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The CFTC's Proposal to Regulate Automated Trading: Our Top 10 Takeaways

The Commodity Futures Trading Commission ("CFTC") has proposed a new rule—so-called Regulation AT—to regulate the use of automated, or algorithmic, trading systems that trade commodity interests (e.g., futures and swaps). The CFTC's proposal comes at the end of a year that saw a noticeable increase of enforcement actions arising from disruptive trading practices, including spoofing and market manipulation, and which included the first criminal conviction for spoofing in *U.S. v. Michael Coscia*.

In this Client Alert, we highlight the most significant aspects of Regulation AT.

1. **A New Registration Mandate.** Under Reg. AT, registration will be required for market participants that (i) engage in proprietary algorithmic trading, (ii) have "direct electronic access" to a designated contract market (*i.e.,* an exchange) (an "Exchange"), and (iii) that are not already registered. Individuals who are considered "AT Persons" and not currently registered with the CFTC will be required to register as floor traders. Thus, for numerous prop shops and hedge funds that have not been required to register in any capacity—or have relied upon an exemption from registration—the requirement to register looks likely to follow. That begin said, important exceptions exist.

2. **Broad Definitions of "Algorithmic Trading" and "AT Person."** The CFTC has proposed definitions that would sweep in a large number of market participants. For example, **"**Algorithmic Trading" is defined as the trading in any commodity interest where: (i) one or more computer algorithms or systems determines whether to initiate, modify, or cancel or an order, or otherwise makes determinations with respect an order, including various aspects such as timing, place and sequence, and (ii) such order is electronically submitted for processing on, or subject to the rules of, an Exchange.

    However, Algorithmic Trading does not include an order, modification or cancellation whose every parameter or attribute is manually entered into a front-end system by an individual, with no further discretion by a computer system or algorithm, prior to its electronic submission for processing on, or subject to the rules of, an Exchange.

    Importantly, moreover, an "AT Person" is defined as any person registered or required to be registered 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 on, or subject to the rules of, an Exchange. The term "high frequency trading" is not defined or otherwise used in Reg. AT. Ultimately, these broad definitions portend to encapsulate a large number of market participants.

3. **Source Code Access**. Critically, Reg. AT requires market participants to maintain a source code repository to "manage source code access, persistence, copies of all code used in the production environment, and changes to such code." Market participants would be required to make the source code repository available to the CFTC for inspection. This recordkeeping requirement would fall under Rule 1.31, allowing the CFTC access to this information in the traditional course of examinations and oversight and without requiring the issuance of a subpoena.

   In addition to the CFTC, other regulators would have access to the source code, including criminal authorities. Reg. AT thus could have significant implications in the context of a civil or criminal investigation. Moreover, the provision of source code raises questions as to whether the CFTC can adequately protect the confidentiality of the source code. Placing the "crown jewels" in the hands of a third-party is never without some risk.

4. **(More) Risk Management**. Each AT Person would be required to meet new standards for managing the risks of Algorithmic Trading and the testing and monitoring of an Algorithmic Trading System ("ATS"). Clearing firms will also be required to implement risk controls for orders generated by an ATS. According to CFTC staff, these rules would require clearing firms to implement risk controls for algorithmic trades originating from anyone that falls under the AT Person definition.

5. **(More) Compliance Reports.** AT Persons and clearing FCMs would be required to submit annual compliance reports to Exchanges describing their risk management programs for establishing and maintaining the required pre-trade risk controls and keep books and records regarding their controls. AT Persons would also be required to submit to Exchanges written policies and procedures demonstrating compliance with testing and other requirements. Annual compliance reports of clearing FCMs would also include (i) a description of the FCM's program implementing its pre-trade risk controls and (ii) a certification by its chief executive officer or chief compliance officer certifying that the information contained in the annual compliance report is accurate and correct.

6. **Increased Exchange Transparency.** Reg. AT seeks to increase market transparency by requiring Exchanges to disclose any attributes regarding their trade matching systems that materially impact market orders so that market participants have better visibility into how their orders are executed.

7. **Self-trade Prevention.** Exchanges would be required to establish self-trade prevention tools and either apply such tools or require them to be used by participants in their markets. Exchanges would be allowed to permit some self-trades when initiated by independent decision makers and would be required to publish quarterly statistics on approved self trades.

8. **Test Environments.** Exchanges must provide test environments, which would allow an AT Persons to test ATSs and ensure that the AT Person can comply with risk controls, order cancellation systems and development and testing requirements..

9. **Market Maker and Trading Incentive Programs.** Exchanges must provide certain disclosures regarding their exchange market maker and trading incentive programs, and implement other controls. Such programs must be submitted as "Rule" filings pursuant to CFTC Rule 40.5 or 40.6.

10. **Increased NFA Role.** The National Futures Association ("NFA") would be required to adopt rules relevant to Algorithmic Trading and apply these to any AT Persons. Additionally, to ensure AT Persons are covered by the NFA rules, those that are not currently required to be members, such as floor traders, would need to become members of NFA.