



March 15, 2019

Mr. Christopher J. Kirkpatrick
Secretary of the Commission
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Industry Filing IF 19-001 - ICE Futures U.S. Amendments to Rule 4.26 Order Execution (New Passive Order Protection Functionality)

Dear Mr. Kirkpatrick

ICE Futures U.S., Inc. (“IFUS” or “Exchange”) submits this comment letter in support of the pending amendment to IFUS Rule 4.26,¹ which was stayed by the Division of Market Oversight (“Division”) pursuant to Commodity Futures Trading Commission (“Commission”) Regulations 40.6(c) and 40.7(a)(2)(iii). The amendment to IFUS Rule 4.26, adds Passive Order Protection (“POP”) functionality for use in the Gold and Silver Daily futures markets. The Division stayed this amendment based upon an initial determination that such functionality presented a novel or complex issue which may potentially be inconsistent with the requirements of designated contract market (“DCM”) Core Principles 9 and 12, codified in Commodity Exchange Act (“CEA”) Sections 5(d)(9) and 5(d)(12), and Commission Regulations 38.500, 38.650 or 38.651.² As discussed below, the Exchange believes that its amendment is consistent with, and furthers the purposes of, Core Principles 9 and 12 and requests that the Commission withdraw the stay of the amendment to IFUS Rule 4.26.

We believe the functionality will foster more open, competitive and efficient markets in certain, specified products where price discovery takes place in a related market rather than, or in addition to, the Exchange’s futures contract. The Exchange believes that by reducing the importance of latency advantages which are only available to a small subset of the fastest firms engaged in arbitrage (without compromising any meaningful market function), we will attract additional participants and liquidity to the screen in such markets.

PASSIVE ORDER PROTECTION RATIONALE AND FUNCTIONALITY

The viability of any centralized market is dependent on displayed liquidity. Without resting bids and offers in the order book, participants cannot trade; and without tight, visible bid/ask spreads, participants simply will not trade. While such liquidity is absolutely essential to markets, it is not easily sourced or maintained. There are inherent risks associated with market making. By placing resting orders, which are exposed on the screen and can be readily picked off when markets move and prices change, liquidity providers subject themselves to immediate loss.

¹ See ICE Futures U.S. Submission No. 19-119 <https://www.cftc.gov/sites/default/files/2019-02/ICEFuturesPassiveOrder020119.pdf>

² See CFTC Request for Public Comment <https://www.cftc.gov/PressRoom/PressReleases/7870-19>



To address this problem, Exchanges have employed various strategies to incentivize traders to provide liquidity. Every exchange across the globe offers some type of fee incentive to participants who agree to post resting orders or make defined bid/ask spreads. While exchange matching algorithms have proliferated and evolved over time to meet the needs of each markets, the common theme of FIFO, pro rata allocation, and other approaches is to prioritize execution for price makers.³ Today's exchange technology also commonly and crucially features functionality intended to assist price-makers in the timely management of their orders, for example, mass quote and risk protection. While such developments disrupted the status quo at the time they were introduced, such practices have undeniably contributed to the growth of healthy markets over time. The POP functionality, which is neither novel nor complex, is simply another example of functionality devised by market operators to protect and incentivize resting orders in modern markets.

With the evolution of trading and the shift to electronic markets, High Frequency Traders ("HFTs") have become the predominant source for resting orders. In robust markets, HFTs that are engaged in liquidity providing strategies regularly compete with each other, bettering bids and offers in fractions of a second to be at the top of the book. The result is often one tick bid/ask spreads, offered even in the most volatile market conditions, which greatly benefit market takers and end users.

We note, however, that it is becoming increasingly difficult to attract these liquidity providers as the risk attendant to such activity is now exacerbated. Firms engaged in these strategies must invest heavily in the fastest technology, because a millionth or billionth of a second can be the difference between winning and losing every trade. As a result, firms have become more reluctant to engage in market making because of the significant cost of investing in the absolute lowest latency technology possible and because of the potential losses stemming from any latency disadvantage.

To incentivize liquidity, exchanges have begun to offer electronic functionality as a solution. Market operators around the world are implementing "speed bumps" as a means to reduce such latency advantages.⁴ The POP functionality, which is an asymmetrical speed bump, is being introduced by IFUS precisely for this reason.

The POP works by creating a very short (3 millisecond⁵) delay for incoming orders that would otherwise transact immediately opposite resting or "passive" orders in the central order book. The delay, which is imperceptible to manual traders, gives HFTs that post liquidity an opportunity to update their prices based on price changes in related markets, breaking news or other market moving events. Because the POP functionality would reduce the fastest HFTs' advantage in responding to price changes, the Exchange believes it will encourage additional HFTs to participate in these markets and

³ For example, exchanges have had multiple different matching algorithms, including matching algorithms with market maker preferences. See, e.g., <https://www.cmegroup.com/confluence/display/EPICSANDBOX/Supported+Matching+Algorithms>

⁴ EUREX, TSX Alpha, ParFX, LMAX, etc.

⁵ The Exchange derived the 3 milliseconds delay time from discussing with market participants and the most similar functionality, which is operated by TMX Alpha.



enter better liquidity-providing orders. More and better posted orders would represent an improvement in overall market quality in the markets where the functionality is deployed. We think it important to note that the technology will not impact or impair quality of manual traders.

As mentioned above, similar protections are in place or being deployed by other market operators across the globe in all asset classes. The functionality is simply an asymmetrical speed bump, which is neither novel nor complex. It is critical to understand that POP only slows down a liquidity taking order and does not function similarly to “last look” functionality in retail foreign exchange trading. With last look functionality, the trader with a resting order will be notified of the matching incoming order and given the option to: (i) execute the trade; (ii) offer an alternative price; or (iii) reject the trade. With POP functionality, the trader with the resting order will not be notified that there is an incoming order waiting to take liquidity. The trader will simply have additional time (i.e., the delay window) to react to external market conditions (e.g. a price change in a related market) and possibly modify their resting passive orders.

In sum, the Exchange hopes POP functionality will encourage additional liquidity providers to place resting orders that increase bid/ask volume in the order book, which we believe will improve overall market quality for our customers. We believe that traders who might not otherwise place liquidity-providing orders due to a latency disadvantage or because of the costs associated with maintaining the fastest technology, may be more inclined to trade IFUS markets with POP functionality in place. The functionality reduces the likelihood that such traders will be picked off by the fastest HFTs and may encourage them to make deeper, tighter bid/ask spreads. In turn, better bid/ask spreads will encourage more participants to trade, increasing volume and liquidity in these contracts.

As this is a market innovation, the Exchange plans to monitor and assess the efficacy of POP functionality and its impact and on overall market quality. The Exchange will make appropriate modifications to the functionality--including duration of the delay -- after gaining practical experience operating the POP.

DCMS HAVE REASONABLE DISCRETION IN COMPLYING WITH CORE PRINCIPLES

In accordance with Core Principle 1, a designated contract market (“DCM”) may exercise reasonable discretion in the manner in which it complies with the other core principles, including Core Principles 9 and 12.⁶ Congress expressly amended the CEA in 2010 to provide that the exercise of such reasonable discretion by a DCM is only limited where the Commission has acted by regulation.⁷ We note that, with respect to Core Principles 9 and 12, there has been no rulemaking and there is no current CFTC guidance beyond the text of the Principles themselves. The Exchange believes that its POP functionality as implemented in the Gold and Silver Daily futures markets is well within its reasonable discretion in meeting Core Principles 9 and 12.

⁶ CEA Section 5(d)(1)(B); 7 U.S.C. 7(d)(5).

⁷ See *id.*



COMPLIANCE WITH CORE PRINCIPLE 9 (EXECUTION OF TRANSACTIONS)

Core Principle 9 states that a DCM “must provide a competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading” in its centralized market.⁸ As stated above, there is no current CFTC guidance on compliance with this Core Principle. In the absence of such guidance, we think it appropriate to look at how centralized markets are currently operated and note in this regard that there are various matching structures operated by DCMs.

While all DCMs operate centralized markets where the best bid and the best offer are matched, additional criteria for execution priority vary amongst exchanges and venues. For example, at IFUS and many other electronic execution venues, the best bid and offer are matched on a first-in-first-out (“FIFO”) basis, meaning that the first orders in at the best prices are filled in their entirety. In addition, there are DCMs that match electronic trades on a pro-rata basis; meaning that best bids and offers will be matched and allocated equally amongst orders at each price level. Under a pro rata allocation methodology, execution priority is not given to the first order received at the price level. Additionally, in open outcry trading, which has been used for centuries, best bid and best offer may be matched on a recognition basis, meaning the executing trader in the ring gets to pick, at such trader’s sole discretion, the counterparty to a trade from amongst the best bidding/offering traders in the ring.

From these various matching structures and execution venues, it is evident that there is flexibility in the application of Core Principle 9. Aside from the matching of best bids and offers, there is no universal standard for what constitutes a “competitive, open and efficient” market under Core Principle 9. The Exchange believes that a market where POP functionality is enabled is no less competitive, open or efficient than any other execution methodology described above. POP functionality simply introduces an asymmetric speed bump into an accepted market structure. With the exception of the delay, all other market functions will remain the same when the functionality is enabled. All classes of participants will continue to have the same access to the market and best bids and best offers in the market will continue to be matched on a FIFO basis.

The Exchange contends that the 3 millisecond execution delay, as applied in the Gold and Silver Daily futures markets, will not affect the efficiency of the market, and will improve the fair and equitable trading of these products, which is one of the tenets of Core Principle 12.⁹ The underlying purpose of the functionality is to protect and foster market liquidity. We believe that the reduction of advantages to a market participant taking liquidity will encourage liquidity providers to enter larger and tighter resting orders. Accordingly, we believe the POP functionality will improve market efficiency in markets where it is deployed and encourage liquidity providers to maintain deeper, tighter markets.

We also note that the use of technologies that create execution delays is not unprecedented. The Commission has embraced the implementation of such short delays where there is a perceived benefit to overall market operation. A prime example of this is the Exchange’s Interval Price Limit

⁸ CEA Section 5(d)(9).

⁹ CEA Section 5(d)(12)(B); 7 U.S.C. 7(d)(12).



(“IPL”) functionality, which is deployed across all IFUS futures markets.¹⁰ The IPL functionality delays the execution of any transaction for a preset period of time at prices that are outside the specified dynamic intra-day price ranges set for each product. Like the POP functionality, IPL functionality creates a slight, brief delay in execution to improve overall market function. Similar technology is utilized by other DCMs.

Based upon the forgoing, the POP functionality is consistent with Core Principle 9.

COMPLIANCE WITH CORE PRINCIPLE 12 (PROTECTION OF MARKETS AND MARKET PARTICIPANTS)

POP functionality is also consistent with Core Principle 12, which obligates a DCM to establish and enforce rules to “protect market participants from abusive practices” and rules to “promote fair and equitable trading”.¹¹ As explained above, the Exchange believes that the functionality promotes fair and equitable trading because it reduces advantages available to those firms that utilize the fastest technologies to trade. Furthermore, the Exchange has appropriate resources to discharge its obligations under Core Principle 12. In accordance with Commission Regulation 38.651, the Exchange’s Market Regulation Department actively monitors for trading abuses using electronic exception reports and will take appropriate action against any participants engaging in misconduct. .

It has been suggested, erroneously, that POP functionality will encourage spoofing and false volume in markets where it has been enabled. The amount of time that an order appears and is exposed in the order book is unchanged with the addition of POP functionality.

Based upon the foregoing we believe that POP functionality is consistent with Core Principle 12.

CONCLUSION

As shown above, the POP functionality is consistent with Core Principles 9 and 12. We believe the functionality will foster more open, competitive and efficient markets which provide for fair and equitable trading by reducing latency advantages. We also believe that the Exchange’s Market Regulation Department can effectively detect and discipline any market abuse that is facilitated through misuse of the POP functionality. Accordingly, we request that the Commission withdraw its stay on the amendment to Rule 4.26.

Very truly yours,

Trabue Bland
President
ICE Futures U.S.

¹⁰ See ICE Futures U.S. Submission 12-06 - https://www.theice.com/publicdocs/regulatory_filings/12-6_Amendments_to_Electronic_Trading_Rules_-_Int.pdf

¹¹ CEA Section 5(d)(12)(B); 7 U.S.C. 7(d)(12).