

REGULATION AUTOMATED TRADING: THE CFTC'S SUPPLEMENTAL PROPOSAL AND BEYOND

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On November 4, 2016, the U.S. Commodity Futures Trading Commission (“CFTC”) in a two-to-one vote¹ approved a supplemental proposal on the regulation of automated trading (the “*Supplemental Proposal*”).² The Supplemental Proposal amends the CFTC’s proposed rulemaking on the Regulation of Automated Trading³ (the “*Initial Proposal*”) unanimously approved by the CFTC in November 2015. It revises a number of the regulations and concepts proposed in the Initial Proposal, while leaving others in place. The Supplemental Proposal addresses issues raised at a roundtable held at the CFTC in December 2015 where market participants expressed concerns with, among other things, the Initial Proposal’s redundant risk control requirements, source code repository requirement, and third-party systems reporting requirements. Specifically, the Supplemental Proposal includes six significant changes to the proposed regulatory framework for automated

trading: (1) revised pre-trade risk controls requirements; (2) a new volumetric threshold for qualification as an “AT Person;” (3) a broader definition of “Direct Electronic Access” (“*DEA*”); (4) clarification regarding the retention of source code; (5) an alternative compliance pathway via certification for parties using third-party Automated Trading Systems; and (6) an elimination of the annual reporting requirements for AT Persons and clearing member futures commission merchants (“*FCMs*”) and review requirements for designated contract markets (“*DCMs*”) proposed under the Initial Proposal. Given the results of the recent U.S. presidential election and forthcoming changes in administration, the ultimate fate of this rulemaking is uncertain.

I. AT Person Status and Floor Trader Registration Requirements

Much of the Regulation Automated Trading regulatory regime focuses on “AT Persons.” AT Person status would result in new or additional regulatory requirements for market participants pertaining to their Algorithmic Trading activity.⁴ Under the Initial Proposal, an entity does not register as an AT Person but rather becomes an AT Person, intentionally or unintentionally, if it is: (1) (a) already registered or required to be registered as an FCM, floor broker, swap dealer (“*SD*”), major swap participant (“*MSP*”), commodity pool operator (“*CPO*”), commodity trading advisor



(“*CTA*”), or introducing broker (“*IB*”) and (b) engages in “Algorithmic Trading”; or (2) already registered as or required to be registered as a “floor trader” (i.e., because it engages in Algorithmic Trading using DEA). Commenters expressed concern that the proposed regulations could impact a much broader swath of market participants than the CFTC’s estimated 420 entities. Accordingly, the CFTC is now proposing a volumetric threshold requirement that will filter out a number of potential AT Persons, even if they meet the qualifications under (1) and (2) above. Entities that trade 20,000 contracts or more per day on average, including for a firm’s own account, the accounts of customers, or both, over a six (6) month period exceed the volumetric threshold and accordingly would be AT Persons. Additionally, the CFTC’s new proposed definition of AT Person will permit entities to elect to become AT Persons by registering as floor traders and complying with related regulatory requirements even if they do not meet the volumetric threshold.

Under the Supplemental Proposal, there would now be three paths to becoming an AT Person. An entity may become an AT Person by:

- 1) Being registered or required to be registered as an FCM, floor broker, SD, MSP, CPO, CTA, or IB that (i) engages in Automated Trading and (ii) satisfies the volume threshold test;
- 2) Being registered or required to be registered as a “floor trader” by (i) engaging in Algorithmic Trading utilizing DEA and (ii) satisfying the volume threshold test; or
- 3) Electing to become an AT Person by (i)

registering as a floor trader and (ii) complying with related CFTC regulatory requirements.

The CFTC estimates that there would be approximately 120 AT Persons under this new definition (50 of which would be new registrants). Entities would be able to drop their designation as an AT Person if they fall below the volumetric threshold for two consecutive six-month periods.

The Supplemental Proposal would also include an anti-evasion provision and an affiliate group aggregation provision. The anti-evasion provision prohibits an entity from trading contracts or causing contracts to be traded through multiple entities for the purpose of evading the floor trader registration requirements or to avoid meeting the definition of an AT Person. The affiliate group provision would require registration in the context of a group that consists of a person or persons and a controlling person. If the group in the aggregate satisfies the volume threshold test, then one or more persons in the group must register as floor traders so that the aggregate average daily volume of the unregistered persons in the group trade an aggregate average daily volume below the volumetric threshold.

II. Revised Definition of Direct Electronic Access

The Supplemental Proposal broadens the definition of “Direct Electronic Access” proposed in the Initial Proposal to encompass much more than is traditionally considered DEA. Under the Initial Proposal, DEA was defined as 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

(“*DCO*”) to which the DCM submits transactions for clearing.⁵ “Routed” means the physical transmission of an order from a customer to a DCM. In other words, DEA is a market connection where a person transmits orders directly into the DCM, without a middleman clearing member. Arguably, submitting orders to an FCM through an electronic system would not constitute DEA under this definition.

Under the Supplemental Proposal, DEA would be defined as the electronic transmission of an order for processing on or subject to the rules of a DCM, including the electronic transmission of any modifications to the order. The rule would exclude orders, modifications, and cancellations (i) electronically transmitted to a DCM (ii) by an FCM (iii) that the FCM received from an unaffiliated natural person (iv) via oral or written communication. In other words, DEA would not include an arrangement where a third party transmits an order orally or in writing to an FCM and the FCM then submits the order to a DCM on behalf of the third party. However, the exclusion would not apply to orders received through electronic systems, such as through an application programming interface or graphical user interface. Accordingly, persons who submit orders to their FCM through any electronic user platform would now be considered to have DEA, in contrast to the Initial Proposal.

III. Source Code Requirements

The Supplemental Proposal adds an additional layer of bureaucracy on top of the already controversial source code regulatory requirements proposed in the Initial Proposal. Under the Initial Proposal, AT Persons would be required to retain source code in repositories and make the code available to CFTC Staff upon request. The

Supplemental Proposal would include a new bureaucratic hurdle that Staff must comply with in order to access source code and related records. Under the Supplemental Proposal, AT Persons would be required to retain for a period of five (5) years: (i) Algorithmic Trading source code; (ii) records that track changes to Algorithmic Trading source code; and (iii) “log files” that record the activity of the AT Person’s Algorithmic Trading system. The term “log files” is not defined in the Supplemental Proposal. Nor does it mandate the retention of specific log files or the form or specific content of log files. All log files generated in the ordinary course of business must be retained.

The Supplemental Proposal would allow CFTC Staff to access the source code and related records by obtaining a subpoena approved by a majority of the Commission pursuant to Part 11 (Investigations) of the CFTC’s regulations or through a “special call” under Part 18 (Reports by Traders) or Part 21 (Special Calls) approved by a majority of the Commission. CFTC Staff would be able to specify the manner that the records be provided, meaning that it could opt for the provision of records directly to Staff. The Supplemental proposal does not include any additional safeguard provisions. It would rely on the confidentiality requirements of the Section 8(a) of the Commodity Exchange Act and Part 140 of the CFTC’s regulations.

The retention of the source code requirements led to a fiery debate on the protection of proprietary information between Chairman Timothy Massad and Commissioner J. Christopher Giancarlo at the Open Meeting on November 4, 2016. Commissioner Giancarlo stated that “any public good achieved by the rule is undone by the source

code requirement.” He argued that the subpoena process respects the due process rights of property owners by giving them the opportunity to challenge the subpoena. The special call process is an end-run around the subpoena requirement that would strip owners of their intellectual property rights. Additionally, he noted that there should be additional provisions related to the protection of source code in the Supplemental Proposal, rather than references to existing protections. Appealing to the Commodity Exchange Act itself, Commissioner Giancarlo raised the argument that source code is not included within “book and records” because it relates to a firm’s future business strategies rather than historic activity. Chairman Massad responded, stating that traders should not be able to “hide behind their machines.” Machine traders must be subject to the same surveillance as human traders, he reiterated.

The idea that source code is comparable to written trading strategies, which qualify as books and records, is questionable. Source code may also be considered in relation to the mental thought processes of a trader. In other words, an artificial or machine intelligence rather than a human intelligence that makes decisions about trades. Allowing CFTC Staff to obtain proprietary source code without a subpoena may be no different from allowing Staff to mandate that witnesses submit to interviews about their mental thought processes without the right to challenge the requirement. Chairman Massad, however, has expressed fears that source code will be used to cloak trading strategies from regulatory oversight.

IV. Third-Party Systems

At a roundtable held at the CFTC on December

17, 2015 regarding the Initial Proposal, market participants expressed concern about the requirement that AT Persons be required to disclose and permit access to electronic systems developed and licensed by non-trading vendors (*i.e.*, proprietary third-party code), particularly best-execution algorithms. They argued that this might cause third parties to stop providing these services to AT Persons. Additionally, AT Persons may lack access to the source code of third parties. Accordingly, the Supplemental Proposal would provide an alternative compliance pathway to AT Persons who, due solely to their use of third-party systems or components, are unable to comply with a particular development or testing requirement or a particular maintenance or production requirement related to Algorithmic Trading source code and related records. These persons could comply with the regulatory obligations by satisfying two requirements: (1) obtaining a certification that the third party is complying with the obligation; and (2) conducting due diligence regarding the accuracy of the certification. Such AT Persons must re-certify every time there is a “material change” in the system.

This alternative compliance pathway is a large win for third parties that develop and lease trading systems. Third-party developers test their products exhaustively, often in collaboration with their customers, before providing them to the market. Under the Initial Proposal’s regulatory framework, third parties would also have to work with each customer individually to ensure compliance and provide them with source code and related records for each customer’s source code repository. The Supplemental Proposal’s certification requirements will reduce the regulatory

burden on both third party developers and their customers by streamlining compliance.

V. Risk Control Framework

The Supplemental Proposal would establish a dual-layered risk control framework. The Initial Proposal included three levels of risk controls at the (1) AT Person level; (2) *clearing* FCM level; and (3) DCM level. The Initial Proposal required pre-trade risk controls at each level. Under the Supplemental Proposal, there would be two levels of risk controls at the (1) AT Person or *executing* FCM level; and (2) DCM level. The Supplemental Proposal allows AT Persons to delegate the risk control function to their FCM. However, the FCM may refuse. In this case, the AT Person would be required to implement the controls. FCMs would not be required to implement risk controls on order messages that are subject to AT Person-administered controls if the AT Person implements pre-trade risk controls, but would be required to implement risk controls on electronic orders originating with non-AT Persons.

Under the Initial Proposal, the pre-trade risk control requirements applied to Algorithmic Trading. The Supplemental Proposal would expand the requirements to encompass all “Electronic Trading.” Commenters largely supported this change, noting that the term Algorithmic Trading encompassed too narrow a category of activity. Electronic Trading would be a broadly defined term that includes trading on an electronic trading facility where the order, order modification, or order cancellation is electronically submitted for processing on or subject to the rules of a DCM. Virtually all non-pit trading would be considered Electronic Trading under this definition.

Rather than focus on each component of the automated trading ecosystem, the CFTC decided to regulate the system as a whole and allow parties that need not implement controls to opt out. The revised pre-trade risk control requirements will afford market participants more flexibility in implementing compliance programs. AT Persons that are required to register as floor traders will be new to the CFTC’s regulatory oversight and may choose to delegate responsibility for pre-trade risk controls to an FCM. FCMs are likely to be in a better position to implement controls than many new floor traders and therefore the Supplemental Proposal would be more efficient for the marketplace as a whole than the Initial Proposal.

VI. Reporting and Recordkeeping Requirements

The Supplemental Proposal would eliminate the annual reporting requirements proposed in the Initial Proposal for AT Persons and clearing member FCMs and corresponding DCM review requirements. Under the Initial Proposal, each AT Person and clearing member FCM would be required to retain records and provide the DCMs on which they operate with annual reports regarding compliance with risk controls. The DCMs would be required to establish corresponding annual review programs. The Supplemental Proposal streamlines these compliance obligations. The Supplemental Proposal retains the recordkeeping requirements for AT Persons and clearing member FCMs but eliminates the reporting requirements and DCM review program requirements. It adds a new requirement that DCMs mandate AT Persons and executing FCMs provide the DCM with an annual certification attesting that the AT Person or FCM complies with the CFTC’s requirements.

VII. The Future of Regulation Automated Trading

With the election of Donald Trump to the U.S. presidency, there will be a number of changes at the CFTC. Commissioner Giancarlo's party -the Republican Party -will be in control of the White House on January 20, 2017 and it will not be long before he has support for implementing a new version of Regulation Automated Trading. After Mr. Trump is inaugurated, Commissioner Giancarlo is likely to ascend to the position of Acting Chairman until Mr. Trump nominates him or a new candidate as Chairman.

Commissioner Giancarlo's prior stated agenda for bringing futures regulation into the 21st Century has included five steps: (1) embrace innovation; (2) stand up for intellectual property; (3) repurpose rules for the Digital Age; (4) unburden the U.S. economy; and (5) champion American markets.⁶ He believes that markets should be permitted to grow organically through trial and error and not be artificially shielded from natural stressors.⁷ Otherwise, in his view, they will be prone to breakdown in the event of sudden shocks, such as the "Flash Crash." Market participants can thus expect principles-based regulation of electronic trading that does not hinder technological innovation in the futures markets. Commissioner Giancarlo has praised the proposed rulemaking for drawing on industry best practices and providing some flexibility in setting risk control parameters, but has criticized it for having a "broad scope, hazy objectives and several significant inconsistencies."⁸

Commissioner Giancarlo has expressed particular concern about the floor trader registration requirement and the source code provisions. He stated that the proposed rule would unnecessarily

ensnare a broad swath of market participants into the regulatory apparatus. He called the rulemaking "regulatory empire building," explaining that it is "a classic Washington maneuver [to] force as many businesses as possible into the regulatory framework so there is someone to investigate if something goes wrong."⁹ Commissioner Giancarlo would prefer that the CFTC focus on issues related to the electronification of the futures markets, such as defining *scienter* in the context of automated trading, assessing surveillance practices, setting regulatory penalties for faulty algorithms, and fostering innovation.¹⁰ Additionally, Commissioner Giancarlo has maintained that "[t]he CFTC must continue to obtain a subpoena to access the source code of market participants."¹¹

There are a number of possible paths forward for Regulation Automated Trading in 2017. First, it may be finalized in its current form, which is very unlikely. Second, certain proposed regulations in the rulemaking may be finalized, such as the pre-trade risk controls requirements, and others excluded, such as the source code and registration requirements. Third, a new re-proposed rulemaking may be issued for public comment. Finally, the entire proposed rulemaking may be placed on the backburner while other items and proposals are prioritized. With new innovations in financial technology developing across the globe, the CFTC is likely to carefully consider commenters' concerns on this important issue and work with the marketplace to craft a rule that protects consumers without impairing liquidity.

ENDNOTES:

¹Commissioner J. Christopher Giancarlo voted against the adoption of a proposed rule-

making for the first time in his tenure as a Commissioner.

²*Regulation Automated Trading, Supplemental Notice of Proposed Rulemaking*, 81 Fed. Reg. 85,334 (Nov. 25, 2016).

³*Regulation Automated Trading, Notice of Proposed Rulemaking*, 80 Fed. Reg. 78,824 (Dec. 17, 2015).

⁴ The Supplemental Proposal would not revise the Initial Proposal definition of “Algorithmic Trading,” which is defined as: trading in any commodity interest . . . 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. 80 Fed. Reg. at 78,937.

⁵ This definition parallels the CFTC’s description of “direct electronic access” in § 38.607 of the CFTC’s regulations, which states that “allowing customers of futures commission merchants to enter orders directly into a designated contract market’s trade matching system for execution” is an example of direct electronic access.

⁶ See Commissioner J. Christopher Giancarlo, *21st Century Markets Need 21st Century Regulation*, Address to the American Enterprise Institute, Sep. 21, 2016, available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-17>.

⁷ See Commissioner J. Christopher Giancarlo, *Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank (White Paper)*, Jan. 29, 2015, at 61, available at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf>.

⁸ See Giancarlo, *supra* note 6.

⁹ See *id.*

¹⁰ See *id.*

¹¹ See *id.*

