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CLIENT MEMORANDUM

CFTC Supplements Regulation AT Proposal

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The Commodity Futures Trading Commission has supplemented its November 2015 proposal to regulate automated trading in the futures markets.[1] The Supplement, among other things, introduces a volume threshold test for determining whether a person comes within the scope of Regulation AT, proposes the establishment of pre-trade risk controls at two, rather than three, stages of a trade's life cycle and narrows the circumstances under which the CFTC staff could access source code. The Supplement also expands certain aspects of the proposed rule to all electronic trading, not just algorithmic trading. Comments on the Supplement are due 60 days following the date of publication of the Supplement in the *Federal Register*.[2]

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[1] As of the date of this memorandum, the CFTC's supplemental notice of proposed rulemaking for Regulation Automated Trading (the "Supplement") has not yet been published in the *Federal Register*. For more information on Regulation AT, please see our client memorandum entitled "CFTC Proposes Rules Governing Automated Trading" (Dec. 22, 2015), available here.

[2] We note that the close of the comment period will coincide with the period of transition to a new administration and a change in the membership of the CFTC. In light of the outcome of the election, the timing of the adoption of a final rule is uncertain.

AT Person Status

The provisions of Regulation AT would apply predominantly to "AT Persons." The Supplement revises the proposed definitions of AT Person and floor trader to introduce a volume threshold test. An AT Person would generally be defined as:

- any person currently registered or required to be registered with the CFTC as a futures commission merchant ("FCM"), floor broker, swap dealer, major swap participant, commodity pool operator, commodity trading advisor or introducing broker that engages in Algorithmic Trading; or

- certain floor traders.[3]

Under the volume threshold test, however, a person would be deemed to be an AT Person only if such person trades an aggregate average daily volume of at least 20,000 contracts for such person's own account, the accounts of customers, or both, during the relevant six-month period. If the trading of such person subsequently falls below the volume threshold for two consecutive six-month periods, such person would no longer be deemed an AT Person.

Regulation AT would generally require a market participant to calculate its aggregate average daily trading volume across all products it trades and across all DCMs on which it trades. Further, a market participant would be required to aggregate, for purposes of the volume threshold test, its own trading volume with that of any person under common control.[4]

Electronic Trading

Regulation AT, as initially proposed, was intended to govern only algorithmic trading by AT Persons. "Algorithmic Trading" is defined in the proposed rule as trading in any commodity interest on or subject to the rules of a DCM where:

- one or more computer algorithms or systems determine whether to initiate, modify or cancel an order, or make certain other determinations with respect to an order; and

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[3]   Regulation AT proposes to amend the definition of "floor trader" to generally include persons engaged in (1) proprietary (2) Algorithmic Trading (defined below) (3) through Direct Electronic Access ("DEA") on a designated contract market ("DCM").

[4]   The Supplement also introduces an anti-evasion provision into Regulation AT that would attribute to a market participant any contracts that such market participant trades or causes to be traded through multiple entities for purposes of avoiding registration or otherwise becoming subject to Regulation AT.

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- such order, modification or cancellation is electronically submitted for processing on or subject to the rules of a DCM.[5]

The Supplement does not change the proposed definition of Algorithmic Trading. Under the Supplement, however, the risk control and order cancellation provisions have been expanded to cover *all* electronic trading. Further, as discussed below, FCMs would be required to comply with such provisions with respect to electronic trading engaged in by non-AT Persons and, in some cases, by AT Persons, while DCMs would be required to comply with respect to electronic trading by all market participants.[6]

"Electronic Trading" is defined in the Supplement as trading in any commodity interest on an electronic trading facility, where an order, modification or cancellation is electronically submitted for processing on, or subject to the rules of, a DCM.

Pre-Trade Risk Controls

As initially proposed, Regulation AT would have required the implementation of pre-trade risk controls at three stages in the life cycle of a trade: the AT Person, the FCM and the DCM. The Supplement, however, would require such controls at two levels only: (1) either at the AT Person or the FCM and (2) at the DCM. The types of pre-trade risk controls that would be required generally remain unchanged from those originally proposed.

Under the revised framework for pre-trade risk controls:

- An AT Person would be required to either (i) implement pre-trade risk controls for any Electronic Trading Order Messages[7] (including any AT Order Messages[8]) originated by such AT Person or (ii) delegate responsibility for implementing such pre-trade risk controls to the AT Person's executing FCM.[9]

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[5] Algorithmic Trading generally would not include any order, modification or cancellation, every parameter or attribute of which 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.

[6] Regulation AT would not require non-AT Persons that originate Electronic Trading Order Messages to implement pre-trade risk controls or comply with any of the other provisions of Regulation AT.

[7] "Electronic Trading Order Message" is defined as "each new order submitted by Electronic Trading and each modification or cancellation submitted by Electronic Trading with respect to such an order."

[8] "AT Order Message" is considered a subset of Electronic Trading Order Message and is defined as "each new order submitted through Algorithmic Trading by an AT Person and each modification or cancellation submitted through Algorithmic Trading by an AT Person with respect to such an order."

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- An executing FCM, in addition to implementing any pre-trade risk controls pursuant to a delegation from an AT Person, would be required to implement pre-trade risk controls in respect of all Electronic Trading Order Messages (including any AT Order Messages) that do not originate with an AT Person.

- A DCM would be required to implement its own pre-trade risk controls for all Electronic Trading Order Messages (including any AT Order Messages) and, if the DCM permits DEA, enable an executing FCM to apply such pre-trade risk controls to Electronic Trading Order Messages submitted to the trading platform through DEA. For orders not submitted through DEA, the DCM would have to require the executing FCM to use either (i) the DCM's systems and controls or (ii) "substantially equivalent" systems and controls that are developed either by the FCM or a third party provider.

Source Code Access

Perhaps most controversially, the initial proposal for Regulation AT would have required all AT Persons to retain all source code in accordance with CFTC Rule 1.31, which provides that all books and records must be open to inspection by any CFTC or Department of Justice representative.[10] The Supplement changes the originally proposed source code requirement in the following ways:

- The Supplement introduces the defined term "Algorithmic Trading Source Code," which is generally defined as computer commands written in a computer programming language that is readable by natural persons.

- The Supplement eliminates the requirement in the original proposal that AT Persons maintain a "source code repository," and would instead require AT Persons to maintain the following records for five years:

    o   any Algorithmic Trading Source Code used by the AT Person;

    o   any records generated by the AT Person in the ordinary course of business tracking material changes to such AT Person's Algorithmic Trading Source Code; and

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[9]   The AT Person would not be permitted to delegate its responsibilities in respect of pre-trade risk controls to an executing FCM unless (i) it is technologically feasible for the executing FCM to effectively implement pre-trade risk controls in respect of such order messages and (ii) the executing FCM accepts the delegation in writing. An AT Person that has delegated responsibility for implementing pre-trade risk controls to an executing FCM would be required to periodically review such FCM's compliance with the pre-trade risk control provisions of Regulation AT on behalf of such AT Person.

[10]   The CFTC Commissioners voted 2-1 to approve the Supplement, with Commissioner J. Christopher Giancarlo dissenting. In his statement of dissent, Commissioner Giancarlo expressed his concerns that the Supplement does not sufficiently protect the due process rights of the owners of source code, as the Supplement preserves the CFTC's ability to examine source code without first having to obtain a subpoena in all cases, and lacks adequate safeguards for protecting the confidentiality of source code.

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    o   any logs or log files generated by the AT Person in the ordinary course of business that record the activity of such AT Person's Algorithmic Trading system.

- The Supplement proposes that the staff be permitted to access such records only pursuant to either (i) a validly issued subpoena or (ii) a special call, in each case only after approval by the CFTC Commissioners.

The Supplement does not set forth any specific protections that would be afforded to source code records obtained by the CFTC.[11] Rather, the Supplement notes that, in executing a special call, the AT Person could communicate with the Division of Market Oversight to establish certain procedures to govern such access, including specifying the means by which the staff will access the source code (e.g., through an on-site inspection) or requiring that records be provided to the CFTC on secure storage media or on computers that lack network connectivity.

Third Party Systems

Regulation AT would require AT Persons to establish certain parameters around the development of Algorithmic Trading systems and regularly test such Algorithmic Trading systems and related source code prior to implementation to identify circumstances that may contribute to an Algorithmic Trading Event.[12] The Supplement addresses circumstances in which an AT Person obtains an Algorithmic Trading system or components thereof from a third-party provider.

The Supplement would permit certain AT Persons that utilize a third-party provider's systems or components to comply with the provisions in respect of the development and testing of Algorithmic Trading systems by:

- obtaining a certification from such third-party provider that the relevant system or component meets applicable regulatory requirements; and

- conducting due diligence regarding the accuracy of the certification.

The AT Person would not be able to wholly rely on a certification in certain circumstances, such as where the AT Person uses a combination of third-party components and components developed in-house. Further, with respect to the maintenance and production of Algorithmic Trading Source Code and related records, the AT Person would be responsible in all cases for ensuring that the maintenance and production requirements of Regulation AT are met.

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[11]   Regulation AT would expressly stipulate that any records required to be maintained under Regulation AT's new recordkeeping rule would be subject to Section 8(a) of the Commodity Exchange Act when produced to the staff under such rule. Section 8(a) generally provides for the confidential treatment of certain information, including trade secrets, obtained by the CFTC in the course of market surveillance.

[12]   "Algorithmic Trading Event" is defined as either an Algorithmic Trading Disruption or an Algorithmic Trading Compliance Issue. As discussed further below and in the Supplement, the CFTC is considering whether to narrow the scope of its currently proposed definitions of "Algorithmic Trading Disruption," "Algorithmic Trading Compliance Issue" and "Algorithmic Trading Event."

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Additional Aspects of the Supplement

The Supplement would eliminate certain other requirements that were initially proposed. For example, as initially proposed, Regulation AT would have required (i) an AT Person to test its Algorithmic Trading systems on each DCM on which the AT Person's Algorithmic Trading would occur and (ii) each DCM to provide a test environment to enable AT Persons to simulate production trading. The Supplement would eliminate these requirements while retaining the requirement that AT Persons conduct certain internal testing of their Algorithmic Trading systems.

The Supplement would also effect certain other changes and technical modifications, including:[13]

- *Direct Electronic Access.* The Supplement revises the proposed definition of "Direct Electronic Access" to "the electronic transmission of an order for processing on or subject to the rules of a contract market, including the electronic transmission of any modification of such order." Direct Electronic Access would exclude any order, modification or cancellation electronically transmitted to a DCM by an FCM that such FCM received from an unaffiliated natural person through oral or written communications (i.e., where the FCM acts in a "true intermediating role").

- *Violation of Internal Policies.* Regulation AT would require AT Persons to implement pre-trade risk controls reasonably designed to prevent and reduce the potential risk of, among other things, any Algorithmic Trading Compliance Issue. The Supplement states that the CFTC is considering whether it should change the proposed definition of "Algorithmic Trading Compliance Issue" to exclude any reference to the failure of an AT Person's Algorithmic Trading to operate in a manner that complies with such AT Person's internal rules or those of its clearing member, any DCM on which it trades or a registered futures association (i.e., National Futures Association). If the CFTC adopts this change, the scope of the term "Algorithmic Trading Compliance Issue" would be limited only to violations of applicable law.[14]

- *DCM Annual Compliance Reports.* As initially proposed, Regulation AT would have required an AT Person and any of its clearing member FCMs to submit to any DCM on which they operated an annual report describing their compliance with certain provisions. Regulation AT would have further required a DCM to implement a program for the effective review and evaluation of such reports. The Supplement would eliminate such requirements. Instead, a DCM would be required to establish a program for the effective periodic review of AT Person and FCM compliance with the pre-trade risk control and order cancellation provisions and, in the case of AT Persons only,

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[13]   We note that not all of the changes to Regulation AT as originally proposed are discussed herein.

[14]   The Supplement states that the CFTC is considering related changes to its definitions of "Algorithmic Trading Event" and "Algorithmic Trading Disruption" that, generally speaking, would eliminate references to the disruption of an AT Person's own ability to trade and limit the scope of those terms only to violations of applicable law or disruptions of the market and the ability of others to trade on such market.

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compliance with the development and testing provisions of Regulation AT. Each AT Person and executing FCM would also be required to:

- o provide an annual certification to the DCM of its compliance with the pre-trade risk control and order cancellation provisions of Regulation AT and the development and testing provisions, as applicable;

- o comply with any periodic reporting requirements established by the DCM to assist it in fulfilling its obligation to review and evaluate AT Person and FCM compliance with Regulation AT; and

- o maintain, and make available to the DCM upon request, books and records relating to its compliance with the pre-trade risk control and order cancellation provisions of Regulation AT and the development and testing provisions, as applicable.

If you have any questions regarding this memorandum, please contact Rita M. Molesworth (212-728-8727, rmolesworth@willkie.com), Deborah A. Tuchman (212-728-8491, dtuchman@willkie.com), James E. Lippert (212-728-8945, jlippert@willkie.com), Michael A. DeNiro (212-728-8147, mdeniro@willkie.com) or the Willkie attorney with whom you regularly work.

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