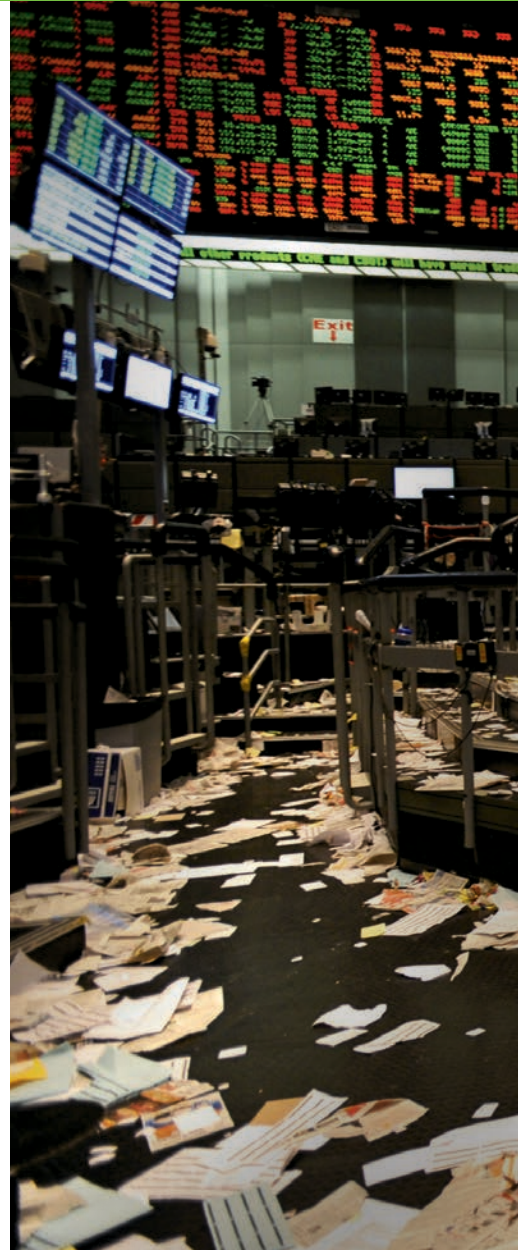


# END OF AN ERA

BY DANIEL P. COLLINS



**O**n Feb. 4, the eve of its quarterly earnings report, CME Group made an announcement that was both a shock and expected, if that is possible: “As open outcry futures trading has fallen to just one percent of the company’s total futures volume, CME Group today announced it will close most of its futures trading pits in Chicago and New York by July 2, 2015.”

With that, the end of the 167-year history of futures floor trading was in sight, creating an uproar in the small, but viable trading community still making a living on the floor. Those traders are angry and believe the decision was more a personal and emotional reaction by CME Group leadership--Executive Chairman Terry Duffy in particular--to a member lawsuit filed last September than it was a sound business decision.

It was on the lips of traders as they filed out of the W Hotel, a block down from the historic Chicago Board of Trade Building, shortly after the beginning of a meeting between members and CME Group leadership two days after the announcement was made. It was clear to many members leaving the meeting early after hearing the reaction to their concerns by exchange leaders that the decision was final. Many used the term “arrogant” and “condescending” when describing the response of the chairman to their concerns.



**Despite the fact that the end of floor trading was an industry-wide known inevitability, the announcement came as surprise to those still making a living on the floor who argue it was more personal vendetta than sound business decision.**

While seemingly counterintuitive — it is assumed in many circles to be the old-time floor traders who are living in the past hanging on to an inefficient way of doing business—there are valid arguments that the remaining business done through open outcry provides value, especially to end-users who would face higher execution costs if forced to place large and complex spread trades electronically.

Those most upset coming out of the meeting were traders from the Treasury complex who make markets during the quarterly Treasury roll. While the vast majority of trading is executed electronically, customers come to the pits to execute a considerable amount of their rolls (carry a position from the front month to the next option). As much as 20% of the roll by numerous estimates (see “Size matters,” page 20). While end users can execute simple calendar rolls, there is a greater demand to trade uneven rolls where floor traders give up an

edge on the tails.

One member said, “We execute a boatload of spreads on the roll for institutional customers including Morgan Stanley, UBS and Smith Barney. Can’t do that on the screen, you can’t do a spread with a tail.”

This brings up another point of contention. While the CME emphasized the 1% number as proof that end-users had voted to close the floor, every member we spoke to that executes customer business said that their customers were taken by surprise.

“What surprises me most is that they say they were being transparent,” one bond trader added. “If they were as transparent as they said, why are all my customers calling me up and saying they were blindsided by this?”

And traders argue the 1% figure is misleading and a product of 24-hour electronic trading and the huge size in Eurodollars and E-mini S&P 500 outrights. However, they acknowledged that

## SIZE MATTERS

The pit saw a surge of volume during the last quarterly Treasury roll.

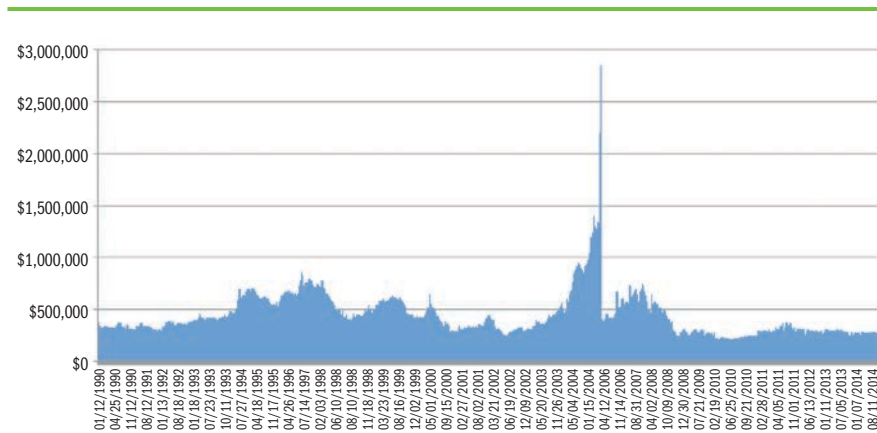
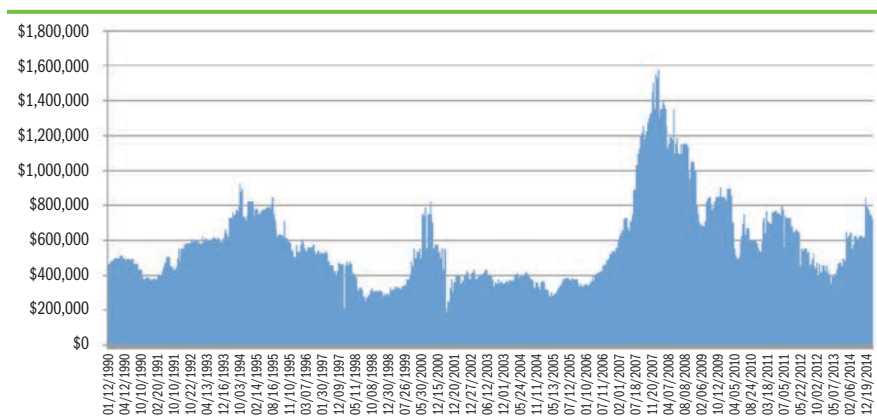
	Monday	Tuesday	Wednesday	Thursday	Friday	Total
2-year	124,070	123,971	118,754	47,054	46,155	460,004
5-year	283,481	116,502	181,507	184,676	84,155	850,321
10-year	115,816	61,339	192,398	167,772	87,913	625,238
30-year	32,263	66,744	196,692	76,285	41,272	413,256
Ultra	52,197	22,717	72,798	65,712	13,591	227,015
Combined	<b>607,827</b>	<b>391,273</b>	<b>762,149</b>	<b>541,499</b>	<b>273,086</b>	<b>2,575,834</b>

Note: Based on preliminary data from CME Group.

Source: CME Group

## MEMBERSHIP SEESAW

The value of full memberships in CME and CBOT has fluctuated over the years and today represents the class B trading privilege. The value spiked for both prior to the exchanges going public and fell after the imbedded class A shares (stock) were delinked from the class B share in 2000 for CME and 2005 for CBOT.



Source: CME Group

it has been several years since the floor volume fell well below the mandated level required to keep it open.

“If they wanted to close the floor five years ago, they should have,” one member exclaimed. But the prevailing view was that this is a push to close the floor entirely because they could have just as easily moved the futures pits into the financial room, and because the CME is not closing options pits, the cost savings are negligible.

Peter Kelly, a longtime member who still stands every day in the soybean oil pit and trades where he can, says CME is putting all its eggs in one “high frequency trading” basket.

“[The exchange] embraced high frequency traders,” Kelly says. “[HFTs] weren’t here 10 years ago and many may not be here five years from now. [CME] pushed people to electronic trading.”

Kelly and fellow traders in the agricultural room tell stories of orders they place on the screen being overshadowed by HFT orders that somehow move in front of their orders despite coming in later. “People don’t think they are getting a fair shake. HFTs don’t take risks, they hang around and steal pennies all day long,” he says.

Kelly says his Dad, who also was a trader, once told him, “If you don’t have customers you don’t have a job.”

Tommy Crouch, principal of TKC Investments, says he will stop trading livestock once the pits go away. Crouch is an end-user who started trading livestock futures when they were launched.

“Those guys [CME leadership] have all forgot what made the exchange. All they care about is algo traders,” says Crouch. “It is impossible for me to do large spreads because the high frequency traders front run them.”

He adds, “Floor traders make market liquid for me, not the screen. Those guys (HFTs) are not risk takers, they don’t carry positions over night, those people don’t make markets, they rape markets.”

Crouch is a colorful guy with strong opinions, but it would be a mistake to dismiss his point of view. The bottom line is that he manages money in the market and he is upset the floor is closing because it provides better fills for his customers.

Too often the argument about electronic trading—like many important arguments—gets broken down to a false

choice, whether it is between the past and future, old school and innovation, more regulation vs. less regulation. While Crouch may feel somewhat betrayed by the folks who earned a living on the floor choosing to close it, his trading decisions are made based on what serves his customers best.

“I have better liquidity, I get better fills. I don’t mind giving up 10¢ or 15¢, if a spreader in the pit takes 1,000 loads from me,” he says. “He helped me get a better fill for my investors,

I never would have gotten it done within 15¢ on the screen. It boils down to, ‘are they getting good fills?’”

Crouch thinks the move could cost CME its meats complex. “I would hope somebody starts another livestock exchange. I don’t mind taking the other side of Smithfield Foods hedges. Who is going to take the other side of those hedges now?”

CME estimated a \$10 million savings based on the move and stated that it was not the driving factor; the driving factor was the 1% figure they kept repeating.

Bradley S. Glass, a local in the live hog pit, confirms many of the Crouch’s fears: “I am willing to take size, but I don’t post size on the screen. We will get picked off on the screen.”

Many traders on the floor think the decision is payback for a lawsuit that is claiming hundreds of millions in damages from the exchange. The reason they see this as personal is because it came out of nowhere and because the functionality within

Globex has not been built to handle the transactions that are now being done on the floor.

### **Lawsuit landscape**

In September, Sheldon Langer, Ronald M. Yermack and Lance R. Goldberg, filed a lawsuit seeking class action status against CME Group in the Circuit Court of Cook County for breach of contract related to “core rights” granted to members at the time of demutualization.

The suit— seeking hundreds of millions of dollars in damages and declaratory and injunctive relief based on CME’s decision to fundamentally change the trading rights and privileges afforded to the Class B Plaintiffs— alleges that CME Group breached core rights granted to Class B shareholders of CME and the Chicago Board of Trade at the time of each exchange’s demutualization.

It claims CME has substantially modified the eligibility

## **What if flash crashnado hits?**

BY MURRAY A. RUGGIERO JR.

**Y**ou might think that the pits are no longer useful, the volume has transitioned to electronic venues years ago, and electronic markets have replaced human traders, except for some specific order types. But there is another reason to keep them around. Human traders offer the financial system a safety net when electronic markets fail. Humans are interacting and watching what is happening and can interrupt problems with electronic trading. They feel a need to protect the system because a computer does not feel and could allow events to cascade. The open outcry system is more costly. Closing the pits might maximize shareholder value but it also creates risk; the financial system might fail during a liquidly disaster.

Computer trading can bring the system to the brink of disaster over a cyberattack, power outage, Internet failure or even another flash crash. In April 2014, CME Group was forced back to the pits because a rare technical problem sent traders scrambling to place their trades on the floor one day before key U.S. crop data was released.

On May 6, 2010, fears of a European sovereign debt crisis sent the S&P 500 down 4%, then the market plummeted almost another 6% in mere minutes before mysteriously rebounding about 20 minutes later. A report by U.S. regulators concluded the flash crash was the product of high-frequency traders halting activity following a massive trade by a single market participant. Because a large percentage of volume is in dark pools, when this volume dried up, the market just cascaded down.

Specialists could have prevented some of the cascade. Many blue-chips like Exelon, Accenture PLC, CenterPoint Energy Inc. and Boston Beer Inc. briefly traded at zero before rebounding. Yes, at zero, thanks to liquidity vacuums.

It’s not just the flash crash. Liquidity evaporated in

Treasury futures on Oct. 15, 2014 between 9:33 a.m. at 9:45 a.m. and prices skyrocketed. Five minutes later prices return to the 9:33 level. The recovery was much quicker because of the existence of a pit market that was reasonably active still at this point.

If we have another flash crash—let’s say an instantaneous 7% to 10% drop in the market at 3:55 p.m. on a Friday afternoon that also happens to be the last Friday of the month—without locals in the futures markets as well as in equities, the market cannot recover before the end of the trading day and the S&P 500 can finish down 10% or more. Blowing through the 200-day moving average, the 50-week moving average, etc. We will end with a negative close for the month—the lowest monthly close in a year. The market would be dark until Sunday evening as a result of all that data and all that technical damage. Because it happened at the end of the week, positions that could have been reversed must stand.

This scenario could cause long-term damage. Even if we rallied back the computerized trading programs, we will see violations of these moving averages and technical support levels and program trades will start a new selloff. Sounds unlikely? Look at what happened in crude oil on the last day of January. It was an orderly move but technically significant as it was straddling a 17-year trendline on a monthly chart.

We need a system of human specialists to oversee the markets when liquidity becomes an issue. High-frequency trading techniques and dark pools create problems where liquidity could disappear. We need to have a system of human interaction with electronic markets or allow for a backup specialist system to kick in the moment things go wrong. Otherwise, the money-saving efforts of electronic trading could put the global financial markets at risk for calamity.

**RED, BLUES, GREENS OH MY!**

This list of Eurodollar positions constitutes one trade with 23 legs. To enter this electronically would require giving up an edge on every leg or taking the risk of legging into multiple positions and opening up greater risk. The broker can break this up into a fewer number of spreads where he can negotiate price—give up an edge on one part and get an edge on another—and provide a much better overall price for the customer.

Buy/sell-size	Contract	Price
S 8	EDZ4	99.7625
S 7	EDH5	99.74
S 7	EDM5	99.615
S 6	EDU5	99.425
S 6	EDZ5	99.185
S 5	EDH6	98.94
B 67	EDM6	98.685
S 5	EDU6	98.44
S 61	EDZ6	98.2
S 2	EDH7	98.015
B 24	EDM7	97.84
B 53	EDU7	97.69
B 34	EDZ7	97.55
B 36	EDH8	97.44
B 31	EDM8	97.34
B 32	EDU8	97.255
B 30	EDZ8	97.17
B 16	EDH9	97.105
S 44	EDM9	97.045
S 71	EDU9	96.98
S 117	EDZ9	96.92
S 12	EDH0	96.86
S 3	EDM0	96.81

Source: Daniel Grant

share,” Kelly says.

Daniel Grant, a member who operates a desk for the DAW Division of Dorman Trading, says, “It is about money and access to the rest of the orders. The people that are creating the rest of this 99% of the average daily volume need access to the rest of the orders. If you are doing 20% to 30% of the Treasury roll in the pit, those people that are running those algos need access to the rest of it. They cannot just have some of it, they need all of it.”

Mike Mette, a local who makes markets in Treasury spreads, says the HFTs don’t like that we are making a tighter market. “I can bid on a 1-lot in the spread and instantly there is a 7-lot there. If I pull my bid that HFT bids goes away, but if the spread trades the HFT order gets filled first,” he says. “It is obvious that they seeing the market sooner.”

The floor mistrust of HFT practices has been affirmed by

requirements under which the Class B shareholders access Globex without obtaining authority of Class B shareholders through a vote that was required under the agreement. At issue is CME opening its Aurora data facility and requiring Class B shareholders to pay colocation fees (see “Membership seesaw,” page 20).

The plaintiffs also take issue with CME allowing other customers access to colocation without requiring the purchase of a Class B share.

The lawsuit claims that rules are being broken to support HFT. “The rule has always been one trader can trade on one membership but there are some HFT firms with 25 traders on one Class B

a recent lawsuit filed by HTG Capital Partners against an unnamed HFT firm. In it, HTG claims it was harmed by illegal spoofing, which was cited as illegal in the Dodd-Frank Act but was not well defined by the law. The Commodity Futures Trading Commission provided guidance in 2013 and more recently CME Group approved Rule 575 to address spoofing. It states, “All orders must be entered for the purpose of executing bona fide transactions. Additionally, all non-actionable messages must be entered in good faith for legitimate purposes.”

The legal theory behind the rule is that the public is entitled to believe bids and offers are reflective of true supply and demand and not intended to entice people, according to one expert.

Chris Hehmeyer, CEO of HTG, says, “The behavior [cited in HTG’s lawsuit] has been dramatically reduced since rule 575 went into affect. It gives markets clarity, which is good.”

**Not about the floor but solutions**

As mentioned before, this is not simply old line traders hanging on, but rather brokers servicing customers that are having a major service taken away.

“My biggest problem going forward is that I can’t affect something called tandems or ratio spreads easily on the [Trading Technologies] or Globex platform,” says Grant. “These are [positions] specifically for non-listed exchange spreads, or spreads with tails or packages in Eurodollars called flex packs.”

Many of the most upset traders were those brokers who execute and make markets in the Treasury complex. Not every Treasury contract is equal, and to complete a perfect hedge most calendar spreads are executed with tails. The end-user is buying and selling an uneven amount. Sometimes it is because of deliverable term structure, the five-year gap in 30-year bond offerings or simply a way for a broker to tighten the available bid/ask spread for the end-user, according to Grant.

And it is not only Treasuries. Grant has many Eurodollar interest rate customers who have extremely complex spreads with multiple legs. If forced to enter these trades electronically, he would be giving up an edge on every leg. Perhaps not a big deal on a simple calendar spread, or even a butterfly, but what if there are up to 23 legs? (see “Reds, blues, greens oh my!” left).

When faced with the prospect of closing futures pits, Grant had a problem, so he came up with four solutions, all of which he proposed to CME. It wasn’t a matter of keeping the futures pits open, but having a way to execute for customers.

His first idea was an expansion of the block trade rule so that the complexity of a particular trade could be one of the benchmarks to do a block and be able to be privately negotiated. For example, instead of having a volume threshold, there would be a complexity threshold. So, if a potential trade had so many various components, it would qualify to be executed as a block.

His second suggestion was to create a small pit where locals would make markets in complex spreads, similar to when the CBOT used to have a flex options pit where locals would make markets in custom and complex option positions.

He also suggested two separate technology based solutions that would improve electronic functionality. “The first one is a TT based trading platform that could accept contracts that I wanted, and trade them,” Grant says. “The downside is that you would have spread risk. You could get legged up on one trade and miss your whole opportunity.”

He also suggested the creation of a non-traditional spread page similar to what is available in options. “That would be the best solution because I could build a transaction of non-listed spreads and be able to trade them on Globex as opposed to trading them on an auto-spreader page, which would work but you have spread risk,” Grant says.

Currently this functionality is not available with futures on Globex.

Grant is not the only broker doing these trades, but he was not encouraged by the reception his suggestions received. “Hopefully they will come up with some solution between now and July,” he says, while adding, “They told me that my transactions are so small that it doesn’t really matter.”

CME Group did not have a specific comment regarding creating additional functionality for various spread trades but noted that the company has been meeting with the floor community on this topic and is working to find an alternative solution.

Grant, like others, pointed out that his customers were never informed of the decision and in sharing this with the CME, was asked by the exchange to have his customers contact the exchange directly. “Oh okay,” he jokes, “This happens to be a relationship business, which they don’t seem to understand.”

### Treasury rolls

One broker whose transactions aren’t so small is Robert Hajdani. He is an order filler and market maker in the two-year Treasury futures pit and will routinely execute large orders for hedge funds and professional money managers.

Hajdani says, “Spreads can be done electronically but that includes leg risk. Here, people are getting in the middle.”

Each Treasury contract has slight differences in its deliverables which means that a true hedge requires uneven spreads. Hajdani can make a market on the bid and then give up the edge on the tail.

“We have outperformed everyone for years,” Hajdani says. He notes that the move to electronic trading has been assumed by end users and there are institutional folks out there that don’t even know that the floor is still open. “I don’t think people know how much money they have lost,” he says.

He says on a typical 10,000 lot spread with a 14% tail, he would secure a fill for a customer by lifting the offer and gaining a two-tick (one full bond tick) edge on the tail, which is equivalent to 1400 ticks. That is \$43,750. Not a bad bit of change and something that would not be possible on Globex, according to Hajdani.

In fact, it made his customer—who wanted to remain anonymous—angry, as he was not contacted by the exchange.

“There is good depth in the pit; they will really lose,” he says. And the depth is reflected in growing size during the rolls. In the last week of February when March Treasuries were rolling to June the pit executed more than 2.5 million contracts (see

## MIGRATION TIMELINE

**March 2015:** Conduct options pit community meetings; initial communication of booth allocation process

**April 2015:** Begin booth allocation meetings with firms

**May 2015:** Complete options pit meetings; complete booth allocation meetings with firms

**June 2015:** Detailed pit layout and booth allocation finalized

**July 2015:** Last day of futures trading (July 2); last day of Denali/Galax-C services (July 2); begin options pit construction; relocate livestock options pits and booths

**August 2015:** Mock trading sessions to finalize pit/booth decorum (TBD); core options pit construction complete

**September 2015:** Final booth migration; move into new agriculture (grains) options complex

Source: CME Group

“Size matters,” page 20).

For floor broker and local Bryan Crement, it’s pretty simple. “They are not trading a roll better on the screen; getting better fills for customers is what it is all about,” Crement says. “They are not going to pay us unless they are getting better fills. These customers get better fills in the pit during the roll.”

Not every end user agrees, though. Jay Feuerstein, managing director of the Alternative Strategies Group at Manning & Napier, has been executing electronically for decades. Feuerstein manages \$800 million, the vast majority of which is in fixed income.

He executes all his trades electronically, which includes a significant number of spreads, including ratio spreads and spreads with tails. “I am very satisfied,” Feuerstein says. “The bid/ask is so tight on the screen. There is risk but you are going to get it done.”

Feuerstein says he constantly reviews the quality of their fills and slippage cost and is satisfied with the screen. An early adopter of electronic trading, Feuerstein adds, “I noticed on the screen my fills were better, we often get inside the offers. I always want to do what is best for clients.”

### Serving customers

One long-time trader says he understands the decision but is most concerned with the lack of innovation coming from the exchange. He claims that CME has not created a successful new product for years and that there is a big difference between activity and progress. “Closing the futures pit was just an attempt to appear like they are making progress, but it is really just motion.”

He says the lack of new products is due to electronic trading. “Risk takers build liquidity and could be rewarded with orders for their trouble. You can’t do that

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**COVER SPECIAL** continued

Cover Special continued from page 23 ►

on the screen. Algos have no memory. Algos can't reward liquidity-creating behavior," he says.

The trader says that it was clear from the meeting with CME leaders that the executives did not know what was occurring on the floor in terms of spreads. He says the CME leadership seemed surprised by some questions and weren't aware of the vibrancy of certain spreads or the reasons why.

Glass adds, "[The exchange] made a decision to close the floor without talking to us or [end users]. They did it based on overall volume. The 1% figure is misleading—they never talked to customers."

Glass went on to ask, "Was it a smart business decision? Did they make an evaluation in the long run? No," he answers. "It is a bad business decision, it hurts liquidity and when you hurt liquidity you hurt volume."

His view is similar to many members who feel that decisions are being made only based on the value of stock and how the street perceives value.

"They don't know what is happening on the floor. They are making decisions based upon how their stock price is being evaluated and not on making sure their customers are happy and using the markets. You can't [only] look at the value of the shares you have to make sure your customers are happy. If you don't have happy customers they are not going to use your products," Glass says.

### **What next?**

The reason the markets went electronic was efficiency. Electronic trading helped lower the cost for end users. Competition lowered the cost of brokerage and the elimination of floor brokerage fees and the cost of maintaining a floor presence saved money. The speed of electronic trading created opportunities. The price discovery function of markets moved to the screen in financial futures more than a decade ago and it happened in agricultural futures quicker once they were placed side by side with the futures pits. But the reason the futures pits has survived to this date is not nostalgia or because some end users have a soft spot in their hearts for friends on the floor.

Those brokers and locals who are still making a living on the floor today are doing it because they are adding value. The handful of order types end-users send to floor are being executed more efficiently—at a lower cost to the end user—than they would if they were entered electronically. It is a simple as that. If the exchange does not come up with a solution to replicate the few remaining efficiencies on the floor—and soon—then they would have made a decision that would cost their end-users money. Like Peter Kelly's dad said, 'Without customers you have no business.' Going electronic was a tough decision but one that had the best interest of the end-users in mind. It is not clear that CME can claim the same thing regarding the decision to close all futures pits. ■