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March 15, 2016

Mr. Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Proposed Rulemaking on Regulation Automated Trading (“Regulation AT”, RIN 3038–AD52)

Dear Mr. Kirkpatrick,

We take this opportunity to share our views regarding the proposed rulemaking on Regulation AT. LCHF Capital Management, Inc. is an investment adviser based in New York, NY. We employ extensive quantitative research and investment in technology to generate superior returns for our investors. We have a focus on Quantitative Global Macro, and trade futures on different global exchanges in order to execute our strategies.

Overview

We agree with the overall purpose of the proposed regulation, i.e. to create a more reliable market by limiting the possibility of disruptive events through the application of risk control requirements imposed on different types of market participants. There are however some aspects of the rule, like the source code repository requirement or the registration of all algorithmic market participants regardless of their potential impact on the market, which in our opinion need modification or elimination from the current set of proposed rules. We provide our specific views on particular aspects of the rule in the following subsections.

Definitions

We think that the definition of “Algorithmic Trading” and “AT Persons” should be revised to include companies or individuals based on their potential to impact the market, regardless of the means used to actually transmit their orders, whether manual or automatic. For this reason, we propose to expand the term “Algorithmic Trading” to include execution algorithms used by large institutional investors, even if

the orders are entered in every aspect by an individual, and the term “AT Persons” to include only organizations or individuals with the potential to cause a major disruptive event, measured for example by the amount of trading over a certain period of time or size of AUM above a given threshold. Following this proposal, the regulation will on one hand target the organizations and individuals with the greatest potential of impacting the markets, and on the other hand limit the regulatory burden on small companies, which are already at disadvantage compared in terms of financial and human resources compared to existing larger competitors.

We also want to point out that major disruptive events can be caused both by badly designed or poorly tested algorithms, and by human errors. Examples are “fat finger” errors or improper usage and lack of understanding of the impact of an execution algorithm on the instrument traded. A specific case is given by the May 2010 Flash Crash, caused in part according to the CFTC report by the improper usage of an execution algorithm by an individual, without thorough understanding of the possible adverse consequences of the algorithms in that specific market condition. For this reason, we think that the regulation should also target individual persons that manually transmit their orders to the markets.

Regarding Direct Electronic Access, we think it’s a useful to impose additional risk filters on entities using such connectivity method, since they don’t usually have risk controls imposed by brokers or other connectivity providers that other participants that don’t use such connection technology have.

Registration with the Commission

In accordance with our views expressed in the preceding section, we believe that the commission should require an entity or an individual to register with the commission based on some metrics related to its potential to cause a material impact on the market, such as volume traded or number of messages generated per unit of time. In this way, it would not create excessive burden for small entities, even if they use algorithms to generate their orders.

Pre-Trade and Other Risk Controls

We agree with the Commission to adopt a principle-based approach in applying such risk controls, since it would be too difficult to consider each individual case under a prescriptive case. We also think that the proposed controls capture the majority of the best practices already in use in the industry. Regarding the possibility of treating order cancellations differently from other orders, in order to reduce the market exposure of a trading participant, we think that it would be very difficult to distinguish between valid and invalid orders when a trading system by a DCM when the trading system of a participant stops working properly. For this reason, we propose to not differentiate between normal and risk-reducing orders, but to only disconnect a participant from the market after some risk levels are broken, possibly in conjunction with visual inspection by a monitoring officer at the exchange.

We also think that the commission should evaluate carefully the introduction of multiple risk filters across different market entities, like trading participant, FCM, and DCM. In fact, while this approach reduces the probability that a wrong message reaches the market by introducing redundancy through multiple controls, it also increases complexity and possible errors if the risk parameters among the multiple participants are not coordinated properly. We therefore propose to implement the following structure in the adoption in risk controls:

- Trading participant: all the risk controls proposed by the commissions, which should be adopted at the most granular level and tailored to the particular trading technology used by the market participant
- FCM / Broker: order size, position, and margin controls
- DCM: continue the adoption of the existing controls, like kill switch or self-trade prevention, with no further risk filter imposed on individual market participants, which could impose in our views coordination problems in case of technological changes, and significant market delays in case of exceptional peak rate events, due to the additional computational burden on the exchange servers

Standards for Development, Testing, Monitoring, and Compliance of ATS

While we agree that each regulated participants should have in place adequate procedures for developing, testing, and deploying into production their trading systems, as it is current practice in the majority of the trading participants, we strongly disagree with the requirement set forth to make available a source code repository. As other commenters have already pointed out, the source code of a quantitative trading company contains trade secrets obtained with years of research and countless man hours of work, and it is one of the most important competitive advantages of a participant over another. It is highly possible that this repository can be the target of attacks by malicious organizations, both trading competitors inside the US and international organizations abroad seeking to obtain illicit rewards through the misappropriation of trade secrets. Because of the potential risk to both the market participants and the US economy as a whole, we firmly believe that the commission should disregard the source code repository requirement, leaving to each market participant the decision and control on how to best secure and document changes to its source code.

We also think that establishing and documenting an appropriate training program is an important aspect to avoid possible market disruption events, since it would reduce the possibility of erroneous orders sent to the exchanges and increase the awareness for final users of internal and third-party systems of the impact on the markets of the adopted technology.

Compliance Reports Submitted to DCM

We believe that the submission of compliance report to DCMs should be imposed only on large market participants to avoid additional compliance costs for small players, thereby hindering competition in the marketplace. Also, in order to avoid undue burden on the DCMs, we also think that they should not be required to review the submitted compliance documents on a periodic basis, but only in particular circumstances, such as an open investigation or a complaint filed on a market participant.

Disclosure and Transparency in DCM Trade Matching Systems

We advocate for the implementation of disclosure on exchange matching systems. Until now there is not much publicly available data on DCMs performances in terms of latencies. We believe that this information should be included in a report publicly available on each DCM website, and it should contain the distribution of latencies, accompanied by some summary statistics, like the mean, median, standard deviation, and some percentiles (e.g. 1% and 99%), in order to evaluate the system in extreme situations. This will increase the confidence in the marketplace, since participants can analyze more accurately the factors affecting the latencies incurred when entering an order in the exchange.

Self-trade Prevention Tools

We support the adoption of self-trade prevention tools by exchanges, and optionally by trading participants. We think that it would be an undue inconvenience for some entities, like large proprietary trading firms using multiple strategies on different trading desks within the same organization, to implement such risk controls at the company level. We also think that, in order to prevent wash sales or deceiving trading activity, an exchange should require its participants to submit orders using an ID at the most granular level, usually the trading strategy. In this case, the DCM can differentiate between legitimate trades between different trading groups within the same company, or misleading orders originating from the same trading strategy. We also support the publication of statistics by the exchange regarding the amount of self-trading, categorized by trading product and over time.

Market Maker and Trading Incentive Programs

In order to increase transparency and confidence in the market, we agree with the requirement to make available to the public any program the exchange may have available for market makers and other liquidity providers. We also think it would be helpful to know the percentage of the total volume traded under this program and a list of liquidity providers for the different products offered by an exchange, in order to analyze the potential liquidity available in a contract before making a trading decision.

Conclusion

In conclusion, we believe that many aspects of the proposed regulation will provide an opportunity to formalize existing risk practices already in use by the existing market participants, and make sure that new entrants adopt sound trading principles in order to avoid market disruptive events. However, there are some aspects, like the source code repository requirement or the registration of all market participants independent of size, which in our opinion should be revised or completely abandoned, in order to make sure that the proposed regulation achieves its objective of making the marketplace a safer and more robust environment for its participants.

Sincerely,

/s/ Andrea Leccese

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CEO and Portfolio Manager
LCHF Capital Management, Inc.