



# Commodity Futures Trading Commission

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## Q & A – Notice of Proposed Rulemaking on Regulation Automated Trading (“Regulation AT”)

The Commodity Futures Trading Commission (“Commission”) proposed a series of risk controls, transparency measures, and other safeguards to enhance the regulatory regime for automated trading on U.S. designated contract markets (“DCMs”). Proposed Regulation AT builds on existing industry best practices and Commission regulations, and is informed by the efforts of standard setting bodies and fellow regulators in the U.S. and abroad. Through Regulation AT, the Commission seeks a comprehensive approach to reducing risk and increasing transparency in automated trading.

### 1. What aspects of trading on or subject to the rules of a DCM are addressed by Regulation AT?

Regulation AT seeks to reduce risk and increase transparency through a series of related measures applicable to certain Commission registrants engaged in “Algorithmic Trading,” as defined in Question 8 below. Among other elements, the proposed rules require registration as Floor Traders of certain persons who are not currently registered with the Commission and who engage in proprietary Algorithmic Trading through “Direct Electronic Access” (“DEA”), as defined in Question 9 below.

In addition to mitigating risks arising from Algorithmic Trading activity, the proposed rules are intended to increase transparency around DCM electronic trade matching platforms and promote the use of self-trade prevention tools on DCMs. The proposed rules are also intended to foster transparency with respect to DCM programs and activities, including market maker and trading incentive programs, that have become more prominent as automated trading becomes the dominant market model.

Key elements of Regulation AT for trading firms, clearing member futures commission merchants (“FCMs”) and DCMs are discussed below.

### 2. What current Commission registrants are covered by Regulation AT?

The proposed regulations predominantly apply to DCMs, clearing member FCMs, and entities falling within the defined term “AT Person,” defined in proposed § 1.3(xxx).

AT Person means any person registered or required to be registered as a (i) FCM, floor broker, swap dealer, major swap participant, commodity pool operator, commodity trading advisor, or introducing broker that engages in “Algorithmic Trading” on or subject to the rules of a DCM; or (ii) floor trader, as defined in proposed amendments to the definition of floor trader in Commission regulation § 1.3(x).

### 3. What are the key elements of Regulation AT for trading firms that fall within the proposed definition of AT Person?

Effective risk controls reduce the potential for market disruptions arising from system malfunctions and other errors or conduct. The risks of such disruptions are heightened by the interconnection of markets and

increased use of high-speed and algorithmic trading, which makes the implementation of pre-trade risk controls and other measures even more necessary. The Commission proposes certain required pre-trade risk controls and other measures to help ensure the safety and soundness of Commission-regulated markets and provide market participants with greater confidence.

**Risk controls.** AT Persons must implement pre-trade and other controls to address the risks of Algorithmic Trading. These must include pre-trade risk controls (maximum order message and execution frequency per unit time, order price and maximum order size parameters), and order cancellation systems. However, the proposed rules provide AT Persons with flexibility regarding the design and calibration of required pre-trade risk controls. (proposed § 1.80(a) and (b)).

**Development, testing, and monitoring.** AT Persons must implement standards for development, testing and monitoring of algorithmic trading systems (“ATs”), and for the designation and training of algorithmic trading staff. These standards must include: keeping the development environment separate from the production environment; testing prior to implementation; a source code repository; real-time monitoring of such systems; and standards to ensure that systems comply with the Commodity Exchange Act and Commission regulations. (proposed § 1.81).

**Compliance reports.** AT Persons must submit annual compliance reports to DCMs regarding their risk controls as well as copies of written policies and procedures developed to comply with testing and other requirements. (proposed § 1.83(a)). AT Persons must also keep books and records regarding their Algorithmic Trading procedures for inspection by DCMs. (proposed § 1.83(c)).

#### 4. What are the key elements of Regulation AT for clearing member FCMs?

The Commission proposes to require clearing member FCMs to implement pre-trade and other controls with respect to Algorithmic Trading orders. All types of market access – both DEA and non-DEA – have the potential to create risks; therefore, the same principles should apply to all types of market access.

**Risk controls.** Clearing member FCMs must implement risk controls for Algorithmic Trading orders originating with AT Persons. For DEA orders, FCMs must implement DCM-provided risk controls. For non-DEA orders, FCMs must establish the controls themselves. As with AT Persons, the proposed rules provide clearing member FCMs with flexibility regarding the design and calibration of required pre-trade risk controls. (proposed § 1.82).

**Compliance reports.** Clearing member FCMs must submit compliance reports to DCMs describing their program for establishing and maintaining the required pre-trade risk controls for their AT Person customers (in the aggregate), and keep books and records regarding their controls for Algorithmic Trading orders for inspection by DCMs. (proposed § 1.83(b) and (d)). AT Persons are required to provide more detailed reports than clearing member FCMs.

#### 5. What are the key elements of Regulation AT for DCMs?

Regulation AT proposes to require DCMs to establish pre-trade and other risk controls designed to address the risks that may arise from Algorithmic Trading. The controls and systems required of DCMs are similar to those required of AT Persons in proposed § 1.80 and of clearing member FCMs in § 1.82.

**Risk controls.** DCMs must implement risk controls for orders submitted through Algorithmic Trading. These must include pre-trade risk controls (maximum order message and execution frequency per unit time, order price and maximum order size parameters), and order cancellation systems. DCMs must also implement parallel controls for orders not originating from Algorithmic Trading (i.e., manually submitted). The proposed rules provide DCMs with flexibility regarding the design and calibration of required pre-trade risk controls. (proposed § 40.20).

**Compliance reports.** DCMs must require risk control compliance reports from AT Persons and their clearing member FCMs. DCMs must periodically review the compliance reports, identify outliers and provide instructions for remediation. DCMs must also review, as necessary, books and records of AT Persons and clearing member FCMs regarding Algorithmic Trading procedures. (proposed § 40.22).

**Test environments.** DCMs must provide test environments where AT Persons may test ATs. The test environments must enable AT Persons to test compliance with § 1.80 (risk controls, order cancellation systems) and § 1.81 (development and testing requirements). (proposed § 40.21).

**Risk controls for DEA orders.** DCMs must establish risk controls for algorithmic orders submitted to DCMs by AT Persons using DEA, and require clearing member FCMs to use the risk controls for such DEA orders. (proposed § 38.255(b) and (c)).

## 6. Does Regulation AT address the role of registered futures associations in addressing the risks of automated trading?

To fully effectuate the design and intent of Regulation AT, the Commission is proposing a new § 170.19 requiring registered futures associations (“RFAs”) to adopt certain membership rules—as deemed appropriate by the RFA—relevant to algorithmic trading for each category of member in the RFA. RFAs would have discretion as to the rules they issue and the categories of members to which their rules apply. Furthermore, to ensure that all AT Persons are subject to rules of an RFA regarding algorithmic trading, the Commission is also proposing a new § 170.18 requiring AT Persons to become members of at least one RFA. Taken together, §§ 170.18 and 170.19 would allow RFAs to supplement elements of Regulation AT as markets and trading technologies evolve over time.

## 7. Does Regulation AT require registration of trading firms not currently registered with the Commission?

Yes. The Commission is seeking to enhance its oversight capabilities as they relate to entities that engage in proprietary, Algorithmic Trading through DEA, and to allow for wider implementation of the pre-trade and other risk controls proposed in Regulation AT. Regulation AT would require the registration of certain unregistered entities whose trading can significantly impact Commission-regulated markets. Such market participants would be required to register as Floor Traders, an existing registration category in § 1a(23) of the Commodity Exchange Act and in Commission regulation 1.3(x).

Specifically, Regulation AT would require the registration of persons who are proprietary traders who engage in Algorithmic Trading on DCMs via DEA. (See the discussion of these terms in questions below.) Such persons must register with the Commission as floor traders, if not already registered in another capacity.<sup>1</sup> (proposed § 1.3(x)(3)). These persons will also fall within the definition of “AT Person.”

## 8. How is Algorithmic Trading important to the proposed rules, and how is the term defined?

Algorithmic Trading is a focal point of Regulation AT. In many cases, elements of the proposed rules are triggered specifically when a registered market participant engages in Algorithmic Trading. This term is used in the definition of “AT Person” and in other proposed rules.

Regulation AT defines the term “Algorithmic Trading” as trading in any commodity interest (as defined in Commission regulation 1.3(yy)) on or subject to the rules of a DCM, 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

<sup>1</sup> Such floor traders must also become members of an RFA. See Question 6 and proposed § 170.18.

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 designated contract market; provided, however, that Algorithmic Trading does not include an order, modification, or order cancellation whose every parameter or attribute is manually entered into a front-end system by a natural person, with no further discretion by any computer system or algorithm, prior to its electronic submission for processing on or subject to the rules of a DCM. (proposed § 1.3(ssss)).

## **9. How does Regulation AT define Direct Electronic Access?**

The term DEA is used to help determine which currently unregistered entities must register with the Commission, as described above.

Regulation AT defines DEA as an arrangement where a person electronically transmits an order to a DCM, without the order first being routed through a separate person who is a member of a derivatives clearing organization to which the DCM submits transactions for clearing. (proposed § 1.3(yyyy)).

## **10. Does Regulation AT define or otherwise use the term high-frequency trading (HFT)?**

No. Regulation AT proposes to require the registration of certain proprietary traders that, while responsible for significant trading volumes in key futures products, are not currently registered with the Commission. Although such entities include a number of traders engaged in what is typically referred to as HFT, Regulation AT requirements do not vary in response to a market participant's algorithmic trading strategies, whether high-frequency or otherwise. Accordingly, HFT is not specifically identified under the proposed regulations and is not proposed to be regulated differently from other types of algorithmic trading.

## **11. Does Regulation AT address the practice of self-trading?**

Yes. Regulation AT would require that DCMs establish self-trade prevention tools, and either apply such tools or provide them to market participants and require their use. "Self-trading" is proposed to be defined as the matching of orders for accounts with common beneficial ownership or under common control. DCMs may either determine which accounts will be prohibited from trading with each other, or require market participants to identify such accounts. As an exception, DCMs may allow matching of orders for accounts with common beneficial ownership when initiated by independent decision makers. To provide greater transparency around such transactions, the proposed rules would require DCMs to publish quarterly statistics disclosing approved self-trading. (proposed § 40.23).

## **12. What are Regulation AT requirements with respect to DCM trade matching systems?**

The Commission believes that each market participant should have ready access to information that explains the existence and operation of any attribute within an electronic matching platform or trade execution facility that will impact how a market participant experiences the market. The structure, architecture, mechanics, characteristics, attributes, or other elements of an electronic matching platform or trade execution facility—elements that are under the design control of the DCM—may affect how market participant orders are received or executed. Proposed amendments to § 38.401 would clarify that DCMs must disclose any attributes of an electronic matching platform or trade execution facility that materially impact market participant orders, but which are not readily apparent to a market participant.

Disclosure must include a description of rules, specifications, or known attributes of the trade matching platform that materially affect the time, priority, price or quantity of execution of market participant orders; the ability to cancel or modify orders; and the transmission of market data and order or trade confirmations to market participants. (proposed revisions to § 38.401(a) and (c)).

### 13. What are Regulation AT requirements with respect to market maker and trading incentive programs?

The Commission believes that market maker and trading incentive programs could have the potential to spur market participants to trade in ways designed to collect program benefits, independently of any contribution they may be making to liquidity or price discovery. The automation and speed of ATSS can allow market participants to quickly reach market-maker or trading incentive program thresholds, and the trading strategies pursued can sometimes result in a large number of trades between the same ATS or between two or more ATSS owned or controlled by the same market participants. The Commission proposes regulations to further the Commission's policy objectives in transparency, market integrity, and effective self-regulation by all DCMs.

The proposed rules would require DCMs to provide certain disclosures regarding their market maker and trading incentive programs, and implement other controls. Such programs must be submitted as "Rule" filings pursuant to Commission regulations 40.5 or 40.6. Filings must describe eligibility criteria and describe payments or other benefits. Payments are prohibited where accounts have common ownership. (proposed §§ 40.25-28).

See also the Fact Sheet regarding the Regulation AT Notice of Proposed Rulemaking, available on the Commission's website.