

[Securities Regulation Daily Wrap Up, COMMODITY FUTURES—Futures industry insiders question proposed CFTC Regulation AT, \(Mar. 18, 2016\)](#)

Securities Regulation Daily Wrap Up

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By [Lene Powell, J.D.](#)

One day after the comment period ended for proposed CFTC rules that would impose new requirements for automated futures trading, an expert panel at a derivatives industry conference discussed the requirements and explored objections to the [proposal](#). Panelists including exchange officials and proprietary traders quizzed a CFTC official on the need for regulation and objected strenuously to a provision that would let the CFTC look at traders' algorithmic source code.

The [comment period](#) for the proposed rules ended March 16, 2016.

Proposed Regulation AT. According to Sebastian Pujol-Schott, associate director of the CFTC Division of Market Oversight, the proposed rules are intended to increase transparency and reduce risks caused by automated trading. The proposal takes a multi-layered approach, with different requirements for trading firms, futures commission merchants (FCMs), and designated contract markets (DCMs).

Pujol-Schott explained that the proposal would create a new category of "AT person" for market participants that engage in algorithmic trading, including both current CFTC registrants and certain market participants that would be newly required to register as floor traders. AT persons would be required to have pre-trade risk controls, including maximum order message, maximum execution frequency per unit of time, and maximum order size parameters, as well as the capacity to cancel orders in a specified manner. The proposal would also require standards for the development and testing of algorithms.

In addition, AT persons would need to submit compliance reports to DCMs describing their pre-trade risk controls. Pujol-Schott said the CFTC decided not to specify in detail how those risk controls should be built, but in exchange, there needs to be some review of the firm's controls. Information received from industry indicated that DCMs would be the best entities to provide that review, he said.

Clearing member FCMs would be subject to requirements that largely mirror those for AT persons, including pre-trade risk controls for customer order flow and compliance reports. DCMs would likewise have to have pre-trade risk controls and would need to review the compliance reports they receive. DCMs would be required to identify "outliers"—firms within a similarly situated peer group whose controls don't measure up to their peers. In addition, DCMs would be required to have a self-trade prevention tool and disclose certain material elements of their trade matching systems.

Is regulation needed? Panel moderator Gary DeWaal, special counsel at Katten Muchin, asked what current gaps in regulation the proposed rules are intended to address. Pujol-Schott said there was a general need to update rules that were developed for natural persons. Markets change, and the rules have to keep up, he said, noting that the SEC, FINRA, and the European Securities and Markets Authority (ESMA) have all adopted or are in the process of adopting risk control measures for automated trading.

Also, major market disruptions caused by operational malfunctions, including multi-million trading errors by Knight Capital Group and others, indicate a need for additional regulation, said Pujol-Schott. "Do you wait to buy insurance until after the accident? Or do you buy it before?" he asked.

But Greg Wood, a director of algorithmic trading at Deutsche Bank, rejected the idea that market disruptions have created a need to regulate in this area. He said the SEC report on the Knight Capital breakdown is "almost a checklist of what could possibly go wrong," including development of software, faulty retired software being

reintroduced, failure to test, and poor deployment. Also, Knight was able to bypass risk management controls in the equity markets, but the futures markets have better risk controls, he said.

There is also the question of who should be subject to the proposed requirements, said Wood. Algorithmic trading has become embedded in many markets, not just futures markets, and is used by many different types of market participants to improve the efficiency of their execution. The proposed risk controls place a burden on certain market participants, yet miss other elements that should be addressed. All electronic trading should have standard risk controls because it all poses risk. A “fat finger” error can cause market disruption, Wood observed.

Chris Zuehlke, a director at DRW Trading, was more sanguine about the proposed risk controls, saying “they’re kind of in the right spot,” and “could probably be moved over the finish line with relative ease.” He believes it would be best to separate the risk control measures from the rest of the proposal and implement that portion first.

Source code worries. A controversial provision would require AT persons to maintain a “source code repository” that includes copies of production code and an audit trail of changes to the code. These records would have to be made available to the CFTC upon a books and records request under Regulation 1.31. Zuehlke warned that proprietary trading firms have major issues with this provision.

“Proprietary software, and proprietary strategies that are encompassed by our software, are the life blood of our business. It’s how we make our money,” said Zuehlke.

Zuehlke said if firms lose control of their source code through cyberattacks or inadvertent data leaks by the CFTC, as has happened with data being made available to academics, firms are not able to guard against that loss. Also, source code is different from other books and records because it is not static, existing only in the past. Rather, it is predictive, prescribing what firms will do in the future. Further, the books and records rule doesn’t translate well to source code, because the concept of indexing source code doesn’t really work. He also believes that the provision “may not jibe” with the Fourth Amendment or protections for intellectual property.

Other objections. Other panelists also had concerns about the proposed rules. Jim Moran, executive director of global markets regulation at CME Group, said the proposal focuses too much on “preventing” disruption. You can’t always prevent disruption, he said, so the emphasis should instead be on mitigation.

Willem Sprenkeler, manager of corporate affairs at Optiver, a principal trading firm, warned that requiring firms to self-report compliance incidents to a regulator creates a disincentive to have a strong risk management program. The incentive would be to have a less stringent program that wouldn’t trigger as many compliance failures needing to be reported, he said.

When is final rule expected? Now that the public comment period has ended, the CFTC will review the comment letters. DeWaal noted that CFTC Chairman Timothy Massad has [said](#) that the Commission hopes to finalize the rules by the end of the year and asked Pujol-Schott if that directive has been given to staff. Pujol-Schott said he couldn’t comment on that.

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