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CFTC Proposes Regulation of Automated Trading

By Julian E. Hammar

On November 24, 2015, the Commodity Futures Trading Commission ("CFTC") approved the issuance of proposed rules to implement a framework of registration, reporting, recordkeeping and other compliance requirements for market participants engaged in algorithmic trading, referred to as Regulation AT. If adopted, the proposed rules would impose requirements on proprietary trading firms, designated contract markets ("DCMs"), clearing member futures commission merchants ("FCMs") and other CFTC registrants that use algorithmic trading systems. It also proposes to require the registration of certain proprietary traders under a new definition of the term "Floor Trader" due to their algorithmic trading through direct electronic access (as defined in the proposed rules) to a DCM. The proposed rules, which were published in the Federal Register on December 17, 2015, are available here, and are open for public comment (including with respect to 164 questions contained in the release) until **March 16, 2016**.

DEFINITION OF ALGORITHMIC TRADING

The CFTC defines the term "Algorithmic Trading" broadly under the proposal as trading in any commodity interest (e.g., futures, options or swaps) on or subject to the rules of a DCM, where:

- 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

- Such order, modification or order cancellation is electronically submitted for processing on or subject to the rules of a DCM.

The proposed rules would exclude from the definition of algorithmic trading any orders modifications, or cancellations that are manually entered into a front-end system by a natural person with no further discretion by any computer system or algorithm, prior to their electronic submission to a DCM.

PURPOSE OF THE PROPOSED RULES

The CFTC believes that the proposed rules are needed to prevent persons from using Algorithmic Trading to violate the Commodity Exchange Act ("CEA") or CFTC regulations, including by disrupting the market. The proposed rules would require risk controls and other requirements in order to address the risks of Algorithmic

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Trading, including the potential for market disruptions arising from system malfunctions, other errors, or intentional disruptive conduct. Under the proposal, risk controls and other requirements must be adopted at three levels:

- Market participants using algorithmic trading systems (AT persons in the proposed rule);

- Clearing member FCMs with respect to their AT Person customers; and

- DCMs executing AT person orders.

The proposed rules would apply whether or not a market participant engages in or facilitates high frequency trading; their requirements would apply to algorithmic trading irrespective of the speed of such trading. The proposal does not apply to trading on swap execution facilities.

REGISTRATION REQUIREMENT

Under current CFTC regulations, persons that engage in proprietary trading (i.e., not on behalf of customers) are not required to register unless they trade for their own account in or around a trading pit, ring, post, or other place provided by a DCM, and, in that case, they must register as a Floor Trader. The proposed rules would amend the definition of the term Floor Trader to include persons who trade commodity interests at a DCM for their own account through "Direct Electronic Access." Direct Electronic Access is defined as an arrangement where a person transmits an order electronically to a DCM, without the order first being routed through a clearing member FCM of a derivatives clearing organization to which the DCM submits transactions for clearing. The CFTC requests comment as to whether the Floor Trader definition should be expanded to all firms operating algorithmic trading systems in CFTC-regulated markets that are not otherwise required to register (not just through Direct Electronic Access).

REQUIREMENTS FOR AT PERSONS

The proposed rules contain requirements that apply to market participants that are "AT Persons." An AT Person is defined as:

- Any person registered or required to be registered as an FCM, floor broker, swap dealer, major swap participant, commodity pool operator, commodity trading advisor, or introducing broker that engages in Algorithmic Trading, or

- A Floor Trader that engages in Algorithmic Trading through Direct Electronic Access.

Risk Controls. AT persons would be required to implement risk controls on orders submitted through Algorithmic Trading, including pre-trade risk controls (e.g., maximum order message and execution frequency per unit time, order price and maximum order size parameters) and order cancellation systems that can disengage algorithmic trading, cancel selected or all resting orders, and prevent submission of new orders.

Development, Testing, and Monitoring. AT persons would be required to implement standards for the development, testing and monitoring of algorithmic trading systems, including complete separation of the environment used for system development from the one used for production, testing before implementation, real-

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time monitoring of such systems, and standards to ensure that systems comply with CFTC regulations, and must designate and provide training for algorithmic trading staff responsible for ensuring compliance.

Source Code Repository. AT persons would be required to establish and maintain a source code repository that includes the documenting of strategy and design of proprietary algorithmic trading software used and any changes implemented, including an audit trail that shows who made a change, when it was made, and its coding purpose. Repository records must be kept under the CFTC's recordkeeping regulation and made available for inspection upon request by the CFTC or the Department of Justice ("DOJ") (for any reason without a subpoena). This requirement has provoked controversy within the industry due to concerns about the CFTC/DOJ being able to protect sensitive proprietary information. Commissioner Giancarlo raised these concerns at the open meeting and in his concurring statement.

Compliance Reports. AT persons would be required to annually prepare and submit to DCMs compliance reports regarding their risk controls, as well as copies of written policies and procedures developed to comply with testing and other requirements. They would also be required to keep books and records regarding their Algorithmic Trading procedures for inspection by DCMs.

Notification Requirement/Use of Self-Trade Prevention Tools. Prior to an AT person's initial use of Algorithmic Trading to submit an order to a DCM, such AT person would be required to notify applicable clearing member FCMs and DCMs that the AT person will engage in Algorithmic Trading, and calibrate or otherwise implement DCM-provided self-trade prevention tools.

REQUIREMENTS FOR CLEARING MEMBER FCMS

Risk Controls. The proposed rules would require that clearing member FCMs implement risk controls for Algorithmic Trading orders originating with AT persons, including pre-trade risk controls applicable to AT persons. Pre-trade risk controls would have to be set at the level of each AT person, or at a more granular level as each clearing member FCM may determine. Clearing member FCMs would have to implement DCM-provided risk controls for Direct Electronic Access orders. They would also be required to have policies and procedures reasonably designed to ensure that natural person monitors at the FCM are promptly alerted when pre-trade risk control parameters are breached.

Compliance Reports. Clearing member FCMs would be required to annually prepare and submit to DCMs compliance reports that describe how they comply with maintenance of risk controls on their AT person customers. The report would have to be certified by the CEO or CCO that the report is accurate and complete to the best of his/her knowledge and reasonable belief. Clearing member FCMs would also be required to keep, and provide to a DCM upon request, books and records regarding their risk controls for Algorithmic Trading orders for inspection by DCMs.

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REQUIREMENTS FOR DCMS

Risk Controls. Under the proposed rules, DCMs would be required to implement risk controls on orders submitted through Algorithmic Trading (and parallel controls for manual orders), including maximum order message and execution frequency per unit time, order price and size parameters, and order cancellation systems.

Compliance Reports. DCMs would have to require risk control compliance reports from AT persons and their clearing member FCMs. DCMs would be required to periodically review compliance reports, identify outliers and provide instructions for remediation, as well as review, as necessary, books and records of AT persons and clearing member FCMs concerning Algorithmic Trading procedures.

Test Environments. DCMs would be required to provide test environments where AT persons can test algorithmic trading systems.

Self-Trade Prevention. DCMs would be required to establish self-trade prevention tools, and either apply such tools or provide them to all market participants (not just AT persons) and require their use. The rules would define "self-trading" as the matching of orders for accounts with common beneficial ownership or under common control. DCMs would be required to determine which accounts will be prohibited from trading with each other, or require market participants to identify such accounts. Exemptions would be provided for order matching for accounts with common beneficial ownership but initiated by independent decision makers, or for certain orders that comply with a DCM's cross-trade, minimum exposure requirements or similar rules. Prior approval from the DCM would need to be obtained in order for a market participant to rely on these exemptions.

Disclosure Regarding Electronic Trade Matching Systems. DCMs would be required to provide public disclosure regarding certain elements of their electronic trade matching systems that materially affect order execution, including the ability to cancel, modify, or limit display of orders; the ability to cancel or modify orders; and the transmission of market data and order or trade confirmations to market participants.

Market Maker and Incentive Programs. DCMs would be required to provide disclosures of market maker and incentive programs submitted to the CFTC as rule filings. Such disclosures would have to specify all of the products or services to which they apply, eligibility requirements, and payment benefits or incentives received (e.g., fee rebates), as well as non-financial benefits (e.g., enhanced trading priorities or preferential access to market data). Payments would be prohibited for trades between accounts under common beneficial ownership.

REGISTERED FUTURES ASSOCIATIONS

The proposal would require registered futures associations to adopt membership rules, as deemed appropriate by the registered futures association, relevant to algorithmic trading for each category of member. AT persons would be required to become members of a registered futures association (currently, the only registered futures association is the National Futures Association).

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Contact:

Julian E. Hammar
(202) 887-1679
jhammar@mofo.com

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