CME Group

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Via On-Line Submission
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Via Electronic Mail: rule-comments@sec.gov
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Re: Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues - Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010

CME Group Inc. ("CME Group") appreciates the opportunity to comment on the recommendations of the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues ("Committee") regarding its report on Regulatory Responses to the Market Events of May 6, 2010 (the "Recommendations").

CME Group is the world's largest and most diverse derivatives marketplace. We operate four separate exchanges, including Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products.

As a pioneer in the globalization of the futures markets, CME Group has helped to expand the customer base for futures products. Our electronic trading platform, CME Globex, is available to users around the world for more than 23 hours a day, and to satisfy the increasing demands of the international marketplace, customers can access CME Globex in more than 150 countries and foreign territories around the world. Telecommunications hubs in Singapore, London, Amsterdam, Dublin, Milan, Paris, Seoul, São Paolo, Kuala Lumpur and Mexico City reduce connectivity costs, increase accessibility, and deliver faster, more efficient trading to our customers. CME Group believes that its significant expertise and experience will provide the Commissions with a unique and valuable perspective on the matters discussed herein.

CME Group commends the Committee for seeking to identify new ways to mitigate systemic risks, harden protections against market disruptions and enhance investor confidence in the securities and futures markets; we also commend the Commissions' staffs for their considerable efforts in support of the Committee's work.

CME Group shares the Commissions' objectives of promoting integrity, transparency and confidence in financial markets, and doing so in a manner that preserves the vibrancy and competitiveness of U.S. markets in the global economy. Market integrity is one of the cornerstones of CME Group's business model, and we employ substantial human resources and technological capabilities to protect and continually enhance the integrity of our markets and to mitigate the potential for market disruptions. We recognize that our customers' confidence in that commitment is essential to our ability to draw participants and liquidity to our markets and allows us to effectively serve the risk management and price discovery needs of users around the globe.

CME Group's comments regarding certain of the Committee's recommendations are set forth below, with each numbered recommendation corresponding to the referenced recommendation number in the Committee's report.

I. Volatility

1. ***The Committee concurs with the steps the SEC (working with the exchanges and FINRA) has taken to:***

    a. ***Create single security 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"***

The Committee implicitly recognizes in its report, and CME Group agrees, that liquidity is the most important facet of market quality and a critical element in the defense against disorderly markets. The Committee, therefore, strongly encourages the development of market structures and rules that are designed to foster liquidity supply. It is empirically clear that the advent of electronic trading and the corollary growth of algorithmic trading have dramatically enhanced liquidity and trading efficiency in both the securities and futures markets, and market participants have benefited on many different levels as a result of this evolution. Liquidity is, however, inherently dynamic – that is the nature of markets and how prices are discovered – and technology and market structures have elevated the speed with which liquidity can be sourced, consumed and withdrawn in response to market factors.

Supply and demand imbalances driven by market fundamentals cannot be wished away, and as the events of May 6th demonstrated, in even the most liquid markets demand for liquidity can at times legitimately overwhelm its supply. The examination of the events of May 6th have also clearly revealed, however, that structural issues and rules which breed uncertainty can exacerbate these imbalances by adversely affecting liquidity supply and undermine the effective and efficient functioning of the markets. By contrast, sound structures and rules can strengthen the orderliness and resilience of markets during periods of turbulence. CME Group concurs with the Committee's view that market centers, regulators and the broader industry should focus their efforts on eliminating the former, extending the latter, and continually exploring new ideas for hardening the markets against instability and disruption.

Rules Regarding Erroneous Transactions – The Committee identifies the lack of trade certainty in the context policies applicable to erroneous trade policies as one important factor that can impair liquidity provision. CME Group supports the Committee's recommendation that all market centers be required to have clear and transparent rules regarding the handling of erroneous trades. CME Group has continuously worked with market participants and evaluated its experiences over the years to develop the present version of its Rule 588 ("Trade Cancellations and Price Adjustments"). The rule has consistently evolved in the interest of establishing transparent standards and appropriately balancing the adverse market impact of clearly erroneous trades with the legitimate need for trade certainty by market participants. Our experience has taught us that clear standards, prompt identification, decision-making and communication, accountability on the part of error makers, and a bias toward repricing rather than cancellation are critical facets of an effective rule.

On May 6th, CME Group did not cancel or price-adjust any trades in its equity index futures complex, primarily because CME Group was well served by numerous automated mechanisms introduced at the trading engine level to mitigate the likelihood of erroneous trades occurring in the first instance. These automated mechanisms include features such as maximum order quantities, price banding on limit orders, stop and market order protection points and stop logic functionality, all of which are discussed in more detail in response to question 3 below.

In contrast, other market centers canceled more than 20,000 trades on May 6th. Most of these trades were canceled many hours after their execution, and during the intervening period it was unclear which transactions would stand and which would be canceled, making it impossible for market participants to assess their exposure in the midst of highly volatile market conditions. CME Group is therefore supportive of the efforts undertaken by the securities exchanges and their regulators to establish greater clarity with respect to rules for the handling of clearly erroneous trades and to eliminate the "stub quoting" practices that contributed to the erroneous trade problem in certain equity markets on May 6th.

From a forward-looking perspective, CME Group believes two points merit additional focus in this regard. First, given the disruption and uncertainty that erroneous trades create, an ounce of prevention is indeed worth at least a pound of cure and greater efforts must be devoted to implementing automated controls, such as those identified above, to prevent erroneous trades before they occur and create the disruption. This technology is proven and available, and should be deployed. Second, it is important to recognize, particularly with respect to broadly interconnected markets such as the equity markets, that participants lay off position risk across markets, and decisions by one market center to cancel trades can leave participants exposed in

other markets, potentially creating reverberating repercussions in the other markets. Consequently, it would be beneficial for market centers that currently employ only trade cancellation policies to examine the benefits of employing price adjustment policies where practicable. Price adjustment policies enhance trade certainty and mitigate exposure, which both heighten market confidence and support liquidity provision. Based on its experiences, CME Group exhibits a strong bias toward price adjustment rather than trade cancellation when dealing with erroneous trades and has found this practice to be less disruptive to markets and broadly supported by market participants.

Single Security Circuit Breakers for the Russell 1000 Stocks and Actively Traded ETFs – The Committee identifies the "speed of volatility" coupled with the "absence of clear stopping points" as another factor that creates uncertainty and that can impair the willingness of participants to provide liquidity. The Committee therefore endorses single security circuit breakers, as have been adopted post-May 6th by the securities exchanges in coordination with the SEC and FINRA, to address instances of extreme market-wide or sector-wide volatility.

CME Group opined in its July 2010 letter to the SEC, and continues to believe, that the imposition of single security circuit breakers actually increases rather than remediates uncertainty in the market during broadly volatile periods and will likely exacerbate market disruptions in a macro-liquidity event because they compromise price transparency and fail to address critical inter-market linkages. Consequently, we do not believe that single security circuit breakers are properly targeted as an appropriate remedy to address market-wide volatility.

Under the current securities market rules, a single security circuit breaker is triggered if the price of a security, including ETFs on broad-based indexes, changes by ten percent or more during a rolling five-minute period between 9:45 a.m. and 3:35 p.m. ET. If triggered, all markets in that security pause trading for at least five minutes. The Committee asserts that this pause allows for an organized opportunity to offset order imbalances when there is extreme volatility and to correct any erroneous trades.

As presently implemented, many ETFs subject to the single security circuit breaker rules are based on indexes that also underlie other financial products including index futures, options on index futures, cash-index options and options on ETFs. Consequently, single security trading halts that would apply to ETFs on broad-based indexes would not be coordinated with the market-wide circuit breakers or with the price limits that currently apply to related index futures and options. One key lesson of the events of May 6th is that closely linked markets should have coordinated halting mechanisms, yet the single security circuit breakers actually undermine that principle and have the potential to exacerbate disruptions across related markets during significant market events.

In a macro-market event, multiple constituent stocks in an index could be halted without a market-wide circuit breaker being triggered, and individual stocks would be halted and opened on staggered timelines, creating complexity and confusion in understanding the index calculation and the true value of the index. Market participants would be required to determine for themselves the relevance of the index values that are disseminated during the time period when various index-component stocks have been halted, and the resulting inability to perform appropriate risk management would impair liquidity provision in index-based products. This, in

turn, will serve to compound the problem by affecting liquidity in critical benchmark products and also make it more difficult for the halted stocks to replenish liquidity. CME Group is not aware that the impact of the single security circuit breaker regime has been effectively modeled in the context of a May 6th type of scenario, and it appears to us to be risky and misguided to have implemented such an approach without fully understanding the unintended and potentially harmful consequences that might occur as a result. CME Group believes there are better alternatives to achieving the objectives of single security circuit breakers and discusses these alternatives in further detail below.

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 security futures on those securities*****.**

For the reasons articulated above, CME Group disagrees with the Committee's recommendation to further expand the single security circuit breaker rules. Expanding their application to a wider universe of securities and using different trigger parameters for these instruments will only add to the complexity, uncertainty and operational burdens in a macro-market event.

The Committee's commentary suggests that the single security circuit breakers are targeted to address liquidity events and anomalous trades in a single security, and to date their application has been triggered as the result of erroneous trades rather than any market-wide event. However, an isolated issue on a single market should not result in halting the trading of that security on all markets and thereby undermine the ability of market participants to manage their exposure while the broader market continues to trade. The Committee itself acknowledges that there are significant "drawbacks" to single security circuit breakers inasmuch as they do not prevent the execution of erroneous trades that trigger the trading halt and restrict trading even when contra-side liquidity has returned to the market.

CME Group believes there are more effective and market-efficient solutions to achieving the objectives of single security circuit breakers that pose significantly less risk of causing collateral distress to the markets and to market participants. Market centers have the ability to employ a variety of automated functionality that would mitigate the potential for erroneous trades to occur and which can manage transitory liquidity gaps in a particular security in a more efficient and less disruptive manner; additionally, the implementation of clear and well-constructed erroneous trade policies allow market centers to promptly address micro-market anomalies that might escape the automated filters without the need to broadly halt trading in the security.

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 security futures exchanges should continue to trade during any equity limit up/down periods.***

The Committee recommends augmenting the single security circuit breaker rules by establishing single security price limits as an initial step, followed by the implementation of the single security circuit breaker (trading halt) if contra-side liquidity fails to appear during a "relatively short set timeframe." The "limit up/limit down" price limits would be defined relative to the volume-weighted average price over the preceding rolling five minutes, and during the "limit state" the security could continue to trade within the specified price limits. CME Group believes that adding yet another layer of complexity to this process will only exacerbate the challenges already identified in the responses to questions 1 and 2 above, in addition to creating new issues such as the treatment of equity options during the limit state. We therefore cannot support this construct as an effective solution to the identified problem.

CME Group does strongly believe, however, that the securities exchanges should implement additional automated volatility mitigation and risk management functionality to address the micro-market liquidity issues that single security circuit breakers appear designed to address. More specifically, we recommend adoption of automated price banding, market and stop order protection points, order quantity limits and stop logic functionality to mitigate the impact of transitory liquidity gaps and the likelihood of erroneous trades. Each of these functionalities, as implemented by CME Group, are briefly described below.

Price Banding: CME Globex subjects orders to price verification upon entry using a process referred to as price banding. Price banding is designed to prevent the entry of orders at clearly erroneous prices, such as a bid at a limit price substantially above the market, thereby mitigating the potential for a market disruption. For each futures product, CME Group establishes a Price Band Variation parameter which is a static value that is symmetrically applied to the upside for bids and the downside for offers relative to a reference price. In the E-mini S&P 500 futures, for example, this parameter is currently set at 12 index points (approximately 1% of the current index value).

The reference price, referred to as the Banding Start Price, is a dynamically calculated value based on market information such as last trade price, best bid and offer price or the indicative opening price. Orders entered at prices beyond the Price Band Variation parameter relative to the reference price are rejected by the Globex engine. Price banding functionality for options on futures is similar to futures price banding except that the Banding Start Price may reference theoretical option prices based on established option pricing models in addition to last trade price. Additionally the width of the price bands may be either a static value for a particular option series or a dynamic value that adjusts based on the option's delta or a delta-adjusted percentage of the option's theoretical price.

Protection Points: CME Group employs proprietary functionality that applies a limit price (protection point) to each market order entered on the CME Globex platform and to each stop order entered without a limit price. This functionality prevents orders from being filled at significantly aberrant price levels because of the absence of sufficient liquidity to satisfy the order at the time the market order is entered or the stop order is triggered. The protection points for each product are generally defined as one half of the product's "Non-Reviewable Range," a value that is established in connection with the exchanges' Trade Cancellations and Price Adjustments rule. The protection point is measured from the best bid price for sell market orders, the best offer price for buy market orders, and the stop trigger price for stop orders. Any quantity on the order that is unfilled at the protection point level becomes a resting limit

order at that price and creates the opportunity to source liquidity. In the E-mini S&P 500 futures contract, for example, this parameter is set at 3 index points (approximately ¼ of 1% of the current index value.)

Order Quantity Protections: Maximum order size protection is embedded Globex functionality that precludes the entry of an order into the trading engine if the order's quantity exceeds a pre-defined maximum quantity. Orders entered for a quantity greater than the prescribed maximum quantity are rejected by the Globex engine. This functionality helps to avoid market disruptions by preventing the entry of erroneous orders for quantities above the designated threshold. In the E-mini S&P 500 futures contract, this parameter is set at 2,000 contracts (approximately $130 million in notional value at the current index value.)

Stop Logic Functionality: CME Group's proprietary Stop Logic functionality serves to mitigate artificial and disruptive market spikes which can occur because of the continuous triggering, election and trading of stop orders in an illiquid market condition. On CME Globex, if elected stop orders would result in execution prices that exceed pre-defined thresholds, the market automatically enters a reserve period for a prescribed number of seconds; the length of the pause ranges from 5 to 20 seconds and varies based on the characteristics of the product and time of day at which the stop logic event is triggered. During the reserve period, new orders are accepted and an indicative price is published, but trades do not occur until the reserve period expires, thereby providing an opportunity for participants to respond to the demand for liquidity. If contra-side liquidity is not sourced during the initial reserve period, the price band will increase by another increment and a second iteration of the stop logic will commence. This process will continue until liquidity is sourced or for up to a maximum of twelve iterations. In the E-mini S&P futures the stop logic price parameter is 6 index points (approximately ½ of 1% of the current index value) and the time parameter is 5 seconds during regular trading hours and 10 seconds outside of regular trading hours.

CME Group believes the various types of automated functionality described above represent a much more effective and efficient solution to the concerns that the single security circuit breakers and the recommended "limit up/limit down" feature are designed to address and avoid the harmful collateral consequences previously discussed.

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.***

The Committee notes in its report that CME Group's stop logic functionality worked effectively on May 6th by interrupting the market decline and providing an opportunity for contra-side liquidity to be replenished. Immediately following the stop logic pause, the futures contract rebounded sharply, leading to a similar recovery in the broader market. The Committee questioned, however, whether the five-second reserve period would be sufficient to address different "news driven" fact scenarios and recommended evaluation as to whether a longer reserve period is appropriate.

In the context of the highly automated trading environment that exists today - an environment in which order turnaround times are measured in, at most, single digit milliseconds - five seconds can be considered a "long" period of time. We agree that depending on the product and the market conditions, five seconds may or may not be sufficient to attract contra-side liquidity in all circumstances. However, as reflected in the response to question 3, CME Group's stop logic functionality is configurable with respect to the price parameter that triggers the pause, the length of time of the pause, and the number of stop logic iterations, and we currently employ different price and time parameters based upon the product and the time of day. Still more important to recognize is that the price parameter is established at conservative levels (½ of 1% of the index value in the case of E-mini S&P 500 futures), meaning that to the extent contra-side liquidity is not attracted in the first iteration, the second iteration of the pause allows for only an incremental additional move in price. This configurable and iterative approach allows us to set the time parameters relatively narrowly in order to minimize the disruption to the market, while simultaneously using tightly constructed incremental iterations in the event the time parameter proves to be too short in a particular circumstance to mobilize liquidity.

CME Group concurs that the efficacy of the parameters established for the types of volatility mitigation and risk management functionalities described above should be carefully evaluated, but we believe that the exchanges are best positioned to conduct that evaluation and determine parameters based upon their experience with the liquidity profiles and broader dynamics of their markets.

5. ***The Committee recommends that the Commissions evaluate the present system-wide circuit breakers and consider:***

a. reducing, at least, the initial trading halt to a period of time as short as ten minutes

b. allowing the halt to be triggered as late as 3:30 pm and

c. using the S&P 500 Index as the triggering mechanism.

At the root of the concern regarding the events of May 6th is a view that the broad market declined too far too fast on that afternoon. We agree, all else being equal, that the rapidity of a market break or rally elevates the level of distress in a market, but given the advancements in technology, it is also fair to conclude that speed will inevitably be a feature of electronic markets going forward. Many of the risks that arise from speed alone can be mitigated by the types of automated volatility and risk management mechanisms discussed above, as well as features such as messaging and/or execution throttles. Taking high-speed markets as a given, it is the magnitude of a market-wide move that presents the more significant systemic risk implications as well as the more substantive challenge to investor confidence. CME Group concurs with the Committee's recommendation that the efficacy of the current market-wide circuit breakers be evaluated in the context of the present market environment; in our view, these circuit breakers, properly designed and calibrated, are a critical buffer to avoiding the type of macro-market price destabilization that might otherwise threaten the market infrastructure of trading, clearing and credit systems.

In CME Group's letter to the SEC in July 2010, we urged the Commissions to reevaluate the current market-wide circuit breakers in order to address the concerns arising from the events of May 6th. Although we believe this is arguably the single most important action to be taken to shield the market from a similar type of occurrence, to date little progress has been made toward examining this issue in a coordinated fashion. Today, the circuit breaker rules are triggered based upon 10%, 20% and 30% declines in the Dow Jones Industrial Average ("DJIA"). These levels were not breached on May 6, 2010, but clearly a lesser move than 10%, coupled with the speed of today's markets, severely roiled the markets and challenged investor confidence on that day. CME Group therefore believes it would be prudent to promptly re-evaluate the current construct and lower the circuit breaker thresholds to levels that would remain infrequently triggered, but better protect the market system and sustain the confidence of market participants in a period of instability.

Second, we support shorter halts and simplification of the time-of-day application of the different thresholds. Given today's highly automated market structure and sophisticated information processing technology, less lengthy halts are necessary to allow the market to assimilate information, assess risk and mobilize liquidity. Specifically, we recommend a 10 minute halt in the event of the first trigger, a 30 minute halt in the event of the second trigger and a closing of the market for the remainder of the trading day in the event of a third trigger. We further recommend that only the second circuit breaker level be applicable beginning at 3:30 p.m. Eastern Time ("ET"), and if that level is initially triggered at 3:30 p.m. ET or afterwards, the market would be halted for the remainder of the trading day.

CME Group strongly encourages the Commissions to promptly consider, in consultation with the industry, the questions regarding the appropriate levels and duration of market-wide circuit breakers, as well as the appropriate market reference and other relevant operational details. We believe that this is the most important of the Committee's recommendations and will be the most impactful in terms of addressing the broader market stability issues raised by the events of May 6th.

II. Restrictions on Co-location and Direct Access

6. ***The Committee supports the SEC's "naked access" rulemaking and urges the SEC to work closely with FINRA and other Exchanges with examination responsibilities to develop effective testing of sponsoring broker-dealer risk management controls and supervisory procedures.***

Although the SEC has historically put the bulk of the burden for pre-trade and post-trade risk management on the broker-dealers in the equity markets, CME Group believes that effective risk management is necessary at the trading firm, clearing firm and exchange levels. This holistic approach of having redundant checks offers the most robust protection to markets by engaging all levels of the supply chain in the commitment to preserving market integrity and eliminating the possibility that a single point of failure will cause significant harm to the market.

Market centers obviously have a critical role to play in this regard as they are last line of defense before orders interact with the market. In addition to the automated pre-trade risk management and volatility mitigation controls deployed by CME Group that are described elsewhere in this letter, we also require all clearing firms to employ CME Globex Credit Control functionality. The

credit control functionality provides automated pre-trade credit controls at the trading firm level without introducing additional order processing latency. The credit limits for each trading firm are established by the clearing firm and the functionality provides for automated early warning notifications as well as automated real-time actions that prevent the limits from being breached.

The exchange-provided controls are intended to complement the other risk management tools used by clearing firms and trading firms to manage risk at a more granular level. CME Group believes that both trading firms and clearing firms should have principles-based supervisory obligations that include the establishment of documented internal control procedures, including appropriate testing before automated systems are deployed in the production environment, as well as the implementation of risk management controls that are appropriate to the entity's business and reasonably designed to protect against activity that could disrupt the market. Trading firms, for example, should be required to certify their implementation of pre-trade controls such as order quantity limits, price sanity checks, messaging throttles and execution throttles, with the parameter ranges of these controls agreed to by the clearing firm.

Trading firms, clearing firms and exchanges each have strong, independent pecuniary and reputational incentives to protect against market disruptions, and clearly, robust, multi-pronged risk management controls and supervisory procedures are critical elements in the collective effort to protect against such disruptions. At least from a futures-centric point of view, any analysis of the evolution of risk management in the electronic trading environment over the past five years would surely reveal, notwithstanding the considerable growth in volumes and the increased speed of trading, tremendous progress in terms of risk management capabilities and execution. CME Group therefore encourages the Commissions to establish an appropriately consistent and appropriately flexible regulatory framework that effectively supports the principles of sound supervisory and risk management protocols without creating unnecessarily onerous bureaucratic burdens or impeding continued innovations in the market.

Although CME Group is strongly supportive of strong supervisory and risk management protocols, as well as accountability to those principles across the supply chain, we encourage the Commissions to be mindful that overly prescriptive and inflexible "one-size fits all" regulation tends to be inappropriately targeted and have unintended adverse consequences given the variability of participant and market circumstances. Additionally, highly prescriptive regulations often become quickly outdated in areas where markets and technology are rapidly evolving and generally function to inhibit innovation. Given the exceptional breadth of automated trading systems and strategies and the dynamic evolution of markets and technology, including risk management technology, any effort by the Commissions to promulgate prescriptive rules in this regard is likely, for the aforementioned reasons, to be counterproductive.

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.***

CME Group responded in detail to the CFTC's Advance Notice of Proposed Rulemaking on Disruptive Practices on January 3, 2011, and the CFTC has since issued for comment a Proposed Interpretative Order with respect to its anti-disruptive practices authority under Dodd-Frank.

In its report, the Committee recommends that the CFTC impose supervisory provisions, "similar to what the SEC has imposed," on any FCM sponsoring algorithmic orders to the exchange. As outlined in our response to question 6, CME Group believes it is appropriate for the CFTC to consider establishing principles of a supervisory regime, including effective implementation of documented pre- and post-trade risk management and supervisory procedures that are reasonably designed to control access, effectively monitor trading and prevent errors or other inappropriate activity that poses a material risk of causing a significant market disruption. Further, although the Committee's recommendation focuses exclusively on algorithmic order routing strategies, it is important that the Commissions recognize that such principles are equally as important in the context of manually entered orders in an electronic environment as they are in the context of orders entered via automated trading systems; the method of order entry simply is not determinative of either the speed of order entry or the potential impact of the participant's orders on the market.

The Committee also raises the question in its report as to whether the Commissions should restrict "large order execution design that results in disruptive trading"[1] and offers the examples of "large order algorithms that employ unlimited use of market orders or that permit executions at prices which are a dramatic percentage below the present market price without pause for human review." "Large" and "disruptive" are of course subjective terms and an order of a particular quantity in a particular instrument may have entirely different impacts depending on the market's liquidity profile at the time the order is entered. This was quite clearly illustrated on May 6th in the context of a series of orders executed algorithmically by an institutional asset manager over a 20 minute period – orders which we assume are the genesis for this recommendation. In that situation, the asset manager utilized a large order algorithm specifically designed with numerous parameters to mitigate the market impact of the order. The order's 75,000 contracts, which were entered to hedge a portion of a portfolio against downside exposure, were broken up into nearly one thousand smaller orders, all of which were entered with a limit price consistent with the exchange's price banding parameters. Further, just under half of the 75,000 contracts were executed as the market declined during the first 13 minutes after the initial order was entered and more than half of the contracts were executed as the market rallied strongly off its lows over the subsequent 7 minutes. Thus, approximately the same quantity of contracts was executed in the same product, using the same "large order execution algorithm," within the same general timeframe, and comprising approximately the same percentage of overall volume, yet the market behaved completely differently because of the rapidly shifting liquidity dynamics during that period of time. In fact, with respect to nearly half the volume the entity executed, the entity was providing rather than consuming liquidity.

[1] Additionally, as we highlighted in our response to the CFTC's Advance Notice of Proposed Rulemaking on Disruptive Practices on January 3, 2011, it is necessary that specific practices that are deemed to contravene a prohibition on disruptive practices be clearly defined as a lack of clarity will negatively impact market participation because of exposure to uncertain regulatory risks and the possibility that legitimate trading strategies will be construed post-hoc to be unlawful.

Large orders represent demand for liquidity and that demand necessarily informs price discovery. Participants typically rely on algorithms to execute large orders today precisely because sophisticated algorithms can employ intelligent real time analytics that allow traders to significantly reduce the market impact of their orders and enhance the quality of their execution. As discussed in our previously referenced letter on this topic, we do not believe the Commissions are equipped or should be involved in regulating the design of algorithms, and should instead focus on regulating conduct that is shown to be harmful to the market.

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."***

CME Group respects the Committee's efforts to consider new ideas that might incentivize liquidity provision in periods of high volatility. Although it is possible that such incentives might have some minimal impact at the margin, CME Group is dubious that potential fee reductions would be sufficient to compensate market makers for the additional risk they would be taking on under severely distressed market conditions, particularly if there is uncertainty with respect to the quality or timeliness of market data.

The Committee suggests that the Commission "should consider encouraging, through incentives or regulation, persons who regularly implement market maker strategies to maintain best buy and sell quotations which are reasonably related to the market," and particularly points to high frequency traders who it notes often engage in multi-market arbitrage activities that provide liquidity to and across markets. The Committee adds that these traders realize significant profits in good times but do not have corresponding obligations to support markets in bad times.

CME Group does not believe that high frequency traders, however such traders are in fact defined, should be *required* by third parties to put their own capital at risk when it is unprofitable to do so. High frequency traders, like other independent traders who are uncompensated by the trading venue, should quote responsibly based upon their ability to responsibly manage the risks associated with the orders they place. It would be extremely irresponsible for a high frequency trader, or any other trader, to continue to operate an algorithm under conditions in which it was not designed to operate or when the inputs to the algorithm are not reliable. Doing so could potentially put the firm itself at risk and arguably subject the firm to regulatory exposure if their algorithm malfunctioned and created or exacerbated a disruption in the market.

In fact, in order to mitigate the risk to capital and reduce the potential for causing disruptions in the market, firms have automated risk management protections built into their algorithmic code to prevent new orders from being entered or to liquidate outstanding positions if certain boundary conditions are identified that would potentially cause the algorithm to malfunction. On May 6th, as the Committee notes, there were a variety of issues that created uncertainty in the market, and although many high frequency traders remained in the market and provided critical liquidity in the face of tremendous liquidity demand, some withdrew. However, parties engaged in the multi-market arbitrage activities referenced by the Committee who cannot rely on timely, accurate data or on trade certainty in one or more of those markets, cannot reasonably be expected to continue to provide liquidity.

Rules that would undermine a trading firm's own risk management processes by creating affirmative trading obligations in highly volatile periods are misguided. Assuming participants in fact complied with such obligations, which they likely would not, this "cure" would simply lead to the depletion of market making capital and result in less liquid and more volatile markets.

CME Group believes that effectively calibrated market-wide circuit breakers, coupled with automated volatility mitigation and risk management mechanisms and certainty regarding trade cancellation policies, are straightforward steps that will be much more impactful in encouraging liquidity providers to remain in the market during highly volatile periods. Additionally, the Commissions should ensure that federal policies and rules, as well as those of exchanges, do not foster conditions that exacerbate uncertainty in the market. One of the key lessons from May 6th was that where liquidity providers lacked confidence in the speed and accuracy of market data, the implementation of error trade policies or the coordination across markets, they were more likely to withdraw from the market. CME Group therefore recommends that the Commissions carefully examine the necessity and design of any policies, rules or operational practices that are likely to aggravate uncertainty and lead to, or exacerbate, a liquidity crisis.

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.**

The Committee, while acknowledging that there are valid reasons for algorithmic trading strategies to drive high cancellation rates, suggests that participants utilizing those strategies should "properly absorb the externalized costs associated with their activity." The Committee therefore recommends that the Commissions explore imposing a uniform fee across all exchange markets based on the average of order cancellations to transactions effected by a market participant. CME Group believes there are a number of problems with this approach.

As an initial matter, the Committee has not identified how the market will be served by this proposal or how it will enhance the stability of markets. Other than apparently seeking to impose a tax on a high frequency trading, the objective is unclear. It is important to recognize that there are a wide variety of high frequency trading strategies, and traders who employ these strategies contribute substantial and diverse liquidity to markets, thereby benefiting other market participants by aiding market efficiency and hedging efficiency.

Inappropriately taxing order cancellations could well prove counterproductive and harm market stability. Every order entered into the market represents liquidity, albeit of varying quality depending on where in the book it is entered, because it can be executed against for as long as it remains in the order book. If order cancellations are taxed, participants will most likely reduce their quoting away from the best bid or offer as those bids and offers are less marketable at the time they are entered; the impact will be less depth deeper in the order book. When there is extreme volatility, as was observed on May 6th, liquidity deeper in the book is important to maintaining stability because in an electronic environment liquidity can be consumed exceptionally rapidly and deeper bids can quickly become the best bids. If those bids are not present as a result of artificial disincentives to quoting, the risk of exacerbating the volatility becomes very real.

CME Group agrees with the Committee that excessive messaging has the potential to impair market efficiency by causing disruptive latencies that negatively impact other market participants. To mitigate this risk, as well as the risk of a malfunctioning algorithm, CME Group employs automated messaging controls at the connection level to the trading engine. If a connection exceeds the CME Group established message per second threshold over a rolling three-second window, subsequent messaging is rejected by the trading engine until the average message per second rate falls below the threshold.

CME Group additionally employs a CME Globex Messaging Policy that is broadly designed to encourage responsible messaging practices and ensure that the trading system maintains the responsiveness and reliability that supports efficient trading. Under this policy, CME Group establishes messaging benchmarks based on a per-product volume ratio which measures the number of messages submitted to the volume executed in a given product. These benchmarks are tailored to the liquidity profile of the contract to ensure that contract liquidity is not compromised. CME Group works with firms who exceed the benchmarks to refine their messaging practices and failure to correct excessive messaging results in a surcharge billed to the clearing firm.

CME Group believes that market centers should have appropriate policies and mechanisms to manage messaging in their markets, but it is our view that the market centers are best equipped to establish these parameters in a manner that best serves its markets.

IV. Information Provision and Regulators' Access to Information

13. ***The Committee recommends that the Commissions consider reporting requirements for measures of liquidity and market imbalance for large market venues.***

The Committee recognizes in its report that given the speed of today's markets, order imbalances can arise quickly and unexpectedly and also be ameliorated just as quickly. It suggests that more transparent information on variables related to the order book may provide a basis for market-generated responses to liquidity imbalances.

CME Group supports the Committee's interest in market transparency and agrees with the Committee that market-based solutions play a preferential role in the efficient functioning of markets. CME Group offers a wide range of market data to users including price quotes and volume, depth of book calibrated based on market demand, market reports and a comprehensive historical data service. We distribute real-time pricing and volume data through a global distribution network of approximately 500 directly connected vendor firms serving approximately 400,000 price display subscribers and hundreds of thousands of additional order entry system users.

In our view, market-based data products are the best way to address any opportunities in this area, and to the extent market participants signal a need for data products that provide additional liquidity and market imbalance metrics, proprietary data products will be developed by us or other vendors to address such commercial needs. Today, many traders perform detailed automated analyses of the data already provided in order to create these types of metrics to facilitate their trading decisions. It is also important to recognize that market participants have capacity issues with respect to consuming market data and there is consequently a need to weigh the benefits of distributing additional data or metrics against the cost of creating additional processing inefficiencies.

14. ***The Committee recommends that the SEC proceed with a sense of urgency, and a focus on meaningful cost/benefit analysis, to implement a consolidated audit trail for the US equity markets and that the CFTC similarly enhance its existing data collection regarding orders and executions.***

CME Group supports the Committee's recommendation that the CFTC continue to enhance its existing data collection regarding orders and executions. We have worked closely with the CFTC with respect to their data needs and our shared regulatory objectives, and they currently receive highly granular data regarding all executions and large trader positions on a daily basis. The CFTC additionally is able to obtain detailed CME Globex order messages upon request, and CME Group is presently actively engaged with CFTC staff to facilitate their preparedness to receive the full scope of detailed order data daily from CME Globex.

We concur with the Committee that it is important to minimize the costs associated with industry reporting requirements and to avoid unnecessary financial burdens and operational complexities on industry participants whenever possible; it is also important that systems designed to collect such information be flexible enough to accommodate future changes in order not to impede continued innovation.

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Again, we appreciate the opportunity to respond to the Committee's report and urge the Commissions to take into account our comments and those provided by other market participants. We are happy to discuss any questions concerning the comments contained in this letter and are otherwise available to assist the Commissions in its efforts to enhance the stability and integrity of the markets. Please feel free to contact me at (312) 930-8275 or via email at Craig.Donohue@cmegroup.com, Bryan Durkin, Chief Operating Officer, at (312)435-3687 or Bryan.Durkin@cmegroup.com, or Dean Payton, Deputy Chief Regulatory Officer, at (312) 435-3658 or Dean.Payton@cmegroup.com.

Sincerely,

Craig S. Donohue

cc: Chairman Mary Schapiro
Chairman Gary Gensler
Commissioner Michael Dunn
Commissioner Bart Chilton
Commissioner Jill Sommers
Commissioner Scott O'Malia