US FUTURES EXCHANGE

August 8, 2007

Eileen A. Donovan
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

RE: USFE Rules 312 and 404 Amendments – New Market Structure

Dear Ms. Donovan:

United States Futures Exchange, LLC ("USFE"), a designated contract market, has determined to amend its rules to establish a market model that will provide market participants with greater liquidity and more continuous and orderly prices. This market model, which is somewhat akin to the concepts underlying the specialist system in the securities markets, will assist USFE in launching and maintaining liquid and orderly markets for its planned innovative retail-oriented products. These amendments, along with amendments already made to its order allocation algorithm,[1] will create a USFE market structure in which USFE will designate a number of competing market makers having affirmative obligations to provide liquidity and more continuous and orderly prices to its markets. In exchange for undertaking affirmative market making duties to the market, and as specified in agreements negotiated between market makers and USFE, market makers will be entitled to the execution of a certain proportion of orders at the best prevailing price, regardless of the market maker's time of order priority. As a separate matter, USFE may also provide market makers with benefits for a stated period of time that are typical of incentive programs that have been used by contract markets in the past. These may include reduced or rebated transaction fees and/or the receipt of compensatory payments. These incentives would also be specified in agreements negotiated between market makers and USFE. For the reasons explained below, USFE believes that these amendments are consistent with the Core Principles, and in particular with Core Principles 9 and 18 of the Commodity Exchange Act, 7 U.S.C. §1 et seq. ("Act").

USFE is self-certifying these rules to the Commodity Futures Trading Commission ("CFTC" or "Commission") under CFTC Rule 40.6(a). This explanation of the USFE rule amendments is being submitted to the CFTC with USFE's self-certification of these rule amendments in order to describe more fully the operation of these amendments to its rules and to explain how they are consistent with applicable Core Principles under section 5 of the Act.

[1] See Rule 40.6 Self-Certification filing dated April 18, 2007.

Role of the Designated Market Maker

Market makers have been recognized generally as providing a public benefit by providing liquidity to otherwise illiquid markets and providing greater price continuity in markets during times of market stress. The Commission in its Glossary defines a "market maker" as

> A professional securities dealer or person with trading privileges on an exchange who has an obligation to buy when there is an excess of sell orders and to sell when there is an excess of buy orders. By maintaining an offering price sufficiently higher than their buying price, these firms are compensated for the risk involved in allowing their inventory of securities to act as a buffer against temporary order imbalances. In the futures industry, this term is sometimes loosely used to refer to a floor trader or local who, in speculating for his own account, provides a market for commercial users of the market. Occasionally a futures exchange will compensate a person with exchange trading privileges to take on the obligations of a market maker to enhance liquidity in a newly listed or lightly traded futures contract.

USFE is proposing to adapt the concept of a market maker to its electronic market. As in the securities markets, USFE market makers will have an affirmative duty to the market to stand ready to take the other side of orders that otherwise would go unexecuted. This role will add depth and liquidity to the market and will also provide more orderly, continuous prices in USFE markets.

In general, the established futures markets have looked upon market makers as a temporary feature of the market adding liquidity only to new or selected products. Thus, futures exchanges have tended to treat market makers as another form of incentive program to encourage trading in selected markets. In contrast, the securities industry, through the Specialist System, has viewed market makers as an inherent part of the market structure and a permanent means of enhancing the competitiveness and orderliness of market prices by bringing greater liquidity and pricing continuity to the market. The utility of a designated market marker for enhancing the competitiveness and orderliness of securities markets may be due in part because securities markets generally list a far greater number of stocks than a futures exchange lists futures contracts. The presence of market makers willing to make markets thus ensures liquidity in all products listed for trading on a securities exchange. Because liquidity on a futures exchange is likely to be spread across fewer trading products than in securities markets, the relative utility of market makers may have been lessened on traditional futures exchanges. Moreover, the securities markets have generally been inclined to favor continuity in price changes compared to the futures industry which has been more accepting of discontinuity in price changes.

Because it anticipates offering a wide number of new, innovative and often niche products, USFE believes that the market maker model may be an appropriate feature of its market model. USFE anticipates that even as its market matures, it will seek to list a relatively greater number of innovative products on an on-going basis. Like the Specialist system of the New York Stock Exchange, market makers can provide liquidity to a market having a relatively large number of individual trading products. This is in contrast to the traditional futures market model where liquidity in an exchange is concentrated in relatively fewer trading products. Moreover, USFE plans for retail customers to form an important part of its customer base relative to the customer base of the established U.S. futures exchanges. Retail traders are likely to be more accustomed to, and more likely to expect, the greater price continuity that can be provided by using market makers and that is currently only associated with trading in the securities markets. This is an additional reason supporting the use of market makers as an integral part of USFE's market model.

Accordingly, based upon a different business model from the established futures exchanges, USFE, as a matter of its business judgment, views market makers as a potentially attractive part of its market model and not simply as a form of incentive program. This is a business judgment of the exchange which rests on its assessment of the differences in USFE's business model from that of the established futures markets. USFE believes that the difference in its business model, including the use of market makers to provide additional liquidity and orderliness to the market, is essential to its ability to gain and sustain customers, especially in light of the very high competitive obstacles that face new futures exchanges.

Description of the USFE Market Model

Under the USFE market model, at the time that each new trading product is introduced, members will be solicited for their interest in assuming the obligations of Market Maker ("MM"). Financial and trading capacity criteria that market makers must meet are provided under amended USFE Rule 312(a). These criteria may be tailored to address the particular characteristics of each new product. At a minimum, however, MMs will be expected to quote bid and ask prices for a minimum number of contracts with a maximum tick spread between the bid and the offer, for a minimum amount of time. The exact parameters would be set forth in the invitation. MMs must also respond to requests for quotes and must make the requisite investment in technical readiness and capacity to fulfill the role of Market Maker.

USFE anticipates that more than one entity will apply to be a MM and that generally it will select between four and six MMs for each product market, although that number may be higher for certain products. Where there are more entities willing and qualified to undertake the role of MM, USFE will make a selection based upon which firms will best satisfy the criteria. In the event that only one MM is designated, such MM will be entitled to no greater than a 30% order allocation, which is the maximum permitted to any individual MM. In the event only two MMs are designated, the maximum allocation to both will be 45%.

USFE anticipates that the entities that are selected to act as MM will vary from one USFE product to another. The particular obligations will also be contained in a contractual agreement between USFE and each entity selected. USFE will monitor for compliance by the entity with its obligations. The term of the agreement is open-ended, but for the avoidance of doubt on the part of the market makers who must make a sizable investment in customer readiness preparations, USFE will provide assurances that the agreement is intended to be for a minimum period of five years. However, USFE will reserve the right to vary the terms of the agreement from time to time and to conduct a new selection process as it deems appropriate for regulatory or business reasons.

The algorithm for the USFE matching engine has been adjusted to reflect the role of market makers in its market. While USFE maintains the price-time priority algorithm, it has added other algorithmic matching options with its new USFE 1.0 software release. As before, orders will be matched in priority based upon the best price offered in the market. Where there is an excess of bids or offers at any particular price, the matching engine will allocate trade execution among MMs and other participants. At least 50% of such allocations will be available to all other market participants on a time-of-order sequencing. The allocation of executable trades to market makers as a group is made without regard to time of order entry.[2]

The adoption of this framework as its market model distinguishes USFE from other futures exchanges that have previously adopted such allocation provisions as part of temporary incentive plans. As noted above, USFE does not view this as an incentive program wherein it pays entities to be present for the short term in its markets. Rather, its philosophy is that Market Makers, in return for a substantial and permanent commitment to add liquidity and enhance market orderliness to USFE markets, will be ensured of receiving an allocation of executable trades when there is an imbalance between bids and offers. As noted above, under this model the best offer or bid will always receive absolute priority in trade execution and where there is an excess of bids or offers at a particular price, the majority of the resulting executable trades will always be reserved for non-market-maker participants under the usual time-of-order priority rules.

[2] *E.g.,* If there are 2 MMs each with a 20% allocation and a non-market maker participant who all have orders in at the same price, then the two MMs will be entitled to 20% each of any order that matches in price and 60% of the ensuing order will be available to all market participants. Assume that MM1 has an outstanding order for 10 contracts and MM2 has an order for 20 contracts and the non-MM has an order for 30 contracts all at the same price. Further assume that an order for 40 contracts is entered on the other side of the bid or offer. Non-MMs will have available to them the majority of executed trades from these orders, in this instance, 24 contracts. The 24 contracts will be distributed based upon the underlying price-time matching algorithm. In this example, the non-MM with the oldest order would be filled for 24 contracts. The remaining contracts, having been allocated to MMs, will be divided by the two MMs with orders in the market. Thus, each will be filled for 8 contracts. For further details on USFE's trade matching algorithm, see *Market Maker Allocation and TOP Orders* at www.usfe.com.

The USFE Market Model Meets the Requirements of Core Principle 9

The Commodity Futures Modernization Act of 2000 replaced a system of prescriptive regulations with a flexible, principles based approach to regulation. In particular, Section 5 of the Act was amended to replace prescriptive criteria governing contract market designation with Core Principles governing the operation of contract markets. Of critical importance, Section 5(d)(1) provides that, "the board of trade shall have reasonable discretion in establishing the manner in which it complies with the Core Principles." The Congressional mandate that the Commission provide contract markets with the ability to determine the method by which the exchange meets a Core Principle is reiterated in Section 5c(a) of the Act, which provides that interpretations issued by the Commission of practices that constitute acceptable practices under the Core Principles "shall not provide the exclusive means for complying with such sections."

Core Principle 9 provides that:

> The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.[3]

7 U.S.C. §7(d)(9). The Commission's Guidance On, and Acceptable Practices for Compliance with Core Principle 9 does not provide guidance with respect to acceptable practices with respect to the participation of market makers on a designated contract market.[4] However, as discussed above, market makers have been included in the market model used by the securities exchanges and their use has generally been accepted as providing the public with the benefit of more liquid markets with greater continuity of pricing.

Moreover, the use of market makers has been a commonly accepted practice in the futures markets. In this regard, a number of contract markets have provided for market makers with respect to certain products and for specified periods. Under these past programs, contract markets generally have required such market makers to carry out affirmative obligations with respect to providing bids and offers during specified periods, responding to requests for quotes, and for maintaining a presence in the market for specified periods of time. In return, futures exchanges have allocated market makers a portion of the order flow and/or paid various types of incentives to such market makers. Contract markets have as a business decision determined to pay incentive fees to such members to ensure their active presence in the selected markets and to provide them an incentive to trade in a new product rather than in an already liquid product on the exchange. Because these were incentive programs carrying with them the significant payments, the exchanges have limited their use of market makers to a stated term.[5]

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[3] In addition to Core Principle 9, Designation Criterion 3 provides that a board of trade shall establish trading rules to establish "fair and equitable trading" through its facilities.

[4] See, 17 C.F.R. Part 38, Appendix B. The Commission's guidance with respect to designation criterion 3 is similarly silent with respect to the role or use of market makers. See, 17 C.F.R. Part 38, Appendix A.

[5] *See e.g.* "New York Mercantile Exchange Proposed Specialist Market Maker," 63 *Fed. Reg.*27058 (May 15, 1998).

USFE's rules providing for market makers under its market model follows the practices that have been widely accepted by the industry and previously approved by the Commission with the difference that USFE, as a business decision, has determined that the permanent presence of market makers will benefit the competitiveness and efficiency of its various products and should be an integral part of its market model. This market model will provide the public with greater and deeper liquidity and with more continuous prices. These benefits will exist even in mature markets. For example, in a fast market, the presence of market makers will have the effect of smoothing out price fluctuations. Although this is a point of departure from other futures exchanges, it in no way undermines the fact that the USFE market maker model follows practices that are generally accepted in the industry and which have been previously approved by the Commission.[6]

USFE Market Maker Model Meets the Requirements of Core Principle 18

Core Principle 18 provides that

> Unless necessary or appropriate to achieve the purposes of this chapter, the board of trade shall endeavor to avoid--
> (A) adopting any rules or taking any actions that result in any unreasonable restraints of trade; or
> (B) imposing any material anticompetitive burden on trading on the contract market.

USFE's adoption of its amended market maker model does not violate Core Principle 18. No feature of USFE's market model market would constitute an unreasonable restraint of trade or impose a material anti-competitive burden on trading on the contract market.

In this regard, unlike the Specialist system used in the securities markets, USFE will endeavor to select more than one qualified market maker in each product. Moreover, USFE does not contemplate providing a single entity with "Lead" Market Maker status.[7] USFE intends to vary the selection of such interested entities with respect to particular products, so that all qualified firms will have an opportunity to compete for, and be chosen to fill, various available market maker positions. In each product, USFE contemplates that competing market makers will be present and that all entities with the technical and financial ability to meet a market maker's obligations to the market will have an opportunity to be selected to fulfill that function. Thus, competition in the

[6] Moreover, the one point of distinction between USFE's practice and that of other futures exchanges is the permanent, rather than temporary nature of the use of market makers. However, market makers are also an accepted, permanent feature of the trading system for securities markets, which are also generally recognized as being "competitive, open, and efficient."

[7] *Compare* OneChicago rule 514, which contemplates that OneChicago may designate a single market maker as a "lead" market maker having enhanced duties.

selection process and the use of competing, rather than a single, market maker, will ensure that the USFE market model does not act as a restraint of trade.

Moreover, nothing in the USFE market model would impose a material anticompetitive burden on trading on the contract market. As noted above, the Commission has previously approved various market maker schemes wherein, as here, a portion of the order flow was allocated to market makers. Under the USFE market model, the best bid or offer will always have execution priority. Moreover, at least 50% of executable trades where there is an imbalance of bids and offers at any particular price always will be reserved for non-market maker entities.[8] In these respects, the percentage of the order flow allocated to market makers under USFE's market model compares favorably with the allocations of order flow to market makers provided by other contract markets. Accordingly, nothing in particular with respect to USFE's market maker program would act as an anticompetitive burden on trading on the contract market.

USFE acknowledges that, as a market matures, the role of the MM may have to change to address possible restraint of trade or material anticompetitive burdens that may arise. Rule 312(d) will require the Exchange to review the MM function at least once every three years. USFE also undertakes to report the results of such a review to CFTC staff on a confidential basis. Even though an individual MM agreement may have a term of at least 5 years, USFE will have the right, unilaterally, to make necessary changes to the individual MM agreements pursuant to either an order by the Commission or in its own discretion.

Even if the Commission were to determine that some portion of the USFE market model acted as a restraint of trade or imposed a material anticompetitive burden on trading, the inquiry of whether the practice would violate Core Principle 18 would only be beginning. Like the duty imposed on the Commission under Section 15(b) of the Act to take into consideration the public interest to be protected by the antitrust laws as well as the policies and purposes of the Act, Core Principle 18 requires weighing the purposes of the Act that a rule or practice may achieve against the possible anticompetitive impact of such a rule or practice. Thus, even if a particular contract market rule or practice acted as a restraint of trade or burdened competition, that impact would have to be weighed against whether the rule or practice were "necessary or appropriate to achieve the purposes of the Act." Thus a contract market would not violate Core Principle 18 by adopting a rule or practice that burdened competition if the rule or practice is necessary or appropriate to achieving the purposes of the Act.

As demonstrated above, the use of market makers is an appropriate means of achieving one of the purposes of the Act, providing deep, liquid and orderly markets, particularly in light of USFE's business model of offering many new innovative products to participants that include a large base of retail customers. In USFE's view, the necessity for and the appropriateness of its market model as a means of achieving the

[8] Note that a market maker who has participated in the allocation may have the oldest order in the queue and, thus, will have the remainder of its order executed before the next order in the queue will be filled, and so on....

Act's policies of competitive, open and efficient markets would outweigh the anticompetitive effect or restraint of trade, if any, resulting from its market maker model.

Accordingly, USFE is aware of no feature of its revised market model which would act as a restraint of trade or as an anticompetitive burden on trading on its market. Even if a feature of its market model were to have such an effect, USFE believes that such an effect would be outweighed by its model being an appropriate means of achieving a fundamental and over-arching purpose of the Act—providing "open, competitive and efficient" markets.

For the above reasons, USFE's amended market model complies with the Act and is so certifying these rule amendments to the Commission.

Yours Truly,

Matthew Lisle
Chief of Compliance

312. Market Maker~~ Program~~.

a) The Exchange, in order to provide liquidity and orderliness in an Exchange market, may ~~adopt a program granting~~ one or more Members, designated as Market MakersError! Bookmark not defined., benefits in return for assuming and adequately performing obligations. ~~Any such program may contain~~Market Makers will be selected based upon criteria which include the following:

~~(a)~~(i) ~~The qualifications to become a Market Maker, including without limitation any m~~Minimum net capital requirements;

(ii) Previous market making experience;

(iii) Technical capability and readiness;

~~(i)~~(iv) Representations and warranties with respect to obligations of a Market Maker including, without limitation, maximum bid/offer spreads, minimum quote size and minimum time in market;

~~(b) The procedure by which a Member may seek and receive designation as a Market Maker;~~

~~(c) The obligations of a Market Maker, including without limitation, maximum bid/offer spreads and minimum quote size; and/or~~

~~(d)~~(b) The Market Maker algorithm pursuant to Rule 404(c)~~.~~will apply in markets providing for Market Makers.

~~(e)~~(c) The ~~benefits accruing~~Exchange may also ~~will~~ provide benefits to a Market Maker~~,~~ which may includ~~e~~~~ing~~, without limitation, reduced transaction fees~~,~~ and/or ~~and/or~~ the receipt of compensatory payments from the Exchange.~~ and/or an order allocation pursuant to the Market Maker allocation algorithm set forth in Rule 404(c).~~

~~(f)~~(d) The Exchange will review the impact of this rule every three (3) years.

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404. Execution of Transactions.

Transactions shall be executed in accordance with procedures established by the Exchange. When the Trading System matches valid bids and offers, such matches shall constitute a valid transaction binding the Members entering the bid and offer. Orders entered into the Trading System shall be executed in accordance with one of the following trade matching algorithms as determined by the Exchange on a Contract by Contract basis (For further details, see *Market Maker Allocation and TOP Orders* at www.usfe.com):

(a) Price time priority algorithm. The price time priority algorithm gives first priority to orders at the best prices, and then gives priority among orders at the same price based on time of entry into the Trading System.

~~(a)~~(b) Price pro-rata priority algorithm. The price pro-rata algorithm assigns first priority on the basis of price and fills orders at the same price on a pro-rata basis.

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(c) Market Maker allocation algorithm. The Market Maker allocation algorithm gives first priority to market orders, second priority (at the Exchange's discretion and by notice to the marketplace) to any order that improves the best price of the Contract, third priority to Market Maker allocated eligible orders at the best price (total allocation among all Market Makers in a single product not to exceed 50% of all orders with the following conditions: i) no individual Market Maker will be permitted an allocation of greater than 30%; and ii) no two Market Makers combined will be entitled to more than 45%), and fourth priority to any limit orders at the best price based on time of entry into the Trading System.