

CFTC Proposes New Rules Governing Automated Derivatives Trading

On November 24, 2015, the Commodity Futures Trading Commission (“CFTC”) approved a number of proposed rules intended to regulate automated derivatives trading on U.S. designated contract markets (“DCMs”). If enacted, the rules, known collectively as Regulation AT, will impose “a series of risk controls, transparency measures, and other safeguards to enhance the regulatory regime for automated trading,” including rules governing algorithmic order origination and routing by market participants.¹ The new rules are a response to the continuing shift from pit trading to electronic trading in U.S. derivatives markets, and build on existing CFTC rules and a CFTC Concept Release addressing current industry practices and “evolving concerns” associated with automated derivatives trading.²

I. Overview

The “[p]rincipal elements of Regulation AT for market participants and clearing FCMs [futures commission merchants] include: (i) codification of defined terms used throughout Regulation AT; (ii) registration of certain entities not otherwise registered with the [CFTC]; (iii) new algorithmic trading procedures for trading firms and clearing firms, including pre-trade and other risk controls; (iv) testing, monitoring, and supervision requirements for ATs [automatic trading systems]; and (v) requirements that certain persons submit compliance reports to DCMs regarding their ATs. Principal elements for DCMs include: (i) new risk controls for Direct Electronic Access (‘DEA’) provided by DCMs; (ii) transparency in DCM electronic trade matching platforms; and (iii) new risk control procedures, including pre-trade risk controls, compliance report review standards, self-trade prevention tool requirements, and market-maker and trading incentive program disclosure and related requirements.”³

According to CFTC Chairman Timothy Massad, Regulation AT was designed to “minimiz[e] the potential for disruptions and other operational problems that may arise from the automation of order origination, transmission or execution,” including those caused by “malfunctioning algorithms, inadequate testing of algorithms, errors and similar problems.” The proposed rules and rule amendments are largely “principles-based,” in that they “set forth requirements for certain controls” but “avoid[] prescribing the parameters or levels at which they should be set.”⁴

II. Definition and Regulation of “AT Persons” and “Floor Traders”

The substantive changes proposed in Regulation AT are built around a number of new definitions specific to automated derivatives trading, which would be codified in new CFTC rules. Among other defined terms, proposed Regulation AT introduces the category of “AT Person,” which “identif[ies] which entities are subject to

¹ See Regulation Automated Trading, Notice of Proposed Rulemaking (“Reg. AT Release”) at 1, available at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister112415.pdf>. Because Regulation AT is intended to address algorithmic trading generally, high frequency trading “is not specifically identified under the proposed regulations, and is not regulated in a different fashion from other types of algorithmic trading.” *Id.* at 16.

² *Id.* at 1-2 (citing the CFTC’s Concept Release on Risk Controls and System Safeguards for Automated Trading Environments, 78 FR 56542 (Sept. 12, 2013)).

³ *Id.* at 16-17. Proposed Regulation AT “generally does not address trading activity on swap execution facilities (‘SEFs’) because the CFTC “believes that neither execution nor order entry on SEF markets are sufficiently automated at this time to require the degree of automated safeguards proposed” in Regulation AT. *Id.* at 15.

⁴ *Id.* at 495-96.

the proposed regulations addressing trading firms' management of the risks of algorithmic trading.”⁵ As proposed, AT Persons would include firms registered or required to be registered as FCMs, floor brokers, swap dealers (“SDs”), major swap participants (“MSPs”), commodity pool operators (“CPOs”), commodity trading advisors (“CTAs”) or introducing brokers (“IBs”), if they “engage in Algorithmic Trading on or subject to the rules of a DCM.” AT Persons would also include firms “registered or required to be registered as floor traders as defined in [proposed] § 1.3(x)(3)” (discussed below).⁶ In turn, the term “Algorithmic Trading” as used in proposed Regulation AT means

trading in any commodity interest as defined in [CFTC] Regulation 1.3(yy) on or subject to the rules of a DCM, where: (1) one or more computer algorithms or systems determines whether to initiate, modify, or cancel an order, or otherwise makes determinations with respect to an order, including but not limited to: the product to be traded; the venue where the order will be placed; the type of order to be placed; the timing of the order; whether to place the order; the sequencing of the order in relation to other orders; the price of the order; the quantity of the order; the partition of the order into smaller components for submission; the number of orders to be placed; or how to manage the order after submission; and (2) such order, modification or order cancellation is electronically submitted for processing on or subject to the rules of a DCM; provided, however, that Algorithmic Trading does not include an order, modification, or order cancellation whose every parameter or attribute is manually entered into a front-end system by a natural person, with no further discretion by any computer system or algorithm, prior to its electronic submission for processing on or subject to the rules of a DCM.⁷

As discussed below, proposed Regulation AT subjects firms defined as AT Persons to various new regulatory requirements, including pre-trade and other risk controls related to orders initiated by trading firms, and development, testing and supervision standards.

Proposed Regulation AT also amends the current definition of “floor trader” under CFTC regulation 1.3(x) “to facilitate the registration of proprietary traders using DEA for Algorithmic Trading on a DCM.”⁸ The “amended definition would expressly include any person who purchases or sells futures or swaps solely for such person’s own account in a place provided by a contract market for the meeting of persons similarly engaged, where such place is accessed by such person in whole or in part through a DEA . . . for Algorithmic Trading, and such person is not otherwise registered” with the CFTC.⁹ Firms meeting the amended definition, including those not currently required to be registered with the CFTC, “would be required to register as Floor traders pursuant to proposed § 1.3(x)(3), assuming that they were not already registered or required to register with the [CFTC] in another capacity.” And designation as a floor trader under this section would automatically bring a firm within

⁵ *Id.* at 81.

⁶ *Id.*

⁷ *Id.* at 66-67. The commodity interests defined in CFTC Regulation 1.3(yy), referenced at the beginning of the Algorithmic Trading definition, include “(1) Any contract for the purchase or sale of a commodity for future delivery; (2) Any contract, agreement or transaction subject to a [CFTC] regulation under section 4c or 19 of the [Commodity Exchange] Act; (3) Any contract, agreement or transaction subject to [CFTC] jurisdiction under section 2(c)(2) of the Act; and (4) Any swap as defined in the Act, by the [CFTC], or jointly by the [CFTC] and the Securities and Exchange Commission.” 17 CFR § 1.3(yy).

⁸ Reg. AT Release at 90.

⁹ *Id.* at 93.

the definition of AT Person, thereby requiring it to “implement the pre-trade controls and risk management tools that Regulation AT requires of AT Persons.”¹⁰

III. Registered Futures Association Rules and Membership Requirements

Proposed Regulation AT also imposes new requirements on Registered Futures Associations (“RFAs”) (such as the National Futures Association) and imposes RFA membership requirements on a new category of market participant. Under sections 170.18 and 170.19 of the proposed regulation, RFAs will be required to adopt membership rules governing algorithmic trading for certain RFA members. In addition, all firms meeting the new definition of AT Person will be required to become members of an RFA.¹¹ According to the CFTC, these requirements “would allow RFAs to supplement elements of Regulation AT as markets and trading technologies evolve over time, and allow frontline regulators to drive future incremental enhancements to the [CFTC’s] basic regulatory structure for algorithmic trading by AT Persons.”¹²

Proposed section 170.18 provides that each registrant that is an AT Person and is not otherwise required to be a member of an RFA pursuant to existing CFTC rules “must become and remain a member of at least one RFA that provides for the membership of such registrant, unless no such futures association is so registered.”¹³ “The membership requirements proposed by § 170.18 will ensure that all AT Persons would be subject to membership rules promulgated by an RFA, including those membership rules promulgated pursuant to proposed § 170.19 to address algorithmic trading.”¹⁴

Proposed section 170.19 requires RFAs to “establish and maintain a program . . . for the prevention of fraudulent and manipulative acts and practices, the protection of the public interest, and perfecting the mechanisms of trading on DCMs . . . by adopting rules for each category of member, as deemed appropriate by the RFA.” Unless deemed unnecessary by the RFA, such rules would require “(i) pre-trade risk controls and other measures for ATs; (ii) standards for the development, testing, monitoring, and compliance of ATs; (iii) designation and training of algorithmic trading staff; and (iv) operational risk management standards for clearing member FCMs with respect to customer orders originating with ATs.”¹⁵ The CFTC’s proposing release notes, however, that the CFTC intends to give RFAs “a wide measure of latitude” in adopting such rules, and that “the determination as to both the necessity of rules and their application to specific categories of members remains with the RFA.”¹⁶

IV. Mandatory Risk Controls, Testing, Monitoring and Supervision

A “fundamental element” of proposed Regulation AT is the requirement that AT Persons implement measures designed to prevent an “Algorithmic Trading Event,” including “pre-trade risk controls [and] order cancellation systems.”¹⁷ The required measures, set forth in proposed section 1.80, are designed to “reduce the

¹⁰ *Id.* at 90, 93.

¹¹ *Id.* at 99.

¹² *Id.*

¹³ *Id.* at 107. Existing CFTC rules require all registered FCMs, IBs, CPOs, SDs and MSPs, and most registered CTAs, to be RFA members. *See* 17 CFR §§ 170.15-17.

¹⁴ Reg. AT Release at 107.

¹⁵ *Id.* at 102.

¹⁶ *Id.* at 103-04.

¹⁷ *Id.* at 108. An Algorithmic Trading Event is defined in section 1.3(vvvv) of the proposed regulation as “an event at an AT

potential for market disruptions arising from system malfunctions, other errors, or intentional disruptive conduct”—the likelihood of which the CFTC believes is “heightened by the increased use of high-speed algorithmic trading.”¹⁸ Proposed section 1.80 includes the following requirements:¹⁹

- *Maximum AT Order Message and Execution Frequencies:* Proposed section 1.80(a)(i)(A) requires AT Persons to implement pre-trade risk controls that establish maximum AT Order Message and execution frequencies per unit time—commonly known as “execution throttles.” The rule is “aimed at preventing market disruptions caused by either inadvertent or intentional submission of AT Order Messages.”
- *Order Price Parameters and Maximum Order Size Limits:* Proposed section 1.80(a)(i)(B) requires AT Persons to implement pre-trade risk controls that limit the prices and quantities associated with individual order messages. The rule is “intended to prevent orders at prices far from prevailing market from entering the market,” which in turn is intended to “protect the natural price discovery process from disruptive behavior such as unintentionally large orders.”
- *Order Management Controls:* Proposed section 1.80(b)(i) requires AT Persons to implement certain management controls (*i.e.*, a “kill switch”) that can (1) immediately disengage Algorithmic Trading, (2) cancel some or all resting orders when required, and (3) prevent submission of any new orders. The rule is “intended to protect against erroneous trading activity caused by an algorithmic trading system malfunction.”
- *Periodic Review for Sufficiency and Effectiveness:* Proposed section 1.80(f) requires each AT Person to periodically review its compliance with section 1.80 to “determine whether it has effectively implemented sufficient measures reasonably designed to prevent an Algorithmic Trading Event,” and remedy any identified deficiencies.

In addition to requiring implementation of these controls, proposed section 1.83(a) requires AT Persons to “prepare, certify, and submit annual reports regarding” the controls to the DCMs on which they operate.²⁰

Person that constitutes: (1) An Algorithmic Trading Compliance Issue; or (2) An Algorithmic Trading Disruption.” An Algorithmic Trading Compliance Issue is defined in proposed section 1.3(tttt) as “an event at an AT Person that has caused any Algorithmic Trading of such entity to operate in a manner that does not comply with the Commodity Exchange Act or the rules and regulations thereunder,” or with various other rules promulgated by a DCM or RFA, or the AT Person’s own internal requirements or the requirements of the AT Person’s clearing member. An Algorithmic Trading Disruption is defined in proposed section 1.3(uuuu) as “an event originating with an AT Person that disrupts, or materially degrades, (i) the Algorithmic Trading of such AT Person, (ii) the operation of the designated contract market on which such AT Person is trading or (iii) the ability of other market participants to trade on the designated contract market on which such AT Person is trading.” *Id.* at 476-77.

¹⁸ *Id.* at 118.

¹⁹ For a complete analysis of proposed section 1.80, *see* Reg. AT Release at 119-31. The proposed regulation imposes similar risk management requirements on DCMs and clearing member FCMs. *Id.* at 157-60, 212-14.

²⁰ *Id.* at 169. Proposed section 1.83(b) imposes similar requirements on each FCM that is a clearing member for an AT Person. *Id.* Proposed section 40.22 requires DCMs to “require each AT Person that trades on the DCM, and each FCM that is a clearing member for such AT Person, to submit the reports described in § 1.83(a) and (b) annually,” and further

Finally, proposed Regulation AT includes a number of provisions requiring AT Persons to establish written procedures aimed at reducing the risks associated with algorithmic trading systems. Under proposed section 1.81, AT Persons would be required to implement written policies and procedures: (1) “for the development and testing of ATSSs”; (2) “reasonably designed to ensure that each of its ATSSs is subject to continuous real-time monitoring and supervision by knowledgeable and qualified staff while such ATSS is engaged in trading”; and (3) “reasonably designed to ensure that ATSSs operate in a manner that complies with the [Commodity Exchange Act] and the rules and regulations thereunder.” In addition, AT Persons would be required to implement written policies and procedures “to designate and train staff responsible for Algorithmic Trading.”²¹

V. Transparency in Trade Matching Systems

Perhaps the most controversial provisions of proposed Regulation AT are those mandating disclosure of elements of “the design and operation of a DCM’s electronic matching platform,” including the disclosure of “any attributes of an electronic matching platform or trade execution facility that materially impact market participant orders, but which are not readily apparent to a market participant.”²² Specifically:

- Under proposed amendments to section 38.401(a)(1)(iii), DCMs would be required to disclose to the CFTC, “market participants and the public” information about “rules or specifications pertaining to the operation of the electronic matching platform or trade execution facility, including but not limited to those pertaining to the operation of [their] electronic matching platform[s] that materially affect the time, priority, price, or quantity of execution, or the ability to cancel, modify, or limit display of market participant orders.”²³
- Under a proposed addition to section 38.401(a), DCMs would be required to disclose to “all market participants any known attributes of the electronic matching platform, other than those already disclosed in rules or specifications under section (a)(1)(iii), that materially affect the time, priority, price, or quantity of execution of market participant orders, the ability to cancel, modify, or limit display of market participant orders, or the dissemination of real-time market data to market participants, including . . . latencies or other variability in the electronic matching platform”²⁴

The CFTC believes that these rule changes will “foster competition among exchanges by incentivizing them to provide the most efficient and fairest venue for trading,” and provide market participants with important information “that explains the existence and operation of any attribute within an electronic matching platform or trade execution facility that will impact how a market participant experiences the market.”²⁵ The proposed rules

“require[s] each DCM to establish a program for effective review of such reports and remediation of any deficiencies found,” among other requirements. *Id.* at 221.

²¹ *Id.* at 140-41.

²² *Id.* at 185-86.

²³ *Id.* at 190.

²⁴ *Id.* The CFTC notes in its Regulation AT proposing release that neither of these proposed rule changes is “intended to require the disclosure of trade secrets by any DCM.” *Id.*

²⁵ *Id.* at 186, 197.

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would apply not only to trade matching engines, but to all systems under a DCM's control that interact with market participant order messages and are involved in market data dissemination. The new rules would, however, include a " 'materiality threshold' . . . so that the disclosure requirements would not capture aspects of the exchange systems that do not have a discernable effect on how orders are entered or executed."²⁶

VI. Conclusion

If adopted as proposed, Regulation AT will be far reaching and costly. According to the CFTC's estimates, the regulation could subject "a total of 420 potential AT Persons," "an estimate of 57 clearing member FCMs," and "an estimate of 15 DCMs" to the new regulatory regime. In addition, Regulation AT would require "approximately 100 potential firms" to register as floor traders.²⁷ In the aggregate, the CFTC estimates that the regulation's requirements will impose one-time costs of \$53,265,930, and annual costs of \$10,867,080, on the entities it affects (excluding RFAs).²⁸ Despite these costs, the CFTC believes that the new rules are necessary to meet "the need for a regulatory baseline that provides a robust and sufficiently clear standard for pre-trade risk controls, supervision standards, and other safeguards for automated trading environments."²⁹

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com, Jon Mark at 212.701.3100 or jmark@cahill.com, John Schuster at 212.701.3323 or jschuster@cahill.com, or David S. Slovic at 212.701.3978 or dslovick@cahill.com.

²⁶ *Id.* at 191-92.

²⁷ *Id.* at 257-59.

²⁸ *Id.* at 426-28.

²⁹ *Id.* at 18.