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## CFTC Regulation Automated Trading (Regulation AT)

**Introduction** On November 24, 2015, the Commodity Futures Trading Commission (“CFTC”) held an open meeting at which it unanimously approved its long-anticipated notice of proposed rules referred to as Regulation Automated Trading (“Regulation AT”).<sup>1</sup>

The proposed rules seek to bolster the U.S. regulatory regime for automated trading through a series of risk controls that target potential risks and volatility sometimes associated with automated or algorithmic trading systems (“ATs”) on three levels: (a) the trader, (b) the intermediary, and (c) the trading platform. Regulation AT requires registration of certain persons as “Floor Traders” who are not currently registered with CFTC, yet nonetheless participate in “Algorithmic Trading.” The proposed rules also seek to increase transparency around designated contract market (“DCM”) electronic matching platforms and market maker and trading incentive programs.

While Regulation AT only refers to ATs, its application is much broader. Given that today less than 10 percent<sup>2</sup> of trading volume on DCMs is executed via voice or on the trading floor – as compared with 90 percent<sup>3</sup> 15 years ago – now automated and algorithmic trading (“Algorithmic Trading”) encompasses the majority of trading volume on the DCMs. In other words, this regulation aims at the most sweeping overall reform of trading on DCMs since federal regulation of DCMs started in 1922.<sup>4</sup>

Below, we first briefly summarize the effects of this regulation on various market participants and on the markets as a whole. Second, we analyze substantive provisions of Regulation AT, such as the new definitions and new compliance requirements on various market participants and systems operators. Third, we discuss potential costs of compliance with these new regulations. Fourth, we

provide a brief summary of EU regulations applicable to high frequency traders (“HFTs”), and conclude with a summary.

**Summary of Regulation AT** Regulation AT formalizes the safeguards and controls that many market participants already utilize in protecting against risks associated with malfunctioning ATSS. It operates by requiring compliance at three distinct levels: (a) compliance for algorithmic trading persons (“AT Persons”) who use ATS with contracts traded on designated contracts markets (“DCMs”); (b) compliance for futures commodity merchants (“FCMs”) operating as clearing members for particular AT Persons; and (c) compliance for DCMs when AT Persons execute Algorithmic Trading Orders. The proposed rules require entities at all three levels to establish and maintain pre-trade risk and other controls, as well as appropriate compliance policies and procedures.

Regulation AT also advances new registration requirements because of its revised definition of a Floor Trader. Currently, many market participants engaging in Algorithmic Trading are not registered with CFTC (i.e., market participants *other* than FCMs, floor brokers, swap dealers, major swap participants (“MSPs”) commodity pool operators (“CPOs”), commodity trading advisors (“CTAs”), or introducing brokers).<sup>5</sup> If any of those unregistered entities engage in proprietary Algorithmic Trading for their own accounts on a DCM via direct electronic access (“DEA”), Regulation AT requires their registration with CFTC under the new definition of a Floor Trader. Because the newly defined category of “AT Persons” includes Floor Traders, many of these new registrants will be subject to additional compliance requirements under Regulation AT. In addition, the proposed rules require all AT Persons, including Floor Traders, to become members of a registered futures association (“RFA”) – the National Futures Association (“NFA”) – and become bound by NFA’s rules and compliance requirements.

It is important to note what is *outside* the scope of Regulation AT. Regulation AT only applies to contracts traded on DCMs (and any other “place” provided by the DCM) and does not apply to swaps traded on swap execution facilities (“SEFs”). It applies to Algorithmic Trading, which means that the orders must be entered automatically (i.e., not manually by a human being). Finally, only those traders who use DEA to access the Algorithmic Trading “place” and who trade in their proprietary capacity will qualify as Floor Traders. AT Persons *other* than Floor Traders, however, are not limited in their method of accessing the DCM (i.e., either via the DEA or via an FCM clearing member) and would qualify as AT Persons because they trade algorithmically and automatically.

AT Persons must implement compliance policies and procedures, submit reports on their risk controls to DCMs under Regulation AT, and maintain books and records for inspection by DCMs. The DCMs must periodically review this information and disclose quarterly statistics of approved exempted self-trading

transactions, as well as attributes of their electronic matching platforms that may materially impact market orders.

## Discussion of Regulation AT

(a) **Key New Definitions** Regulation AT introduces several concepts into CFTC's regulatory regime and proposes to codify a new set of terms necessary for implementing the proposed rules. The following are some of the more significant additions.

- (i) **"Algorithmic Trading"**<sup>i</sup> Algorithmic Trading is at the heart of Regulation AT because once market participants engage in Algorithmic Trading, Regulation AT applies to them. Algorithmic Trading is defined as trading in any "commodity interest"<sup>6</sup> on or subject to the rules of a DCM, where (1) computerized calculations determine what to trade, where to trade, how much to trade, and when to trade. These algorithmic functions may also determine the sequence of trades, whether or not to execute those trades, and order prices. Algorithmic Trading also requires (2) that the orders and modifications be electronically submitted on or subject to the rules of a DCM.

The definition of Algorithmic Trading is very broad, and as Commissioner Giancarlo observed, it can include even trading based on simple spreadsheets or off-the-shelf systems.<sup>7</sup> Accordingly, the broader this definition, the more entities will qualify as AT Persons and be subject to Regulation AT.

However, Algorithmic Trading does not include certain trading formats, such as manual entry of orders by a human being. Manually entering orders refers to a natural person submitting orders, modifications, or cancellations into a front-end software system prior to electronic submission of processing on a DCM, and when no discretion is provided to any computer system or algorithm between the front-end entry and the submission to the DCM (for example, submitting an order via email constitutes a manual entry as long as it lacks algorithmic discretion and calculations).

Note that for the purposes of defining Algorithmic Trading, it is irrelevant whether trading is high or low frequency, and only the method of trading is relevant.

- (ii) **"Algorithmic Trading Events"**<sup>ii</sup> Algorithmic Trading Events include two scenarios: (a) "AT Compliance Issues," and (b) "AT Disruptions."<sup>iii</sup> AT Compliance Issues include situations in which an AT Person's algorithmic system operates in a noncompliant manner with the Commodity Exchange Act ("CEA")<sup>8</sup> and the rules promulgated thereunder. An AT Disruption, on the other hand, includes an event originating from an AT Person that essentially impedes that same AT Person's ability to trade on the contract market.

Even though these two events may occur simultaneously, CFTC distinguished them because AT Compliance Issues are relevant to Regulation AT's pre-trade risk and other control requirements for AT Persons, while AT Disruptions relate to proposed pre-trade risk controls for both AT Persons *and* clearing member FCMs. The controls required of clearing member FCMs differ from those of AT Persons, and thus CFTC created these separate terms to provide more clarity.

- (iii) *"AT Order Message"*<sup>iv</sup> Each new order or quote submitted via Algorithmic Trading to a DCM by an AT Person, or any subsequent deletions or changes to that order submitted through Algorithmic Trading, constitute an AT Order Message. Regulation AT seeks to place risk controls on these transmissions by mandating, for example, message throttles that cap AT Order Message units in a given time period.
- (iv) *"AT Person"*<sup>v</sup> CFTC proposed this term to identify entities that trigger Regulation AT's risk control provisions. AT Person is a functional definition that includes: (a) FCMs, floor brokers, swap dealers, MSPs, CPOs, CTAs, or introducing bankers that engage in Algorithmic Trading on or subject to the rules of a DCM, and (b) the newly defined Floor Traders under section 1.3(x)(3), discussed below. Note that these two groups are somewhat exclusive of each other: while Floor Traders include those unregistered traders using DEA, there is no DEA access requirement for registered traders. Therefore, registrants engaging through non-DEA Algorithmic Trading on DCMs qualify as AT Persons. But regardless of these nuances, both entities will be subject to Regulation AT's risk control requirements as AT Persons.

Given the vast amount of practices the term Algorithmic Trading may encompass, the term AT Person may be interpreted to include even the slightest amount of electronic or Algorithmic Trading activity (i.e., Regulation AT does not provide a de minimis exception for Algorithmic Trading in its current form).<sup>9</sup>

- (v) *"Floor Trader"*<sup>vi</sup> Regulation AT amends the current definition of "Floor Trader"<sup>10</sup> to include about 100 market participants not currently registered with the CFTC. Any unregistered person who uses DEA to conduct Algorithmic Trading on DCMs must register as a Floor Trader with the CFTC (NFA). Under Regulation AT, Floor Traders access contract markets to trade commodities for future delivery, security futures products, swaps, or any commodities option authorized under section 4c of the CEA. Note that the underlying instruments of Floor Traders' trades do not differ from the current definition.<sup>11</sup>

For now, market participants need not register as Floor Traders for the following: engaging in Algorithmic Trading on SEFs<sup>12</sup>; if they are otherwise already registered as a floor broker, FCM, swap dealer, MSP, CPO, CTA, or introducing broker; or if they do not have direct electronic access (“DEA”) to the markets. However, once a participant is registered as proposed, Regulation AT would apply *regardless* of whether the floor trader’s orders are submitted through DEA or a clearing member FCM.

Because the newly defined AT Persons include Floor Traders, this registration obligation is critical – it subsequently subjects all Floor Traders to the same requirements as FCMs, floor brokers, swap dealers, MSPs, CPOs, CTAs, and introducing brokers. Effectively, this new registration requirement will expose Floor Traders to regulation like never before: principals of non-natural floor persons must register with the NFA and cannot be statutorily disqualified; Floor Traders will be subject to new supervision requirements; and serious regulatory violations will be subject to sanctions such as civil penalties, and suspension or revocation of registration status.

- (vi) *“Direct Electronic Access (DEA)”*<sup>vii</sup> DEA refers to an arrangement where a trader electronically transmits an order directly to a DCM, but without first transmitting that order through a separate DCO clearing member that the DCM might use for clearing transactions.

The use of DEA is a critical component in determining whether an entity needs to register as a Floor Trader (and therefore becomes an AT Person). Also, when AT Persons use DEA, clearing FCMs cannot apply market risk controls to orders received for clearing before they reach the DCMs. To remedy this lack of pre-trade control, Regulation AT requires FCMs to implement DCM-provided controls for DEA orders.

#### (b) Effects of Regulation AT

- (i) *Effects on Entities Defined as AT Persons*<sup>13</sup> To mitigate the risks posed by Algorithmic Trading, AT Persons must implement pre-trade risk controls and other measures, including, but not limited to: maximum message and execution frequencies (i.e., message “throttles”); order price parameters and maximum order sizes; order cancellation and disconnect systems (i.e., “kill switches”) that can cancel all or selected orders and prevent submission of new ones; and systems to monitor connectivity. However, AT Persons are granted significant latitude to design and set their control levels because CFTC recognizes that many entities already make use of similar systems to protect against compliance issues and trading disruptions.

AT Persons must also create and implement standards to test their ATSS, including these core elements: segregation of development and production

trading environments; testing of all ATS codes and systems prior to their actual implementation; regular ATS back-testing through analysis of historical trade data; periodic ATS stress tests; procedures for documenting strategy and design of ATS software; maintenance of a source code repository; and must train staff dedicated to these systems.

With respect to monitoring, Regulation AT requires continuous, real-time personal monitoring of ATs by AT Persons. The AT Persons must train staff dedicated to the monitoring of the ATs. Dedicated means dedicated – those monitors may not simultaneously engage in trading themselves. The monitoring staff must: receive automated alerts if the ATs breach design parameters or lose connectivity; have the authority to operate the kill switches; and be trained to escalate any issues.

Regulation AT also requires AT Persons to submit annual compliance reports to DCMs outlining their risk controls, as well as copies of the written policies and procedures developed to adopt the above-listed monitoring standards and a certification of accuracy by the AT Person's CEO or COO.

Perhaps the most controversial element of Regulation AT pertaining to AT Persons is the requirement that they maintain source code repositories to manage: source code access; copies of all code used in the production environments; and any changes to that code. AT Persons must maintain these repositories under current CFTC Rule section 1.31.<sup>14</sup> Under Rule section 1.31, AT Persons would be required to make all of the information in the repositories available to any representative of the CFTC or U.S. Department of Justice.<sup>15</sup>

- (ii) *Effects on Clearing Member FCMs*<sup>16</sup> Because all types of market access can subject the markets themselves to risk from malfunctioning or uncontrolled ATs, CFTC proposes to require clearing member FCMs to implement their own pre-trade and ATS controls, whether or not DEA is involved.

To prevent and mitigate disruptions for DEA AT Order Messages originating from an AT Person, FCMs must make use of risk controls provided to them by the DCMs. FCMs must, however, implement and calibrate their own controls for non-DEA orders. FCMs enjoy the same flexibility as AT Persons in designing these risk controls, but Regulation AT maintains the controls should be set at the level of each AT Person, and that natural person monitors receive prompt alerts should those risk controls fail or malfunction. Those specific types of risk controls – just like those required of AT Persons – include maximum message and execution frequencies, order price parameters and maximum order sizes, order cancellation and disconnect systems, and systems to monitor connectivity. Note that these

controls are only required for Algorithmic Trading. Any additional controls should be reasonably designed to prevent an AT Event.

Lastly, Regulation AT subjects clearing member FCMs to similar record keeping and reporting requirements as AT Persons: FCMs must submit CEO-certified compliance reports to DCMs outlining their steps to establish and maintain the required risk controls for their AT customers, although the level of detail required in these reports is less than that required of AT Persons. Books and records must likewise be maintained for inspection by DCMs.

(iii) *Effects on DCMs*<sup>17</sup> Regulation AT requires DCMs to provide and implement the same risk controls as listed for AT Persons and clearing member FCMs, above, to protect the integrity of orders submitted through Algorithmic Trading. DCMs similarly enjoy leeway in implementing risk controls that best fit their individual models. DCMs must also implement parallel controls for manual orders not originating from algorithmic orders.

DCMs must require clearing member FCMs and AT Persons to provide the above-referenced compliance reports by June 30 of each year. Regulation AT mandates DCMs periodically review these reports to identify and correct any insufficient mechanisms, and to provide instruction for necessary corrections. DCMs must additionally review FCM and AT Person Algorithmic Trading books and records.

Notably, Regulation AT requires DCMs to set up safe testing environments where AT Persons can test their ATs. These simulations must ensure AT Persons are operating in compliance with the proposals outlined in Regulation AT by providing test participants access to historical transactions, orders, and message data. DCMs must also establish risk controls for those algorithmic orders submitted by AT Persons using DEA, and require FCMs to utilize those risk controls for such orders.

(c) *Additional Elements – Registration, Self-Trading, Trade Matching, and Market Maker Programs* Regulation AT requires RFAs (i.e., the NFA) to adopt Algorithmic Trading membership rules for each category of member within it. CFTC believes this will help effectuate the overall purpose of Regulation AT, and again gives the RFAs latitude to draft their own rules. Further, the proposed rules require all AT Persons to become registered members of at least one RFA (i.e., the NFA since currently it is the only RFA). In addition, Regulation AT requires certain unregistered entities to register as Floor Traders, as discussed above.

Regulation AT defines “self-trading” as the matching of orders for accounts that have common beneficial ownership or are under common control, and DCMs must establish measures to prevent those transactions. The DCMs may apply those measures themselves or provide them to market participants for their use.

DCMs may determine which accounts will not be allowed to engage in trading with each other, or they may require market participants to identify such accounts on their own.

However, DCMs may allow the matching of orders for accounts with common beneficial ownership as long as those orders are initiated by independent decision makers.<sup>18</sup> In keeping with the larger goal of promoting transparency around these types of transactions, Regulation AT requires DCMs to publish quarterly statistics that disclose any approved self-trading transactions under this exception.

DCMs will be required to disclose any known attributes of their electronic matching platforms that advantage a particular market participant, as well as those attributes about which they should have known.<sup>19</sup> These attributes include those that materially affect the time, priority, price, or quantity of execution of market orders; the ability to cancel, modify, or limit display of orders; or the dissemination of real-time market data to market participants. Public disclosure means prominently displaying this information on the DCM's website where the public can easily find and access it – these disclosures cannot be hidden away in password-protected or user-only sections of the website.

Finally, with respect to market maker and trading incentive programs, Regulation AT requires DCMs to make certain disclosures about their eligibility criteria, thresholds, payments, and benefits. These disclosures should be filed as “Rule” filings pursuant to CFTC regulations sections 40.5 and 40.6.

**(d) What Regulation AT does *not* address – High Frequency Trading, Swap Execution Facilities, and other Concept Release Proposals** Regulation AT does not define or address the term “high frequency trading” (“HFT”). Although many of the entities captured under the new rules engage in HFT, Regulation AT focuses on mitigation of risks incident with algorithmic trading generally (which may or may not include high-frequency trading).

CFTC chose not to address swap execution facilities (“SEFs”) in Regulation AT because it did not find that automated swap executions and order entries on SEF markets currently amounted to a level warranting formalized automated safeguards and risk controls proposed therein.

Regulation AT only applies to contracts traded on DCMs (and any other “place”<sup>20</sup> provided by the DCM), and applies to Algorithmic Trading, which means that the orders must be entered automatically (i.e., not manually by a human being). Further, only those traders who use DEA to access the Algorithmic Trading “place” and who trade in their proprietary capacity will qualify as Floor Traders.

Lastly, CFTC excluded a number of proposed measures discussed in its 2013 Concept Release: post-trade reports (post-order, post-trade, and post-clearing drop copies); “reasonability checks” on incoming market data; policies and procedures for identifying “related” contracts; and standardization of order types.

## Regulation AT Concerns and Implications

**(a) Views of CFTC's Commissioners** CFTC Chairman T. Massad opened the November 24 meeting by expressing support for the proposals as a means to minimize operational market disruption caused by glitches in ATs, such as malfunctioning algorithms. Commissioner S. Bowen cited the immense shift toward ATS use over the past 15 years as a catalyst in CFTC's efforts to establish reasonable regulation that simultaneously allows for the continuing evolution of trading technology. But she insisted that Regulation AT will not alter how firms use algorithms – only that it formalizes best practices already in use. Commissioner C. Giancarlo raised his concerns with Regulation AT, as essentially a window dressing exercise that will impose higher costs and burdens on smaller market participants, and would require registration of about 100 new entities.<sup>21</sup> Particularly, he criticized the requirement that registrants hold primary source codes available for inspection “to any representative of the CFTC or the U.S. Department of Justice for any reason.”<sup>22</sup>

**(b) Increased Costs** Despite Regulation AT's unanimous adoption, Commissioner Giancarlo noted its apparent redundancy as it merely codifies a set of best business practices already utilized effectively by market participants.<sup>23</sup> Thus, an important question becomes: “Does Regulation AT impose additional costs on market participants that outweigh the anticipated benefits?”

The cost estimates provided in Regulation AT represent CFTC's industry-wide expectations, but those expectations likely do not match with reality. While it may be true that many market participants already implement Algorithmic Trading risk controls, Regulation AT brings steep increases in operational and compliance costs. Small participants in particular would incur costs to develop or purchase from third-party vendors the risk controls in Regulation AT, and to hire personnel to implement programs for development, testing, compliance, reporting, and real-time monitoring associated with the proposed rules.<sup>24</sup> And, because of the broad definition of Algorithmic Trading, Regulation AT will apply to market participants using perhaps even the simplest algorithms, like in an Excel spreadsheet or from “off-the-shelf” software.<sup>25</sup>

**(c) Disclosure of Intellectual Property** Regulation AT will require market participants to maintain source code repositories for their algorithms and to make them available for inspection by representatives of the CFTC. This differs greatly from a requirement to provide, for example, data and records. Source code – the algorithms themselves – is intellectual property; data and records are not. Still, Regulation AT allows government officials to access confidential business information without a subpoena.

Under what authority CFTC may obtain and possess confidential intellectual property is unclear. At the November 24 meeting, Commissioner Giancarlo

pressed the presenting staff members on this issue, asking whether they could point to any government agency that similarly takes business information from private sector entities for examination without a subpoena. The staff could not cite to such an interaction between private entities and government agencies, but acknowledged that CFTC could, in the alternative, refrain from obtaining the algorithms and elect simply to examine them as needed.

**The European Angle** From a European perspective, algorithmic trading and, in particular, HFT, is also in the regulatory spotlight. MiFID II<sup>26</sup> includes provisions that place requirements on regulated markets,<sup>27</sup> and operators of other trading venues<sup>28</sup> requiring them to have in place effective systems, procedures and arrangements, including requiring members or participants to carry out appropriate testing of algorithms and providing environments to facilitate such testing. It also requires algorithmic traders themselves to have effective systems and controls to ensure their algorithmic trading systems are resilient, have sufficient capacity, are subject to thresholds / limits, and do not send erroneous orders or give rise to disorderly market conditions<sup>29</sup>.

ESMA's<sup>30</sup> final report on draft regulatory and implementing technical standards for MiFID II published September 28, 2015 ("2015 Final Draft RTS"), included draft regulatory standards<sup>31</sup> for investment firms engaged in algorithmic trading, as well as for all types of trading venues (including regulated markets) that allow algorithmic trading.

The standards applicable to firms include, among other things, requirements that:

- (i) a firm must have clear lines of accountability for the development, deployment and updates of algorithms, and effective procedures for communication of information;
- (ii) compliance staff must have at least a general understanding of how the firm's trading systems and algorithms operate (having sufficient knowledge to follow up on alerts and challenge trading staff when activity gives rise to disorderly trading conditions) and be in continuous contact with persons with detailed technical knowledge of those trading systems and algorithms;
- (iii) testing must ensure that systems conform with the rules and systems of the relevant trading venue, risk controls work as intended, and systems will not contribute to disorderly trading and can continue to work effectively in stressed market conditions;
- (iv) their systems must include kill functionality enabling them as an emergency measure to cancel unexecuted orders submitted to individual trading venues originated by individual traders, desks or clients, where applicable, or to immediately cancel all the firm's outstanding orders at all trading venues to which a firm is connected;

- (v) they must perform an annual self-assessment and validation process, which includes preparation of a validation report;
- (vi) they must keep records of material changes made to software, including when a change was made, who made it, who approved it, and the nature of the change;
- (vii) their monitoring systems must have real-time alerts that assist staff in identifying when an algorithm is not behaving as expected, and must have a process for remedial action when alerts occur, including a process for an orderly withdrawal from the market;
- (viii) they must operate pre-trade controls, execution throttles and risk limits on order entry (including price collars and maximum order values, maximum order volumes and maximum message limits) with the ability to automatically block or prevent orders that do not meet these parameters and post-trade controls (including credit and market risk monitoring, reconciliation and limits) which may include adjusting or shutting down an algorithm if triggered; and
- (ix) they must monitor all trading activity which takes place through the firm's systems (including by clients) for market abuse, and must establish and maintain automated surveillance systems for this purpose.

Additional requirements apply to firms operating HFT, including a requirement to:

- (i) store, in an approved form, accurate and time-sequenced records of all placed orders (including cancellations, executed orders and quotations on trading venues); and
- (ii) provide records to a competent authority on request.<sup>32</sup>

The requirements on trading venues are consistent with those on firms engaging in algorithmic trading or HFT, and also require, among other things:

- (i) due diligence to check prospective and existing members against the trading venue's standards (including pre- and post-trade controls, qualification of staff, systems testing and kill functionality policy);
- (ii) monitoring requirements for trading venue rule breaches, disorderly trading and market abuse (with specific minimum parameters);
- (iii) business continuity arrangements;
- (iv) mechanisms to manage volatility, including mechanisms to automatically halt or constrain trading; and
- (v) security to protect systems from misuse or unauthorized access, and protect the integrity of data.

There are also requirements governing transparent and non-discriminatory access and fee structures for co-location services<sup>33</sup> relating to algorithmic trading and HFT on trading venues.

**Conclusion** Regulation AT is likely to have a significant impact on how U.S. futures markets will operate in the future. Furthermore, even though Regulation AT does not apply to trading on SEFs, it is likely that the principles laid out in this regulation will eventually apply to trading in swaps on SEFs as well. Accordingly, it is important for the industry to adequately assess the impact of this regulation (and its EU counterpart), and to assist CFTC in its drafting of the final regulation.

The comment period for this regulation will be open for 90 days after its publication in the *Federal Register* (i.e., counting from December 17, 2015, the date of the publication).

**Annex 1: Key Implications of Regulation AT**

Participant / Issue	Analysis and Implications
<p>1. <i>What qualifies as an AT Person?</i></p>	<ul style="list-style-type: none"> <li>• Any participant currently registered or required to be registered with CFTC: FCMs, floor brokers, swap dealers, major swap participants, CPOs, CTAs, or introducing broker; provided that it engages in Algorithmic Trading on or subject to the rules of a DCM.</li> <li>• Any Floor Trader under the amended definition.</li> <li>• Thus, many unregistered participants become Floor Traders, and by definition, AT Persons under Reg. AT. They are consequentially subject to its AT Person requirements.</li> </ul>
<p>2. <i>New Registrants – Floor Traders</i></p>	<ul style="list-style-type: none"> <li>• Reg. AT requires registration as Floor Traders of certain unregistered participants who engage in Algorithmic Trading through DEA.</li> <li>• CFTC Staff estimates this currently includes about 100 market participants, many of them small.</li> <li>• Note that Floor Traders are summarily included in the definition of AT Persons. Floor Traders are automatically AT Persons, but that maxim does not necessarily play vice versa.</li> </ul>

Participant / Issue	Analysis and Implications
<p>3. <i>What about trading through a FCM – does Regulation AT affect those trades?</i></p>	<ul style="list-style-type: none"> <li>• Reg. AT contemplates trades executed via FCMs originating from AT Persons despite the language that AT Persons include participants trading subject to the rules of a DCM.</li> <li>• The implications are observed more for FCMs than for the AT Persons themselves: for DEA orders originating from AT Persons, FCMs must implement DCM-provided controls. For non-DEA orders, however, the FCMs may use their own controls.</li> </ul>
<p>4. <i>Non-U.S. Participants vs. U.S. Participants</i></p>	<ul style="list-style-type: none"> <li>• Reg. AT makes no distinction here. Non-U.S. participants may very well fall under the proposed rules as AT Persons and Floor Traders.</li> </ul>
<p>5. <i>Limitations – What Regulation AT does not cover</i></p>	<ul style="list-style-type: none"> <li>• Reg. AT does not cover swap execution facilities.</li> <li>• Reg. AT does not cover trading other than Algorithmic Trading.</li> <li>• With respect to Floor Traders, Reg. AT does not apply to connectivity other than DEA (although AT Persons are not limited by DEA).</li> <li>• Reg. AT does not cover certain proposals from the 2013 Concept Release.</li> <li>• Nor does Reg. AT seek to regulate high frequency trading (HFT). While the participants described in the definitions of AT Persons and Floor Traders include many participants that engage in HFT, HFT is not proposed to be regulated differently from other types of Algorithmic Trading. Note that EU regulations cover HFT trading.</li> </ul>

<sup>1</sup> Regulation Automated Trading (proposed Nov. 24, 2015) (to be codified at 17 C.F.R. pts. 1, 38, 40, 170); see also Concept Release on Risk Controls and System Safeguards for Automated Trading Environments, 78 Fed. Reg. 56542 (Sept. 12, 2013). <http://www.cftc.gov/ucm/groups/public/@Irfederalregister/documents/file/2015-30533a.pdf>.

<sup>2</sup> Appendix 3 – Concurring Statement of Commissioner Sharon Y. Bowen, Regulation AT (Nov. 24, 2015) (citing Keynote Address by Commissioner Sharon Y. Bowen before ISDA North America Conference, CFTC (Sep. 17, 2015), <http://www.cftc.gov/PressRoom/SpeechesTestimony/>

opabowen-6) (also available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement112415>).

- <sup>3</sup> *Id.*
- <sup>4</sup> See Grains Futures Act of 1922, c. 369, § 1, 42 Stat. 998 (1922) (revised into the Commodities Exchange Act, June 15, 1936).
- <sup>5</sup> CFTC estimates that there are approximately 100 such entities. See Regulation AT, Section V, Part A – Calculation of Persons Subject to Regulations.
- <sup>6</sup> Defined in Regulation AT, proposed § 1.3(yy).
- <sup>7</sup> See Appendix 4, Regulation AT.
- <sup>8</sup> Commodities Exchange Act, 7 U.S.C. § 1 (1936).
- <sup>9</sup> CFTC is considering whether adding a de minimis exception would be appropriate, whereby only those persons with DEA who meet certain trading or message volume thresholds would be required to register. See Regulation AT, Section V, Part E – Cost Benefit Considerations.
- <sup>10</sup> The current definition of “Floor Trader” can be found at CFTC Rule section 1.3(x): Floor Trader. This term means any person: (1) Who, in or surrounding any pit, ring, post or other place provided by a contract market for the meeting of persons similarly engaged, purchases, or sells solely for such person’s own account— (i) Any commodity for future delivery, security futures product, or swap; or (ii) Any commodity option authorized under section 4c of the Act; or (2) Who is registered with the Commission as a floor trader.
- <sup>11</sup> See *Id.*
- <sup>12</sup> The Staff of the CFTC believes that it is difficult at this time to engage in algorithmic trading on SEFs because most SEFs operate request for quote (“RFQ”) matching systems, where it is virtually technologically impossible to algorithmically trade, and only few are offering active central limit order books (“CLOBs”), where technically, one can engage in Algorithmic Trading.
- <sup>13</sup> Regulation AT, proposed §§ 1.80, 1.81, 1.83.
- <sup>14</sup> See CFTC Rules, 17 C.F.R. § 1.31 (2013).
- <sup>15</sup> See *Id.*
- <sup>16</sup> Regulation AT, proposed § 1.82.
- <sup>17</sup> Regulation AT, proposed §§ 38.255, 40.20 – 40.22.
- <sup>18</sup> Regulation AT, Proposed § 40.23(b).
- <sup>19</sup> Note that the standard is “should have known,” i.e., an objective standard of liability.
- <sup>20</sup> Commodities Exchange Act, 7 U.S.C. § 1a(23)(A)(i). These “places” include anywhere “in or surrounding any pit, ring, post, or other place provided by a contract market for the meeting of persons similarly engaged...” *Id.*
- <sup>21</sup> Regulation AT estimates that approximately 100 additional entities will have to register if this rule becomes enacted in its current form. See Regulation AT, Section V, Part A – Calculation of Persons Subject to Regulations.
- <sup>22</sup> Appendix 4 – Statement of Commissioner J. Christopher Giancarlo, Regulation AT (Nov. 24, 2015) (also available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement112415>).
- <sup>23</sup> Appendix 4, Regulation AT.
- <sup>24</sup> See *Id.*
- <sup>25</sup> *Id.*
- <sup>26</sup> Directive 2014/65/EU. This is one of the key elements of the current extensive financial market regulatory reform programme in the EU.
- <sup>27</sup> Article 48(6) of MiFID II.
- <sup>28</sup> Article 18(5) of MiFID II and Recital (2) in draft RTS 7 of Annex I to ESMA’s Final Report of 28 September 2015.
- <sup>29</sup> Article 17 of MiFID II.
- <sup>30</sup> The European Securities and Markets Authority.
- <sup>31</sup> Draft RTS 6 in Annex I to ESMA’s Final Report of 28 September 2015 for investment firms and RTS 7 or operators of trading venues.

<sup>32</sup> Article 17(2) of MiFID II.

<sup>33</sup> Article 48(8) of MiFID II and draft RTS 10 of Annex I to ESMA's Final Report of 28 September 2015.

<sup>34</sup> The staff of CFTC asked commenters to respond to 164 questions.

<sup>35</sup> <http://www.cftc.gov/ucm/groups/public/@Irfederalregister/documents/file/2015-30533a.pdf>.

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1. Regulation AT, proposed § 1.3(ssss): Algorithmic Trading. This term means trading in any commodity interest as defined in paragraph (yy) of this section on or subject to the rules of a designated contract market, 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 designated contract market; 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 designated contract market.
  2. Regulation AT, proposed § 1.3(vvvv): Algorithmic Trading Event. This term means an event at an AT Person that constitutes— (1) An Algorithmic Trading Compliance Issue; or (2) An Algorithmic Trading Disruption.
  3. Regulation AT, proposed § 1.3(tttt): Algorithmic Trading Compliance Issue. This term means 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, the rules of any designated contract market to which such AT Person submits orders through Algorithmic Trading, the rules of any registered futures association of which such AT Person is a member, the AT Person's own internal requirements, or the requirements of the AT Person's clearing member, in each case as applicable. Regulation AT, proposed § 1.3(uuuu): Algorithmic Trading Disruption. This term means an event originating with an AT Person that disrupts, or materially degrades— (1) The Algorithmic Trading of such AT Person, (2) The operation of the designated contract market on which such AT Person is trading, or (3) The ability of other market participants to trade on the designated contract market on which such AT Person is trading.
  4. Regulation AT, proposed § 1.3(wwww): AT Order Message. This term means each new order or quote submitted through Algorithmic Trading to a designated contract market by an AT Person, and each change or deletion submitted through Algorithmic Trading by an AT Person with respect to such an order or quote.
  5. Regulation AT, proposed § 1.3(xxxx): AT Person. This term means any person registered or required to be registered as a— (1) Futures commission merchant, 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 designated contract market; or (2) Floor trader as defined in paragraph (x)(3) of this section.
  6. Regulation AT, proposed § 1.3(x)(3): Floor Trader (x) ... (3)(i) Who, in or surrounding any other place provided by a contract market for the meeting of persons similarly engaged purchases or sells solely for such person's own account— (A) Any commodity for future delivery, security futures product, or swap; or (B) Any commodity option authorized under section 4c of the Act; and (ii) Who uses Direct Electronic Access as defined in paragraph (yyyy) of this section, in whole or in part, to access such other place for Algorithmic Trading; and (iii) Who is not

registered with the Commission as a futures commission merchant, floor broker, swap dealer, major swap participant, commodity pool operator, commodity trading advisor, or introducing broker.

7. Regulation AT, proposed § 1.3(yyyy): Direct Electronic Access. This term means an arrangement where a person electronically transmits an order to a designated contract market, without the order first being routed through a separate person who is a member of a derivatives clearing organization to which the designated contract market submits transactions for clearing.

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