MEMO# 30401

November 17, 2016

CFTC Approves Supplemental Notice of Proposed Rulemaking for Regulation AT

[30401]

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TO: Derivatives Markets Advisory Committee
Registered Fund CPO Advisory Committee RE: CFTC Approves Supplemental Notice of Proposed Rulemaking for Regulation AT
The Commodity Futures Trading Commission ("CFTC") recently approved a supplemental notice of proposed rulemaking[1] to modify certain provisions of proposed Regulation Automated Trading ("Regulation AT"). The CFTC initially proposed Regulation AT late last year to enhance the regulatory regime for automated trading on US designated contract markets ("DCMs") by requiring various risk controls, transparency measures, and other safeguards.[2]

The Supplemental would change proposed Regulation AT in four key ways.[3] First, the Supplemental would narrow the scope of persons required to register under Regulation AT by introducing a new volume threshold test to supplement the registration requirements in the initial proposal. Second, the Supplemental would apply pre-trade risk controls at two levels—instead of three—and would apply these risk controls to all electronic trading rather than limiting their application to algorithmic trading. Third, the Supplemental would reduce the annual reporting requirements of Regulation AT. Fourth, the Supplemental would ensure that the CFTC votes on any request to obtain source code used by algorithmic traders. This memorandum provides a brief overview of the salient concepts of Regulation AT as initially proposed and then summarizes each of the key changes proposed in the Supplemental.

Comments on the Supplemental are due 60 days after its publication in the Federal Register, which is expected soon. **ICI does not intend to submit a comment letter on the Supplemental. If you have any concerns regarding the Supplemental, please contact Sarah Bessin at** sarah.bessin@ici.org **or George Gilbert at** george.gilbert@ici.org **no later than November 25.**

Background on Proposed Regulation AT's Approach to Defining Algorithmic Trading and Registering Entities that Engage in Algorithmic Trading

The CFTC proposed Regulation AT to update its rules in response to the increased reliance on electronic trading on DCMs. Proposed Regulation AT would create a new class of

Commission registrant, known as an AT person, and impose a variety of risk controls and other requirements on the algorithmic trading activities of these persons. The proposal would define an AT Person as: (1) any a futures commission merchant ("FCM"), floor broker, swap dealer, major swap participant, commodity pool operator, commodity trading advisor, or introducing broker that engages in algorithmic trading on or subject to the rules of a DCM; or (2) a floor trader as defined in other CFTC rules.[4] Proposed Regulation AT would expand significantly the definition of floor trader to encompass any person that engages in proprietary, algorithmic trading through direct electronic access[5] on a DCM in any futures or security futures product or swap.

Both prongs of the proposed definition of AT Person would require a market participant to engage in algorithmic trading before triggering a registration requirement. The CFTC proposed to define "algorithmic trading" as trading in any commodity interest on or subject to the rules of a DCM where "[o]ne or more computer algorithms or systems determines whether to initiate, modify, or cancel an order, or otherwise makes determinations with respect to an order" and the order, modification, or cancellation is "electronically submitted for processing on or subject to the rules of a [DCM]."[6] The proposal would provide a single carve-out for any order, modification or 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."[7]

The Supplemental Introduces a Volume Threshold Test that Would Reduce the Number of AT Persons

As initially proposed, the requirement to register as an AT Person was activities-based. As noted above, a CFTC registrant other than a floor trader would be required to register as an AT Person if that person engaged in any amount of algorithmic trading on a DCM. A floor trader would be required to register as an AT Person if the floor trader engaged in any amount of algorithmic trading through direct electronic access on a DCM. Commenters believed this proposal would impose registration requirements and attendant obligations on too large a population of market participants.

The Supplemental proposes to address these concerns by revising proposed Regulation AT to add a volume threshold test to narrow the scope of persons that would be required to register as AT Persons.[8] Under the volume threshold test, a person that engages in the activities of an AT Person must register only if the person trades an aggregate average daily volume of at least 20,000 contracts for such person's own account, the accounts of customers, or both over a six-month period. The calculation of a person's aggregate average daily volume would include all products on the electronic trading facilities of all DCMs on which the person trades. The volume threshold test would require a person to aggregate its own trading volume with that of any other persons, controlling, controlled by or under common control with the person.[9]

The reference to "customers" in the proposed volume threshold test and the CFTC's explanation of this test create some ambiguity about the type of presently unregistered person that would become a floor trader—and, by extension, an AT person—under proposed Regulation AT. The proposed revisions to the definition of floor trader would require registration only of a person that "purchases or sells solely for such person's own account."[10] In the preamble of the Supplemental the CFTC notes that currently unregistered market participants would likely look to their proprietary trading volume to see whether they satisfy the volume threshold test.[11] The Commission also states, however, that if a currently unregistered market participant is trading the accounts of

customers consistent with the Act and Commission regulations, they should also include their customer trading volume in addition to their proprietary volume, for the volume threshold test.[12]

The Supplemental Refines the Risk Controls in Proposed Regulation AT

Regulation AT as initially proposed would have required DCMs, FCMs, and AT Persons to design and implement various pre-trade risk controls. The Supplemental would replace this three-tier structure for pre-trade risk controls with a two-tier structure.[13] Under the rules proposed in the Supplemental, risk controls would be set at the levels of: (1) the AT Person or its executing FCM;[14] and (2) the DCM.[15] An AT Person would be permitted to delegate pre-trade risk controls to its executing FCM, but the FCM would have no obligation to accept the delegation. If the FCM declines to accept the delegation, the AT person would be responsible for implementing the relevant risk controls.

The CFTC notes that the two-tier structure proposed in the Supplemental responds to commenters that believed the three-tier structure of the initial proposal would impose redundant requirements and would be costly to implement.[16] The CFTC further explains that two levels of risk controls would provide a backstop to a malfunction or other failure at one level and facilitate monitoring of different characteristics of the risk associated with an order at different points in the order submission process.[17]

The Supplemental also would change the scope of trading covered by the risk controls in proposed Regulation AT. As initially proposed, Regulation AT would have required risk controls only with respect to the algorithmic trading of AT Persons.[18] The Supplemental would expand AT Persons', FCMs', and DCMs' risk control obligations to include not only algorithmic trading, but also electronic trading.[19] The Supplemental would require AT Persons to apply risk controls to their electronic trading order messages in addition to their algorithmic trading order messages.[20] Under the Supplemental, FCMs would be required to implement risk controls on all electronic trading order messages not originating with an AT Person.[21] DCMs would be required to implement risk controls on all electronic trading order messages, regardless of their source.[22] As a result of these proposed changes, a larger number of orders would be subject to the risk controls of Regulation AT.[23]

The Supplemental Would Reduce Annual Reporting Requirements

As initially proposed, Regulation AT would require each AT Person to provide to the DCMs on which it operates an annual report containing information on its compliance with Regulation AT's risk controls.[24] The Supplemental would replace this annual reporting requirement with an annual certification attesting that the AT Person complies with the pre-trade risk controls and certain other requirements of the regulation.[25] The Supplemental also proposes to require DCMs to establish a program for periodic review of AT Persons' and FCMs' compliance with specified provisions of Regulation AT.[26]

The Supplemental Would Limit Access to Algorithmic Trading Source Code

As initially proposed, Regulation AT would have required AT Persons to maintain their source code[27] records and make them available to Commission staff in accordance with the CFTC's general recordkeeping requirements.[28] This proposal elicited significant negative comment regarding the proprietary value of algorithmic trading source code and the importance of preserving its confidentiality.[29] In the Supplemental, the Commission proposes to make source code available only via a subpoena or special call approved by the

Commission itself. Commission staff no longer would be able to access source code absent Commission approval.[30] The Commission further proposes that any access to algorithmic trading source code would be subject to policies and procedures to protect confidentiality.

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endnotes

[1] *See* Regulation Automated Trading, Supplemental Notice of Proposed Rulemaking, *available at* http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister110416.pdf ("Supplemental").

[2] Regulation Automated Trading, Proposed Rule, 80 Fed. Reg. 78824 (Dec. 17, 2015), *available at* http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-30533a.pdf ("Proposal Release").

[3] The Commission notes that the Supplemental is a continuation of the original proposed rule. All of the rules in the original proposal remain under consideration as originally proposed unless specifically amended in the Supplemental. *See* Supplemental at 8.

[4] *See* Proposal Release at 78937, proposed rule 1.3(xxxx).

[5] Direct electronic access would refer to "an arrangement where a person electronically transmits an order to a [DCM], without the order first being routed through a separate person who is a member of a derivatives clearing organization to which the [DCM] submits transactions for clearing." *Id.,* proposed rule 1.3(yyyy).

[6] *See id.* Release at 78937, proposed rule 1.3(zzzz).

[7] *Id.*

[8] Supplemental at 29.

[9] *Id.* at 219, proposed rule 1.3(x)(2).

[10] *Id.* at 219, proposed rule 1.3(x)(1)(iii)(A). This text was included in the initial proposal of Regulation AT and remained unchanged in the Supplemental.

[11] *See id.* at 29.

[12] *Id.* at 29, n.50.

[13] *See id.* at 81.

[14] As initially proposed, clearing FCMs would have been responsible for implementing the risk controls applicable to FCMs. The Supplemental would shift this burden to executing FCMs.

[15] *See* Supplemental at 81.

[16] *See id.* at 81-82.

[17] *Id.* at 82.

[18] *See id.* at 84.

[19] Proposed rule 1.3(aaaaa) would define "electronic trading" as "trading in any commodity interest…where the order, order modification or order cancellation is electronically submitted for processing on or subject to the rules of a designed contract market." Supplemental at 222.   This definition was not included in the original proposal.

[20] *See id.* at 88 and 224-225, proposed rule 1.80(g). As noted above, an AT person could delegate this responsibility to its executing FCM.

[21] *See id.* at 87, proposed rules 1.83 and 38.255.

[22] *See id.* at 87, proposed rule 40.20.

[23] *See id.* at 84.

[24] Proposal Release at 78939, proposed rule 1.83, The clearing FCM for an AT person also would be required to prepare an annual report detailing the FCM's pre-trade risk controls for algorithmic trading and file this report with each DCM on which the AT person engages in algorithmic trading.

[25] Supplemental at 234-235, proposed rule 40.22. Executing FCMs would be required to make a similar attestation.

[26] *See id.* at 115 and 234-235, proposed rule 40.22(a).

[27] The original proposal did not propose a definition of algorithmic trading source code. The Supplemental would define algorithmic trading source code as "computer commands written in a computer programming language that is readable by natural persons." Supplemental at 223, proposed rule 1.3(ccccc).

[28] *See id.* at 47, proposed rules 1.83 and 40.22.

[29] *See id.* at 47.

[30] *See id.* at 228-29, proposed rule 1.84 (b)-(c).