to accommodate the evolutionary nature of markets.

As such, each exchange should be allowed to work with their customers to come up with incentive structures that take into account the market dynamics of each individual product.

One such market-based mechanism that may be employed to incentivize liquidity provision is, of course, pricing. “Peak load” pricing mechanisms that offer increased liquidity taker fees and increased liquidity provider rebates, as proposed by the Joint Advisory Committee, may be one means of curbing liquidity taking while incentivizing liquidity provision in turbulent markets (assuming no overall increase in aggregate fees). However, “peak load” pricing mechanisms are not a cure-all. To understand why, it is important to understand the reasons why liquidity gaps emerge during times of extreme volatility.

During these volatility events, the root cause of liquidity erosion is not that participants are unsure as to which direction the market is moving, as the Committee recommendations seem to suggest. Rather, it is the participants’ uncertainty about the eventual status of their positions, which trades are going to stand as good, and which trades are going to be busted or adjusted due to extreme market moves and the degree of discretion built into trade cancellation policies. Until the exchanges provide the industry with clear, deterministic, time-restricted trade adjustment policies, traders will, as part of their prudent risk management efforts, continue to pull their orders in times of high volatility even at the risk of failing to capture significant rebates, profits or complying with market making obligations.

10. The Committee recommends that the SEC and CFTC explore ways to fairly allocate the costs imposed by high levels of order cancellations, including perhaps requiring a uniform fee across all Exchange markets that is assessed based on the average of order cancellations to actual transactions effected by a market participant.

High-frequency trading (HFT) is an instrument used by a variety of market participants, including electronic liquidity providers (“ELPs”), not a strategy itself. In order to assess the implications of allocating costs resulting from messaging capacity requirements amongst participants who engage in HFT, it is critical to first discuss the present state of modern electronic trading.

ELPs add liquidity to the marketplace by bridging the gap between natural buyers and sellers who may not be in the marketplace at exactly the same time. By playing this important intermediary role, ELPs permit individual and institutional investors to immediately transfer the risk often associated with financial instruments. ELPs use technology and put their own capital at risk, creating efficiencies and reducing trading costs for investors. In fact, ELPs can offer better prices to investors when they reduce

their own costs, including exchange fees, overhead costs and the attendant risks associated with trading.

Technology and speed are two essential mechanisms by which ELPs manage their risk; the greater control they have over their exposure time, the less risk exposure for the firm's capital. In other words, for every quote in the market that an ELP provides, it is exposed to that quote for the time it takes for a cancellation to be processed or the time it takes to remove the exposure following a market move or a move in a related instrument. The higher the speed of their quoting system, the less time elapses between when information is received and when that information is incorporated into prices. For any given order, the value of this fraction of a second of exposure is very low, *but across an entire market the exposure can be significant*. In those markets where exchange speeds are high (and latencies low), ELPs are able to manage their risk more effectively and are therefore willing to quote narrower spreads and larger size, all of which improves liquidity and reduces costs for end users.

The ability to cancel and replace orders quickly and reflect updated information in revised prices is integral to this process. The relationship between speed, spreads, order messaging capacity, and liquidity is evident on many exchanges and clearly adds value to all participants. It is also clear that over the past 10 years, major markets have become substantially more liquid with narrower spreads and lower transactions costs. Advanced technology and greater speed (and the resultant increased order messaging capacity by participants and exchanges alike) has played an essential role in this development.

In this context, it becomes clear that modern electronic market making benefits all participants in the form of narrower spreads, increased transparency, larger size and reduced transaction costs. Any effort to increase costs for ELPs by requiring a uniform cancellation fee in order to "allocate costs," decrease speed, or reduce order messaging capacity requirements, will reduce those critical benefits for all market participants.

Exchanges should implement policies around message use, to discourage market participants from creating excessive, low quality messaging, which can negatively impact both exchange and customer bandwidth and systems. An example of a creative, non-prescriptive, and effective approach to curtailing superfluous bandwidth usage while maintaining a deterministic order life-cycle is ICE's "Weighted Volume Ratio" ("WVR") messaging rule. ICE's WVR accomplishes all of this by defining a ratio between the number of messages (new orders, cancels, modifies, etc.) an electronic trading system ("ETS") sends and the total volume of orders the ETS executes. If an ETS exceeds the posted WVR limits, the ETS' owner is fined. If this behavior continues, the ETS' owner faces possible suspension of direct market access privileges.

The truly creative part of this solution is that ICE assigns a weighting scale based on the message's price level relative to the current best bid and offer. If the order in question has a price equal to the best bid or offer, the message does not count towards the WVR. If it is one tick away from the best bid or offer, the message has a weighting multiplier of 0.5 for orders on outright futures and 0.25 for spreads. This multiplier continues to increase

until the order in question is more than five ticks away from the best bid or offer. At that point, the message has a weighting multiplier of 3.0 for outright futures and 2.0 for spreads. By imposing the WVR, ICE has simultaneously incentivized firms to submit orders that are likely to be filled while penalizing firms that submit orders that are unlikely to be filled.

Conclusion

The FIA appreciates the opportunity to comment on the recommendations of the CFTC-SEC Joint Advisory Committee. We support efficient and well-regulated markets and will be happy to work with regulators to develop appropriate protections.

Sincerely,

John M. Damgard
President
Futures Industry Association

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
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