INVESTMENT COMPANY INSTITUTE

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July 2, 2020

CFTC Proposes Electronic Trading Risk Principles for Designated Contract Markets

[32577]

July 2, 2020 TO: Derivatives Markets Advisory Committee RE: CFTC Proposes Electronic Trading Risk Principles for Designated Contract Markets

On June 25, 2020, the Commodity Futures Trading Commission (CFTC or "Commission") voted to formally withdraw its outstanding proposals on Regulation Automated Trading ("Reg AT") and issue, in their place, proposed electronic trading risk principles for designated contract markets (DCMs).[1] The proposed risk principles, which are summarized below, would amend the CFTC's Part 38 regulations utilizing a principles-based approach to address the potential risk of a DCM's trading platform experiencing a disruption or system anomaly due to electronic trading.

Comments on the proposed risk principles are due to the CFTC the later of August 24 or 30 days following publication in the Federal Register. If you have comments, please contact Sarah Bessin at sarah.bessin@ici.org by Friday, July 31.

Background

In 2013, the CFTC issued a concept release on Risk Controls and System Safeguards for Automated Trading Environments.[2] In 2015, the Commission issued proposed Reg AT—a proposed rulemaking that included risk controls, registration and recordkeeping requirements, transparency measures, and other safeguards to address risks arising from automated trading on DCMs.[3] In 2016, the Commission issued a supplemental notice of proposed rulemaking that would have modified certain aspects of the Reg AT proposal, including the risk control framework.[4] Commenters raised significant concerns about certain aspects of Reg AT including, with respect to the original proposal, (i) opposition to the proposed risk control framework; (ii) opposition to identification and registration of a new category of persons that would be subject to Reg AT; (iii) opposition to provisions relating to source code preservation and accessibility to the Commission without a subpoena; and (iv) opposition to the prescriptive nature of the proposed rules.[5] Commenters also raised concerns regarding the supplemental proposal, and the rulemaking therefore remained outstanding until the Commission voted last week to withdraw it.[6]

Proposal

The proposal consists of three risk principles that would apply to DCMs, along with proposed acceptable practices, which provide that a DCM satisfies the risk principles by adopting and implementing rules and risk controls that are reasonably designed to prevent, detect, and mitigate market disruptions and system anomalies associated with electronic trading.[7] The Commission states that DCMs "are addressing most, if not all, of the electronic trading risks currently presented to their trading platforms" and that the risk principles therefore may not require DCMs to take additional measures. The Commission intends the risk principles to be flexible so that "they will be able to evolve over time along with market developments."

Risk Principle 1, proposed Regulation 38.251(e), would provide that a DCM must adopt and implement rules governing market participants subject to its jurisdiction to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading. The Commission notes that certain existing DCM practices would satisfy proposed Risk Principle 1, such as exchange-provided risk controls that are designed to address financial or market risk, and that also address preventing or mitigating market disruptions or system anomalies caused by electronic trading activities.

Risk Principle 2, proposed Regulation 38.251(f), would provide that a DCM must subject all electronic orders to exchange-based pre-trade risk controls to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading. The Commission explains that certain current pre-trade risk controls included in the existing DCM Core Principles Acceptable Practices[8] may satisfy Risk Principle 2, including, with respect to DCM Core Principle 4, pre-trade limits on order size, price collars or bands around the current prices, message throttles, and daily price limits. The Commission notes, however, that it would expect DCMs to continue to develop controls that are effective to prevent, detect, and mitigate market disruptions or system anomalies, regardless of whether they are listed in existing Appendix B to Part 38.

Risk Principle 3, proposed Regulation 38.251(g), would provide that a DCM must promptly notify the Commission staff of a significant disruption to its electronic trading platform(s) and provide timely information on the causes and remediation. The Commission states that a "significant disruption" is "a situation where the ability of other market participants to execute trades, engage in price discovery, or manage their risks is materially impacted by a malfunction of a market participant's trading system." The Commission distinguishes proposed Risk Principle 3, which is intended to address market disruptive events, from existing Commission Regulation 38.1051(e), which requires DCMs to notify the Commission in the event of significant systems malfunctions.

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endnotes

[1] *Electronic Trading Risk Principles*, *available at* https://www.cftc.gov/media/4121/FederalRegister062520b/download.

[2] 78 Fed. Reg. 56542 (Sept. 12, 2013).

[3] *Regulation Automated Trading*, 80 Fed. Reg. 78824 (Dec. 17, 2015).

[4] *Regulation Automated Trading*, 81 Fed. Reg. 85334 (Nov. 25, 2016).

[5] *See* note 6, *infra*.

[6] *See Regulation Automated Trading*, *available at* https://www.cftc.gov/media/4061/votingdraft062520c/download (withdrawal of proposed rulemakings). Commissioners Behnam and Berkovitz dissented from the withdrawal of the proposed Reg AT rulemakings, although Commissioner Berkovitz voted in favor of issuing the proposed risk principles for public comment. Commissioner Behnam's statement is *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement062520b and Commissioner Berkovitz's statement is *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement062520.

[7] The Commission interprets "reasonably designed" to require that a DCM adopt rules that are objectively reasonable.

[8] *See* Appendix B to Part 38 of the CFTC's Regulations, *available at* https://www.law.cornell.edu/cfr/text/17/appendix-B_to_part_38.
