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The latest in a series of regulatory moves highlighting heightened scrutiny of automated trading came late last year with the CFTC's Notice of Proposed Rulemaking on Regulation Automated Trading (Regulation AT).

Aimed at addressing the inherent risks in algorithmic trading that may undermine the integrity of the US markets, Regulation AT proposes new risk control, transparency and compliance measures for automated trading on US designated contract markets (DCMs).

While the market evolution from pit trading to electronic trading has led to many efficiencies and benefits, it has also resulted in increased potential for market disruptions. Regulation AT is designed to consolidate previous work of the CFTC and other regulators, as well as practice by industry participants, into a unified body of law addressing automated trading systems (ATS) in US derivatives markets. Its overarching goal is to reduce the potential of automated trading disruptions, such as the 'Flash Crash' of May 6, 2010, and the events of October 15, 2014, when the market for US Treasury securities and futures underwent unusually high volatility. A very rapid upswing was followed by an equally rapid downswing in prices.

While many safeguards that Regulation AT would require of market participants are already broadly used in the industry, several requirements will come as a surprise to many. Automated traders will need to adjust their program logic accordingly.



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Only those engaged in what the CFTC defines as ‘algorithmic trading’ will be subject to this new regulation. The CFTC defines algorithmic trading as trading in any commodity interest on, or subject to the rules of, a US 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 DCM. Thus, one will not be subject to the regulation where a person enters every parameter of an order into a front-end system, and there is no further discretion by any computer system or algorithm prior to submission for processing.

Second, Regulation AT will only regulate certain market participants involved in algorithmic trading. For traders, the CFTC has coined the term ‘AT Person’, which means a person or entity that engages in automated trading and is also one of the following: registered or required to be registered as a futures commission merchant, floor broker, swap dealer, major swap participant, commodity pool operator, commodity trading advisor, introducing broker or floor trader. In the lingo of the CFTC, ‘floor trader’ is a catch-all term for most proprietary trading firms (or natural persons trading for their own account).

REGISTRATION WITH THE CFTC AND RFA MEMBERSHIP

The CFTC is proposing a significant change for proprietary traders using direct electronic access for algorithmic trading on a designated contract market. While not previously subject to registration requirements, these market participants will now be required to register with both the CFTC and at least one registered futures association (RFA).

Additionally, all AT Persons who are registered with the CFTC must also become a member of at least one RFA and thus be subject to the membership rules of

at least one RFA. This proposed regulation particularly affects floor brokers and floor traders who are not otherwise required to be RFA members.

RISK CONTROL MEASURES

The CFTC proposes that AT Persons adopt significant new risk control measures. To ease the burden, the CFTC will allow AT Persons the discretion to tailor their risk control programs to their own strategies. Additionally, an AT Person may outsource its risk management to an external vendor or comply with the new requirements through its DCM.

While many safeguards that Regulation AT would require of market participants are already broadly used in the industry, several requirements will come as a surprise to many.

Prior to the submission of an initial message or order to a designated contract market trading platform, AT Persons will be required to notify their clearing firms and their designated contract market that they will engage in automated trading. AT Persons must also notify the DCM any time their resting orders should be cancelled or suspended or a disconnection with the designated contract market occurs. Though the regulation requires a predetermined policy, it gives the AT Person flexibility in determining what should be done in different circumstances.

AT Persons will be required to establish maximum AT Order Message and execution frequencies. The regulation defines an AT Order Message as a new order, quote, change or deletion. This requirement is set at an AT Person-level and at further levels, such as by product, account number or designation, or natural person identifier. The regulation will allow AT Persons the discretion to set levels that are best suited for them, but it would require notice of a breach to be given to monitors responsible for the automated trading strategy.

AT Persons will be required to establish pre-trade risk controls limiting both the price and the quantities associated with each individual AT Order Message, often

called ‘price collars’ or ‘price tolerance limits’ and ‘fat-finger limits’. Each order will also be required to pass through a predetermined limit check that sets a maximum quantity and a maximum deviation level in order price as measured against a predetermined price, such as last trade price or market open price.

AT Persons will be required to implement a ‘kill switch’ control that immediately stops trading, cancels some or all of the resting orders, and prevents any new AT Order Messages. Further, AT Persons must maintain systems that monitor connectivity with the trading platform and any system used by a DCM to provide the AT Person with market data.

WRITTEN POLICIES

To minimize the operational risk of automated trading, Regulation AT requires AT Persons to develop and implement written policies dealing with the development and testing of their automated trading system, monitoring, compliance and staff.

AT Persons would be required to establish written policies and procedures on the testing of automated trading systems, both internally and on each contract market to be used, to identify circumstances that may lead to a compliance issue or a trading disruption. Policies and procedures will be required to document the strategy and the development of a proprietary automated trading software. Regulation AT proposes that DCMs provide a test environment that enables AT Persons to simulate production trading.

Written policies and procedures will also be required to ensure that each automated trading strategy has continuous, real-time monitoring by knowledgeable staff who are not engaged in trading. Staff must be able to trigger the ‘kill switch’ control and coordinate with the DCM and clearing firm staff to cancel orders. Additionally, automated alerts will be necessary when there is a breach or when market conditions move away from those within which the strategy is designed to operate.

Lastly, AT Persons will be required to maintain an auditable source code repository. This must manage source code access, persistence, copies of the entire code base used in the production environment and changes to this code base. These changes are to be captured in the common ‘source control’ sense: i.e. who made the material change, when it was made, and the

purpose for such material changes. Most significantly, the CFTC is proposing the source code to be maintained as part of an AT Person's books and records, open to inspection by the CFTC. However, there have been significant concerns around the idea of the CFTC inspecting essentially the trade secrets of a trading firm without a subpoena. The CFTC is currently considering its options around this controversial subject and may or may not soften its stance regarding this issue.

ANNUAL REPORT AND RECORD KEEPING

If the proposed regulation becomes effective, each AT Person must file a certified annual report with any DCM on which they engaged in Algorithmic Trading. In addition to the annual report, AT Persons would be required to maintain the records of their compliance, to be provided upon request to the applicable DCMs. DCMs are tasked with the review and evaluation of the books and records and may request access whenever it is deemed necessary.

NEW OBLIGATIONS FOR DCMs THAT IMPACT AT PERSONS

As part of the CFTC's effort to facilitate compliance with Regulation AT, the CFTC seeks to add an additional level of DCM controls directly impacting AT Persons' conduct. Regulation AT would impose similar requirements on DCMs in relation to pre-trading and trading risk controls, as well as additional disclosures related to the DCM trade matching systems. Since DCMs are already subject to regulation requiring risk controls for trading, the proposed regulation expands DCMs' obligations to provide risk control systems that directly address market participants that use direct electronic access. To encourage all market participants to develop and implement risk controls and systems that safeguard the system, Regulation AT would impose much the same requirements on DCMs as it does on AT Persons. A major difference between the obligations placed on AT Persons and DCMs, however, is that DCMs must also implement the same risk controls for manual orders that do not originate from algorithmic trading.

The CFTC also seeks to require DCMs to apply mechanisms specifically designed to prevent self-trading. Self-trading is defined as the intentional or unintentional "matching of orders for accounts that have

common beneficial ownership or are under common control". These requirements are intended to prevent trading that inaccurately signals the level of market liquidity while still allowing "bona fide and desirable self-match trades". Bona fide and desirable self-match trades are trades that result from the matching of orders for accounts with common beneficial ownership where such orders are initiated by independent decision makers or comply either with the DCM's cross-trade or minimum exposure requirements.

DCM's will be required to publish statistics on the self-trading prevention mechanisms above and inform on how much self-trading they have prevented and how much they have authorized on their respective trading platforms.

The CFTC does not plan on stopping here. A CFTC commissioner described Regulation AT as "merely the first step in a process".

The new rules on self-trade prevention are also intended to complement the prohibition under CEA regulations on wash trades. The CFTC defines wash trading as "entering into, or purporting to enter into, transactions to give the appearance that purchases and sales have been made, without incurring market risk or changing the trader's market position". While the wash-trading prohibition requires a level of intent, Regulation AT goes further by prohibiting certain types of unintentional self-trading. Additionally, Regulation AT does not include a de minimus exception for a certain percentage of unintentional self-trading which would have been tolerated before.

Further, Regulation AT would require DCMs to provide additional information to regulators and the public about their market maker and trading incentive programs. Regulation AT codifies the CFTC's expectation that DCM market maker and trading incentive programs may not provide payments or incentives for market maker or trading activity between accounts under common beneficial ownership.

CONCLUSION

The days of pit trading are long gone. As trades involving algorithms now make up a substantial portion of US markets and fear of market disruptions from automated trading has proliferated, the CFTC has decided to act. While this rulemaking largely formalizes best practices, several pieces of Regulation AT are new and will require close attention by compliance. Yet, the CFTC does not plan on stopping here. A CFTC commissioner described Regulation AT as "merely the first step in a process". In addition to continuous updating of the Regulation to keep up with changing technology, automated traders and market participants should be ready for rules that go even further in regulating the industry. As the commissioner further remarked, Regulation AT "is a starter home rather than a two-story". [AT](#)