Financial Services Advisory

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December 15, 2015

Proposed CFTC Regulation To Impact Algorithmic Trading and Traders

On November 25, 2015, the Commodity Futures Trading Commission (the "Commission" or the CFTC) proposed a comprehensive set of new rules ("Regulation AT") that, if adopted, potentially would impose many new obligations on most CFTC registrants that use, or whose customers use, algorithmic trading systems (ATS) to trade futures, options or swaps on a designated contract market (but not on a swap execution facility (SEF)). The impacted registrants include futures commission merchants, introducing brokers, floor brokers, swap dealers, major swap participants, commodity trading advisors and commodity pool operators.[1]

The proposed rules also would affect any futures commission merchant (FCM) that is a clearing member of a designated contract market (DCM) and carries accounts for customers who use ATS, as well as any DCM and any registered futures association (RFA) (a category of entities that currently consists solely of the National Futures Association (NFA)).

The proposed rules also would require any non-registrant that uses an ATS to route electronic orders directly to a DCM to register with the NFA as a floor trader.[2] Importantly, all (1) specified CFTC registrants that engage in algorithmic trading; and (2) persons required by Regulation AT to register as floor traders (collectively, "AT Persons") would be required to maintain copies of all source code used in a live environment, including all changes, in accordance with general CFTC record-keeping requirements (which mandate a five-year retention), and, upon request, make available such source code for inspection by the Commission and US Department of Justice staff without subpoena or other process of law.

Algorithmic Traders

Importantly, under proposed Regulation AT, algorithmic trading is not limited to the black box derivation and electronic placement of orders on DCMs. Covered activity also may include solely automated order placement. There is no minimum number of transactions that constitutes algorithmic trading.

Algorithmic trading is defined broadly to include any trading of any future, option or swap subject to DCM rules where an order, modification, or order cancellation is electronically submitted and one or more computer algorithms or systems:

- decides whether to initiate, modify or cancel the order, or
- otherwise makes "determinations" with respect to the order, including but not limited to:

1 Existing floor traders appear not to be covered by the CFTC's proposed new rule.

2 The CFTC estimates there will be a maximum of 100 new floor trader registrants under this proposed new requirement.

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- ➢ the product to be traded;
- ➢ the DCM where the order will be placed;
- ➢ the order type;
- ➢ the order's timing;
- ➢ whether to place the order;
- ➢ the sequencing of the order (compared to other orders);
- ➢ the order price;
- ➢ the order quantity;
- ➢ the partition of the order into smaller components for submission;
- ➢ the number of orders to be placed; or
- ➢ the management of orders after submission.

This broad definition likely would capture at least some electronic order entry systems.

All AT Persons will be required to implement certain minimum pre-trade risk controls and other measures "reasonably designed" to avoid a so-called "algorithmic trading event" (see the chart below).[3] Under proposed Regulation AT, an algorithmic trading event occurs when there is (1) a compliance breach **of any magnitude** (a "compliance issue"), or an operational breakdown that is disruptive at any level (an "trading disruption"). A compliance issue would occur when an AT Person's algorithmic trading does not comply with relevant law, CFTC regulations, or the rules of a relevant DCM or the NFA. Such an issue also would arise when the AT Person's algorithmic trading does not comply with the AT Person's own internal risk controls or other written policies and procedures, or the risk controls and written policies and procedures of its clearing member.

Because an AT Person will be exposed to enforcement risk for failure of any magnitude to comply with its own written policies and procedures, an AT Person might hesitate before adopting any internal requirement that goes beyond the minimum CFTC requirements, lest there be penalties later for violating a voluntarily adopted higher standard. This requirement also could expose an AT Person to enforcement risk for failure to comply with FCM requirements of which it might not be aware.

A trading disruption would be an event "originating" with an AT Person that "disrupts or materially degrades:"

1. the algorithmic trading of the AT Person;
2. the operation of the DCM where the AT Person is trading; or
3. the ability of other market participants to trade on the DCM where the AT Person is trading.

All AT Persons would be required to implement policies and procedures to prevent "algorithmic trading events" under Regulation AT, with certain additional requirements applicable to FCMs, DCMs and NFA. Such policies and procedures would need to include:

[3] The CFTC estimates that approximately 420 persons will qualify as AT Persons and potentially be affected by this requirement.

	AT Persons	FCMs	DCMs and NFA
Risk Controls	• maximum order message frequency per unit time and maximum execution frequency per unit time; • order price parameters and maximum order size limits; • the ability to: a) immediately disengage algorithmic trading; b) cancel selected or all resting orders; and c) prevent submission of new order messages; and • for AT Persons with direct DCM access only, systems to indicate on an ongoing basis whether there is proper connectivity to a DCM's trading platform and market data.	• pre-trade risk controls "reasonably designed to prevent or mitigate an Algorithmic Trading Disruption," and ensure that natural persons are promptly informed when pre-trade risk controls are breached; and • for direct access clients, pre-trade risk controls and order cancellation systems provided by DCMs, and non-direct market access clients should establish and maintain their own pre-trade risk controls and order cancellation systems.	• risk controls for orders submitted through algorithmic trading. These must include pre-trade risk controls, and order cancellation systems; and • parallel controls for orders not originating from algorithmic trading (i.e., manually submitted).
Development, Testing and Monitoring	• written policies and procedures related to the development and testing of their ATS; • procedures to document the strategy and design of their software as well as changes that are implemented in the production environment; • policies and procedures to ensure ongoing, real-time monitoring to detect potential algorithmic trading events, and to empower "monitoring staff" to be able to stop an ATS from functioning (e.g., activate a kill switch) if system or market conditions warrant; and • policies and procedures to designate and train staff responsible for algorithmic training, and escalation procedures whenever an algorithmic trading event has been identified.	• order cancellation systems that would be required for all AT Persons, although it is not clear under what circumstances or within what time frames such systems must be used.	• a designated virtual environment where AT Persons may simulate production trading, policies and procedures designed to identify issues that may arise in a production environment. The test environment should enable AT Persons to conduct conformance testing of their ATS to verify compliance with the proposed pre-trade risk controls requirements and the proposed requirements relating to the testing and compliance of ATS.

Compliance Reports	• periodic review of all relevant policies and procedures, and promptly document and remedy deficiencies; and • an annual report by June 30, filed with each DCM on which an AT Person trades, a report describing its pre-trade risk controls and a certification by its CEO or CCO that to the best of his or her knowledge or reasonable belief, the information in the report is accurate and complete. The annual report must include copies of written procedures addressing the development and testing of its ATS and its ability to detect potential algorithmic trading compliance issues.	• an annual report by June 30, filed with each DCM on which an AT Person customer trades that describes how the FCM complies with its maintenance of pre-trade risk control requirements. The CEO or CCO would have to certify to the best of his or her knowledge or reasonable belief that the information in the report is accurate and complete. This is in addition to compliance reports that FCMs are already required to file with CFTC annually.	• risk control compliance reports from AT Persons and their clearing member FCMs; • periodic review of the compliance reports to identify outliers and provide instructions for remediation; and • review, as they believe necessary, of the books and records of AT Persons and clearing member FCMs regarding algorithmic trading procedures.
Miscellaneous	Additionally, all AT Persons must: • be members of the NFA; and • have a written plan of coordination and communication between compliance staff and other staff to predict and prevent an algorithmic compliance issue.		Additionally, all DCMs and NFA must: • implement rules "reasonably designed" to prevent self-trading by market participants; • provide to the CFTC and publish on their websites statistical and other information regarding proposed market maker and trading incentive programs, as well as the operation of their electronic matching platforms or trade execution facilities that materially impact the time, priority, price or quantity of execution or the ability to cancel, modify or limit display of market participant orders; and • prevent payment of market maker or trading incentives for trades between accounts under common beneficial ownership.

Regulation AT also would require the NFA to implement and maintain "a program for the prevention of fraudulent and manipulative acts and practices, the protection of the public interest and perfecting the mechanism of trading on designated contract markets…" The CFTC expects the NFA to accomplish this by obligating each category of NFA member to adopt rules that require:

1. pre-trade risk controls and other measures for ATS;
2. standards for developing, testing, and monitoring ATS, and compliance;
3. designation of algorithmic trading staff and provision of training for such persons; and
4. "operational risk management standards" for FCMs for orders originating with algorithmic trading systems."

Although the proposed rule requires the NFA to "establish and maintain a program," the accompanying CFTC release offers the NFA flexibility and discretion in determining what rules it should implement or steps it should take to fulfil its obligation. It is not clear whether the NFA could adopt such a program without amending its Articles of Incorporation.[4]

Costs, Benefits and Miscellaneous

The release that accompanies the proposed Regulation AT includes an extensive discussion regarding the potential costs and benefits of Regulation AT and invites comment on whether its assumptions are accurate. (The CFTC analysis concedes that the cost of implementing the proposed rules will have a deleterious impact on at least some FCMs.)

The proposal contains 164 questions and more than 500 pages. Comments must be received within 90 days of the proposal's publication in the Federal Register. To see the proposal, click here.

The CFTC also has published helpful questions and answers to illustrate the application of Regulation AT. To see the questions and answers, click here.

[4] See current NFA Articles of Incorporation, Article III, Section 2(b) which states that "NFA shall not adopt, administer or enforce upon any Member or Associate a rule, standard, requirement or procedure which purports to govern or otherwise regulate… (iii) The rights, privileges, duties or responsibilities of membership in any Contract Market or Clearing Organization. (iv) The content, interpretation, administration or enforcement of any rule, standard, requirement or procedure of a Contract Market or Clearing Organization."