CLIENT MEMORANDUM

CFTC Proposes Rules Governing Automated Trading

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AUTHORS

Rita M. Molesworth | Deborah A. Tuchman | James E. Lippert

The Commodity Futures Trading Commission has proposed broad new regulations governing automated and algorithmic trading.[1] The proposed regulations focus on automation of order origination, transmission and execution, and the risks that may arise from that activity. As proposed, Regulation AT would require, among other things, the implementation of pre-trade risk controls at multiple stages along the life-cycle of a trade. Regulation AT would apply to current CFTC registrants that engage in algorithmic trading and potentially also require some currently unregistered entities to register with the CFTC as floor traders if they have direct electronic access to a designated contract market ("DCM"). Regulation AT would also require the National Futures Association ("NFA") to consider adopting additional membership rules relevant to algorithmic trading. Comments on the proposed rule are due by March 16, 2016.

Key Definitions

Regulation AT would add or amend certain definitions to CFTC regulations, most notably:

- "Algorithmic Trading" would generally be defined as trading in any commodity interest on or subject to the rules of a DCM, where (i) one or more computer algorithms or systems determine whether to initiate, modify or cancel an

1 Regulation Automated Trading, 80 Fed. Reg. 78824 (Dec. 17, 2015) ("Regulation AT").

order, or make certain other determinations with respect to an order, and (ii) such order, modification or order cancellation is electronically submitted for processing on or subject to the rules of a DCM.

Algorithmic Trading generally would not include any order, modification or order 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.

- "AT Person" would generally be defined as any person registered or required to be registered with the CFTC as (i) a futures commission merchant ("FCM"), floor broker, swap dealer, major swap participant, commodity pool operator ("CPO"), commodity trading advisor ("CTA") or introducing broker that engages in Algorithmic Trading or (ii) a floor trader, as defined below.

  One of the 164 questions posed by the CFTC in the proposal was whether, in the event a CPO uses Algorithmic Trading to enter orders on behalf of a commodity pool, the CFTC should consider the pool, rather than the CPO, to be engaged in Algorithmic Trading pursuant to its definition of AT Person. Notably, to date, the CFTC has not imposed registration or other obligations on commodity pools themselves. Moreover, the Commodity Exchange Act (the "CEA") does not contemplate commodity pools as a registration category. However, if the CFTC treated the pool, rather than (or in addition to) the CPO (or CTA) of the pool, as engaged in Algorithmic Trading, the pool would potentially have to register as a floor trader if the Algorithmic Trading activities on behalf of such pool otherwise satisfied the criteria of the amended definition of floor trader.

- The definition of "Floor Trader" would generally be amended to include any person who (i) purchases or sells solely for its own account certain commodity interests on a DCM, (ii) uses Direct Electronic Access, in whole or in part, to access the DCM for the purpose of trading and (iii) is not registered with the CFTC as an FCM, floor broker, swap dealer, major swap participant, CPO, CTA or introducing broker.

- "Direct Electronic Access" would generally be defined 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." The CFTC noted that the manner in which an order is routed is "the operative element" of Direct Electronic Access. The CFTC further commented that other factors such as co-location or the use of FCM-provided software "are not on their own determinative of whether a customer is submitting orders through [Direct Electronic Access]."

- "Algorithmic Trading Event" would generally be defined as any event at an AT Person that constitutes either (i) an Algorithmic Trading Compliance Issue or (ii) an Algorithmic Trading Disruption.
  - An "Algorithmic Trading Compliance Issue" would generally be defined as any event that has caused any Algorithmic Trading of an AT Person to operate in a manner that does not comply with (a) the CEA or any

rule promulgated thereunder, (b) any NFA rule,[2] (c) any rule of any DCM on which the AT Person engages in Algorithmic Trading or (d) the policies and procedures of any AT Person or its clearing member(s).

- An "Algorithmic Trading Disruption" would generally be defined as any event that disrupts or materially degrades (a) the Algorithmic Trading of the AT Person, (b) the operation of the DCM on which such AT Person is trading or (c) the ability of other market participants to trade on that DCM. The CFTC interprets the third prong of this definition broadly.

Key Elements of Regulation AT for AT Persons

Regulation AT would generally require an AT Person to (i) implement pre-trade risk controls, (ii) develop, test and monitor Algorithmic Trading systems according to established procedures and (iii) submit annual compliance reports and other materials to DCMs. An AT Person would also have to provide prior notice to each clearing member FCM through which, and DCM on which, it plans to engage in Algorithmic Trading of its intent to engage in such activity.

<u>Pre-Trade and other Risk Controls</u>

Regulation AT would generally require an AT Person to implement pre-trade risk controls, order cancellation systems and other measures "reasonably designed to prevent an Algorithmic Trading Event," regardless of the volume of such AT Person's Algorithmic Trading. At a minimum, an AT Person would have to implement:

- maximum AT Order Message[3] frequency and execution frequency per unit time (so-called "throttles");
- order price parameters (so-called "price collars") and maximum order size limits; and
- order cancellation systems with the capability to, among other things, immediately disengage any Algorithmic Trading and prevent submission of new AT Order Messages.[4]

An AT Person would also have to communicate to the DCM on which it plans to conduct Algorithmic Trading whether its resting orders should be cancelled or suspended in the event that such AT Person's Algorithmic Trading system becomes disconnected from the trading platform. In addition, it would have to ensure that a natural person is promptly alerted when

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2 All AT Persons would have to become members of NFA.

3 Regulation AT defines "AT Order Message" as "each new order or quote submitted through Algorithmic Trading to a [DCM] by an AT Person and each change or deletion submitted through Algorithmic Trading by an AT Person with respect to such an order or quote."

4 An AT Person with Direct Electronic Access would also have to implement systems to ensure, on an ongoing basis, proper connectivity with a trading platform.

risk control parameters are breached. Finally, an AT Person would have to periodically review its risk controls to determine whether they effectively mitigate the risk of an Algorithmic Trading Event and remedy any deficiencies.

Development, Testing, Monitoring and Compliance of Algorithmic Trading Systems

Regulation AT would also generally require an AT Person to implement written policies and procedures for the development, testing, monitoring and compliance of its Algorithmic Trading systems. The CFTC intends that Regulation AT's development, testing and monitoring rules be consistent with related initiatives of other regulators and with industry best practices.

***Development and Testing*:** An AT Person would have to implement written policies and procedures for the development and testing of its Algorithmic Trading systems that provide for, among other things:

- maintaining a development environment that is adequately isolated from the production trading environment;
- testing of all Algorithmic Trading code and related systems (and any changes thereto) prior to their implementation, including testing to identify circumstances that may contribute to an Algorithmic Trading Event;
- regular back-testing of Algorithmic Trading using historical transaction, order and message data to identify circumstances that may contribute to an Algorithmic Trading Event; and
- regular stress-testing of Algorithmic Trading systems to verify their ability to operate in the manner intended under a variety of market conditions.

***Source Code Repository*:** Notably, an AT Person would generally have to maintain a source code repository to manage source code access and copies of all code used in the production environment (and any changes to such code). Perhaps most controversially, the AT Person would have to maintain the source code in accordance with CFTC Rule 1.31. Rule 1.31 provides, among other things, that all required books and records must be open to inspection by any CFTC or Department of Justice representative.

***Monitoring*:** An AT Person would have to implement written policies and procedures designed to ensure continuous real-time monitoring of its Algorithmic Trading systems by knowledgeable and qualified staff.[5] Such policies and procedures would generally have to provide for, among other things, automated alerts whenever an Algorithmic Trading system's AT Order Message behavior breaches design parameters or upon loss of network connectivity or data feeds and the ability and authority of monitoring staff to quickly disengage an Algorithmic Trading system and cancel resting orders, where appropriate.

5 The CFTC believes that staff responsible for monitoring Algorithmic Trading should not simultaneously be engaged in trading.

***Compliance*:** An AT Person would generally have to adopt written policies and procedures reasonably designed to ensure that its Algorithmic Trading system operates in compliance with the CEA and the rules promulgated thereunder. Accordingly, an AT Person would have to ensure that competent staff review Algorithmic Trading systems in order to detect potential Algorithmic Trading Compliance Issues. An AT Person would also have to implement a plan of internal coordination between compliance staff and staff responsible for Algorithmic Trading and establish and follow procedures for designating and training of all staff involved in designing, testing and monitoring Algorithmic Trading systems.

Annual Report and Recordkeeping Requirement

An AT Person would have to submit an annual report to each DCM on which it engages in Algorithmic Trading, as well as copies of certain written policies and procedures. Each annual report would have to include a description of pre-trade risk controls implemented by the AT Person and a certification made by the chief executive officer or chief compliance officer of the AT Person. Additionally, an AT Person would have to keep, and provide to a DCM upon request, certain books and records regarding its compliance with Regulation AT.

Key Elements of Regulation AT for Clearing Member FCMs

Regulation AT would generally require a clearing member FCM to (i) implement risk controls for Algorithmic Trading orders originating with AT Persons and (ii) submit annual compliance reports.

Pre-Trade and other Risk Controls

A clearing member FCM would generally have to implement pre-trade risk controls “reasonably designed to prevent an Algorithmic Trading Disruption” caused by an AT Order Message originating with an AT Person. Such controls would have to include, at a minimum, the same types of pre-trade risk controls that must be implemented by AT Persons and would be calibrated generally at the level of each AT Person. The location of the pre-trade risk controls would generally depend on whether an AT Order Message of an AT Person is placed through Direct Electronic Access or intermediated by its clearing member FCM:

- If the AT Person uses Direct Electronic Access, the FCM would have to calibrate and control pre-trade risk controls located at, and established and provided by, the DCM.

- If the AT Person is routing its AT Order Message through the FCM, the FCM would have to establish, calibrate and control its own pre-trade risk controls and other measures.

Further, a clearing member FCM would generally have to make use of order cancellation systems and implement policies and procedures reasonably designed to ensure that a natural person is promptly alerted when a risk control parameter is breached.

Annual Report and Recordkeeping Requirement

A clearing member FCM of an AT Person would have to submit an annual report to each DCM on which such AT Person engages in Algorithmic Trading. Each annual report would have to include a description of pre-trade risk controls implemented by the FCM and a certification made by the chief executive officer or chief compliance officer of the FCM. In addition, a clearing member FCM would have to keep and provide to a DCM upon request certain books and records regarding its compliance with Regulation AT.

Key Elements of Regulation AT for DCMs

Regulation AT would generally require a DCM to (i) implement pre-trade risk controls and other measures for all orders, including orders not originating from Algorithmic Trading, (ii) collect and analyze the annual reports and books and records submitted by each AT Person and clearing member FCM and (iii) provide test environments where AT Persons may test Algorithmic Trading systems.

Pre-Trade and other Risk Controls

A DCM would generally have to establish, at a minimum, the same pre-trade risk controls and order cancellation systems that would be separately implemented by AT Persons and clearing FCMs. However, a DCM would also have to implement pre-trade risk controls for manually entered orders and establish order cancellation systems with cancel-on-disconnect functionality.

Further, a DCM that permits Direct Electronic Access would be required to have in place systems and controls designed to facilitate a clearing member FCM's management of the risks that may arise from Algorithmic Trading by an AT Person customer using Direct Electronic Access. Each such DCM would have to require an FCM to use such controls with respect to any AT Order Message originating with an AT Person that is submitted through Direct Electronic Access. Such controls would be similar to those implemented by AT Persons.

Annual Report and Recordkeeping Requirement

A DCM would generally have to require each AT Person that trades on the DCM and each FCM that is a clearing member for such AT Person to submit an annual report. In addition, a DCM would have to establish a program for the effective review of such reports and remediation of any deficiencies found. A DCM would also be required to implement rules that require each AT Person and clearing member FCM to keep and provide to the DCM certain books and records regarding its compliance with Regulation AT. Additionally, a DCM would be required to review and evaluate, as necessary, such books and records.

Test Environments

A DCM would generally have to provide a test environment that will enable an AT Person to simulate production trading. The test environment would have to (i) provide access to historical transaction, order and message data and (ii) enable an AT Person to conduct conformance testing of its Algorithmic Trading systems to verify compliance with the pre-trade and other risk controls and the testing and compliance requirements of Regulation AT.

Market Transparency

Regulation AT includes new rules designed to increase transparency and, according to the CFTC, foster competition among trading venues by "incentivizing them to provide the most efficient and fairest venue for trading." These proposed rules relate to self-trading, electronic trade matching systems and market maker and trading incentive programs.

Self-Trade Prevention Tools

A DCM would generally be required to implement rules designed to prevent self-trading[6] by market participants. Moreover, a DCM would generally be required to either apply or provide and require the use of self-trade prevention tools reasonably designed to prevent self-trading. The DCM would have to apply these self-trade prevention tools to all orders on its electronic trade matching platform. Nevertheless, a DCM may, in its discretion, implement rules that permit a self-trade resulting from the matching of orders for accounts with common beneficial ownership where such orders are initiated by independent decision makers. Additionally, a DCM would generally be required to publish quarterly on its website certain statistics concerning self-trades.

Electronic Trade Matching Systems

A DCM currently has to disclose generally to the CFTC, market participants and the public accurate information about rules and specifications related to the operation of any electronic matching platform or trade execution facility. Regulation AT would clarify that such disclosure would include, but not be limited to, any such rule or specification that materially affects "the time, priority, price, or quantity of execution, or the ability to cancel, modify, or limit [the] display of market participant orders." Regulation AT would also require a DCM to disclose any known attribute of an electronic matching platform (in addition to those otherwise disclosed in any rule or specification) that materially affects "the time, priority, price, or quantity of execution of market participant orders, [or] the ability to cancel, modify, or limit [the] display of market participant orders." Further, Regulation AT would require a DCM to disclose any such attribute that materially affects "the dissemination of real-time market data to market participants, including but not limited to latencies or other variability in the electronic matching platform and the transmission of message acknowledgements, order confirmations, or trade confirmations, or dissemination of market data."

[6] Self-trading would be defined to mean the matching of orders for accounts that have common beneficial ownership or are under common control.

Market Maker and Trading Incentive Programs

A DCM may currently implement new rules or rule amendments by filing with the CFTC a certification that the rule or rule amendment complies with the CEA and the rules promulgated thereunder and/or by requesting approval from the CFTC. Regulation AT would require a DCM to provide additional information in such public filings regarding its market maker and trading incentive programs. Such information would include, among other things, a description of such programs' eligibility criteria and payments or other benefits. Further, Regulation AT would restrict certain types of payments by a DCM in connection with such programs and require a DCM to surveil such programs for abusive practices.

National Futures Association and Regulation AT

In 2002, NFA published Interpretive Notice 9046 requiring NFA members to diligently supervise the use of automated order routing systems. Regulation AT would call for NFA to implement a program that addresses the risks of Algorithmic Trading for each category of its members. The CFTC notes, however, that "the determination as to both the necessity of rules and their application to specific categories of members remains with [NFA]."

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) or the Willkie attorney with whom you regularly work.

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