

Investment Management Alert

November 16, 2016

Key Points

- The supplemental proposed rulemaking to Regulation AT heightens the procedural mechanisms by which source code is made accessible to the CFTC.
- The supplemental proposed rulemaking adds a volume-based quantitative threshold test to determine whether unregistered traders as well as current registrants are AT Persons and thus subject to Regulation AT.
- Under the supplemental proposed rulemaking, risk controls would take place at designated contract markets and either future commission merchants or trading firms.



Supplemental Proposal to Regulation AT: What Investment Managers Need to Know

A year has now elapsed since the Commodity Futures Trading Commission's (CFTC) publication of its Notice of Proposed Rulemaking on Regulation Automated Trading (Regulation AT), and the CFTC has just announced a supplemental proposal aimed at tempering industry backlash against certain of Regulation AT's most controversial proposals.

Regulation AT's overarching goal is to reduce the risk of market disruption posed by automation. With more than 70 percent of trading in futures now automated, the CFTC's proposal is intended to modernize the CFTC's regulatory oversight to keep up with the markets. To that end, Regulation AT proposes new risk control, transparency and compliance measures for automated trading on U.S. designated contract markets (DCMs). The supplemental proposal primarily modifies the original proposed rulemaking in four areas: the definition of an AT Person, risk controls, annual reporting requirements and CFTC access to source code.

Definition of an AT Person

As envisioned in the original proposed rulemaking, Regulation AT would regulate only certain market participants involved in algorithmic trading. For traders, the CFTC coined the term 'AT Person,' which means a person or entity that engages in automated trading and is also registered or required to be registered as one of the following: a futures commission merchant (FCM), 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 catchall term for most proprietary trading firms (or natural persons trading for their own account).

To respond to concerns that Regulation AT would capture too large a population of market participants, the supplemental proposal adds a volume-based quantitative threshold test to determine whether unregistered traders as well as current registrants are AT Persons. The volume threshold test involves quantitative metrics based on market participants' average daily trading volume across all products on the electronic trading facilities of all DCMs on which a market participant trades. Specifically, potential AT Persons must determine whether they trade at least 20,000 contracts on average per day over a six-month period. The calculation includes contracts that the potential AT Person trades for its own account, customer accounts or both. The calculation also requires that a potential AT Person aggregate its own trading volume and that of any other persons controlling, controlled by or under common control with the potential AT Person.

Pursuant to the supplemental proposal, a market participant could fall under the definition of an AT Person in one of two ways. First, AT Persons include market participants currently registered with the CFTC that engage in algorithmic trading and that satisfy the volume threshold test. Second, AT Persons include market participants not currently registered with the CFTC that engage in algorithmic trading utilizing direct electronic access and that satisfy the volume threshold test. Additionally, market participants who do not satisfy either of the prior two prongs may elect to become AT Persons, thus voluntarily opting into the AT Person obligations. Those in the second group and those voluntarily electing to become AT Persons would be required to register with the CFTC as floor traders, and all AT Persons must become members of at least one registered futures association to the extent not already a member.

Thus, under the supplemental proposal, unlike the original proposal, simply using direct electronic access to connect to the markets would no longer result in automatic registration. The registration regime's volume threshold test is intended to focus regulation on the firms that are responsible for the most substantial amount of automated trading in the markets and to avoid becoming overly burdensome to small firms. "Today in our markets, a smaller number of traders can represent a large percentage of total trading volume including during these periods of high volatility," CFTC Chair Timothy Massad noted recently. "For example the evening after the Brexit vote, the 10 most active firms represented approximately 60 percent of trade activity in the British pound futures. Without a registration requirement, we cannot make sure that some of the biggest traders in our markets are following the basic risk controls that our proposal calls for."

The CFTC estimates that the proposed new criteria will result in approximately 120 AT Persons, which includes approximately 70 market participants who are already registered with the CFTC in some capacity.

The CFTC has also indicated that it may be open to amending the 20,000 trades per day threshold based on comments from market participants.

Risk Controls

The CFTC's original proposed rulemaking called for pre-trade risk control and other requirements, such as order cancellation systems, at three levels—the DCM, the FCM and the trading firm. After comments that such a system would be too burdensome and cost-prohibitive, the CFTC is now proposing a two-tiered structure. The first level of risk controls would take place at either the FCM or the trading firm, and the second level would occur at the DCM as a backstop to further reduce the possibility of trading disruptions.

Whether the first level of risk control is implemented at the FCM or the trading firm depends on whether the order originates with AT Persons or the FCM. For orders originated by AT Persons, the supplemental proposal provides flexibility for AT Persons that do not wish to operate their own pre-trade risk controls, and it permits them to delegate that responsibility to their FCM. The supplemental proposal does not require the FCM to accept the delegation. If the FCM declines, the AT Person must implement the controls itself. Conversely, FCMs would not be required to implement risk controls if orders are subject to AT Person-administered controls. As to orders not originating with AT Persons, FCMs would be required to implement risk controls.

For non-AT Person trading firms that prefer to implement their own risk controls rather than delegate to their FCMs, such market participants would be permitted to voluntarily elect to become AT Persons.

Finally, risk control rules applicable to DCMs and FCMs have been revised to generally apply to the new and broader category of electronic trading instead of merely algorithmic trading. Electronic trading is defined as trading in any commodity interest 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. An electronic trading order message is defined as each order, modification or cancellation of such order submitted using electronic trading. All trades on CME Globex, for example, would now fall under the definition of electronic trades. As a result, a larger number of orders will be subjected to two levels of risk controls.

Annual Reporting Requirements

The CFTC's original proposed rulemaking called for annual reports to be filed by AT Persons with each DCM on which they engage in algorithmic trading certifying their compliance with Regulation AT. Industry participants commented that annual reports would be overly burdensome and with little benefit in mitigating risks associated with algorithmic trading. The CFTC now proposes a more streamlined approach by replacing the annual compliance report with a simplified annual certification requirement. AT Persons would still be required to maintain records of their compliance. To leverage the role of DCMs on the front lines of algorithmic trading, DCMs would also still be required to periodically review and evaluate AT Persons' compliance with Regulation AT.

Access to Source Code

Undoubtedly the most controversial piece of Regulation AT is the requirement that AT Persons maintain an auditable source code repository to be kept as part of the books and records of AT Persons that are

open to inspection by the CFTC. The repository must manage source code access, persistence, copies of all code 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 coding purpose for such material changes).

The supplemental proposal attempts to address industry participants' significant concerns around the notion of the CFTC inspecting what are essentially a firm's trade secrets. As a limitation on the original proposal of requiring AT Persons to produce source code like any other record upon request, the CFTC is now proposing to heighten the procedural mechanisms by which source code is made accessible to the CFTC. Under the supplemental proposal, review of source code can be authorized in two ways. First, when the CFTC is investigating potential violations of law, access to source code must be authorized pursuant to a subpoena. Second, when acting in its market surveillance capacity, access must be approved pursuant to a 'special call,' a procedure that requires commissioner authorization.

This revised proposal is an attempt to address the confidentiality concerns of market participants while maintaining the CFTC's ability to investigate, understand and respond to market events. Subpoenas are typically issued in connection with CFTC enforcement proceedings. The special call process, however, is intended to require similar CFTC review but to recognize the need for the CFTC's Division of Market Oversight to potentially review source code in connection with unusual trading events or market disruptions.

Whether the heightened protection offered by the supplemental proposal is sufficient to protect source code confidentiality remains open to debate. In the CFTC's open meeting announcing the supplemental proposal, Commissioner Giancarlo expressed his frustration that the CFTC in its surveillance capacity may still access source code without the protections afforded by the process of obtaining a subpoena, such as the ability to seek to limit the scope of the data being turned over. Commissioner Giancarlo even went so far as to suggest that the CFTC's proposed rulemaking with respect to source code may be unconstitutional.

There are also substantial data privacy concerns surrounding the disclosure of source code to the CFTC. In issuing the special call, the proposed rulemaking offers that the CFTC may specify procedures that further safeguard the records provided. For example, the proposed rulemaking mentions that the CFTC could specify the means by which it would access source code obtained through the special call process, such as on-site inspection at the facilities of an AT Person, the provision of records on computers without network connectivity or on secure storage media. The proposed rulemaking also emphasizes that the CFTC handles other proprietary and trade secret information under strict retention and use requirements. However, the proposed rulemaking does not require special protections in the handling of source code beyond the standard protections currently embedded in the Commodity Exchange Act and CFTC regulations. In an era of increasing cyber espionage, many market participants are concerned about whether source code will remain secure in government hands.

Conclusion

The supplemental proposal to Regulation AT modifies certain major pieces of the original proposed rulemaking. It is an attempt to balance the CFTC's responsibility to oversee markets and market participants with the concerns of those it is regulating. However, after Donald Trump's U.S. presidential election victory, it is less clear whether Regulation AT will be adopted and, if adopted, whether it will be subsequently rescinded or amended in part. In particular, given the controversy surrounding the source code repository, the source code retention obligation and inspection provision may be significantly amended prior to effectiveness.

Contact Information

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