March 16, 2016

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

VIA ONLINE SUBMISSION

Re: Regulation Automated Trading, Notice of Proposed Rulemaking, RIN 308-AD52

Dear Secretary Kirkpatrick:

The Minneapolis Grain Exchange, Inc. ("MGEX" or "Exchange") would like to thank the Commodity Futures Trading Commission ("CFTC" or "Commission") for this opportunity to respond to the Commission's request for comment on the above referenced matter published in the December 17, 2015 Federal Register Vol. 80, No. 2015 (the "Rulemaking").

Introduction

MGEX is both a Designated Contract Market ("DCM") and Derivatives Clearing Organization. As such, MGEX has a vested interest to ensure that its contract market remains robust, transparent, and fair. MGEX recognizes that electronic trading has been transformative and that market participants are increasingly relying on new tools, technology, and software for all aspects of their enterprise, including entering orders. Notably, within the electronic trading universe is the world of automated trading. This is a large, complicated and evolving expanse. MGEX applauds the Commission for shining a light on electronic and automated trading and pre-trade risk controls, and supports common-sense rules to mitigate the disruptive market risks that electronic and automated trading presents. MGEX and other DCMs have been both proactive and responsive to the use of such trading, in part by developing, implementing, offering and even requiring the use of pre-trade controls. DCMs anticipate that development of further enhancements and adjustments will undoubtedly occur as technological capabilities evolve.

After reviewing this Rulemaking, MGEX makes the following comments:

1. **Scope of this Rulemaking**: MGEX urges the Commission to segregate this Rulemaking into natural divisions and order. For example, pre-trade risk controls is a logical first step and can be more quickly implemented. The other subjects covered by this Rulemaking could and should be addressed separately at a later time. MGEX agrees with the Commission that additional rules are likely warranted

in light of developments in electronic trading. MGEX believes that the most pressing issue concerning electronic trading is the risk of market disruption that is posed by certain types of electronic trading, in particular automated trading. Pre-trade risk controls are the best way to mitigate and prevent such risk. It is therefore paramount that the Commission arrive at sensible, workable rules about pre-trade risk controls. To ensure that is accomplished, the Commission should focus first on rules about pre-trade risk controls, and save other subjects for subsequent discussion and rulemaking.

2. **Pre-Trade Risk Controls**: The Commission should streamline its approach on pre-trade risk controls and fully embrace a principles-based approach. MGEX recommends the following principle: any order that is submitted electronically must be subject to pre-trade risk controls, regardless of how the order accesses a matching engine. Under this approach, the Commission could avoid the need for its proposed defined terms, among other things. MGEX believes this would not only better achieve the Commission's stated objective, but would provide the public with enhanced clarity. Moreover, MGEX has some comments as to which entities should bear the burden to develop and implement pre-trade risk controls.

3. **Ancillary Contents/Collateral Material**: MGEX has concerns with other subjects of this Rulemaking – subjects that do not or only tangentially relate to the pre-trade risk controls and the goal of preventing or mitigating market disruption risk. Specifically, MGEX has comments on: (a) the role of a DCM; (b) compliance programs; (c) selftrading; (d) registration; (e) order cancellation systems; (f) matching engine; (g) test environments; (h) system heartbeats; (i) market maker programs; and (j) source code.

4. **Cost-Benefit Analysis**: MGEX believes that the Commission's estimates of the implementation and ongoing costs of the proposed regulations are inconclusive and conservative. In particular, the cost to each DCM's review of compliance programs as well as the Commission's finding on selftrading need further assessment. As detailed below, the Commission should reconsider some aspects of its cost estimates and cost-benefit analysis. The Commission should also take into consideration other indirect costs and unintended consequences, such as reduced competition and market participation, which may be caused by this Rulemaking.

MGEX thanks the Commission in advance for reviewing this comment letter. Specific components of the Rulemaking appropriately reflect changes in the industry regarding electronic and automated trading. MGEX, however, wants to have sensible and workable rules that effectively redress the risks and concerns that electronic and automated trading pose to derivatives markets. Due to the volume and complexity of this Rulemaking, MGEX expressly reserves the right to submit modifications or additions to this comment letter, provided it would be beneficial to the Commission.

1. Scope of this Rulemaking

The Commission should focus on getting pre-trade controls correct, and save other topics for subsequent rulemakings. MGEX shares many of the Commission's concerns regarding electronic trading, and understands the need to appropriately respond to numerous meaningful changes that have occurred within the industry by promulgating practical rules. The Commission has correctly identified that the evolution from pit to electronic trading has resulted in increased reliance on technology. As the Commission describes, "Modern DCMs and DCM market participants, in particular, are characterized by a wide array of algorithmic and electronic systems for the generation, transmission, management, and execution of orders …."[1] The Commission has described this as an "automated trading environment".[2] MGEX also shares the Commission's sentiments that the purpose of a DCM – providing risk mitigation and price discovery - remains the same, despite the advent of the automated trading environment. MGEX further supports the Commission's commitment to the safety and integrity of markets. MGEX, therefore, applauds the Commission's efforts to address risks posed by technological changes.

MGEX, however, is concerned that this Rulemaking is overly ambitious in scope. Initially, the Commission describes this Rulemaking as "a series of pre-trade risk controls and other measures intended to address the risks related to automated trading on DCMs".[3] It is therefore reasonable to view this Rulemaking's primary purpose as addressing the risks of the automated trading environment. The Commission, however, elaborates that "[a]s an overarching goal, the Commission [also] seeks to update Commission rules in response to the evolution from pit trading to electronic trading."[4]

In addition to pre-trade risk controls, the Commission proposes other rules that do not directly relate to the risks posed by the automated trading environment. The Commission proposes an expansion of the pool of persons who must be registered, requires a DCM to establish a new program to review compliance programs, and proposes additional rules on selftrading, among other things.[5] While these other subjects are not without some merit, they do not relate to the first fundamental goal of this Rulemaking. The Commission, by introducing numerous independent subjects in this single Rulemaking, is placing a heavy burden on DCMs and the public to understand it, not to mention the many efforts that would be needed to implement and then stay in compliance with all aspects of this Rulemaking.

MGEX has evaluated and assessed the electronic and automated trading environment in the context of market disruption or manipulation. MGEX believes that the Commission should reduce the initial scope of this Rulemaking to address only pre-trade risk controls. MGEX believes that tackling pre-trade risk controls is a logical first step, consistent with

[1] See Regulation Automated Trading, Notice of Proposed Rulemaking, 80 Fed. Reg. 78825 (Dec. 17, 2015) ("Regulation AT")
[2] See Regulation AT at 78825.
[3] See Regulation AT at 78827.
[4] See Regulation AT at 78827.
[5] See proposed rules 1.83, 40.22, and 40.23.

the Commission's primary goal for this Rulemaking: market integrity. Implementation of such controls will effectively mitigate or prevent the market disruption risk, and therefore promote market integrity.

Another important reason to proceed first with pre-trade risk controls is because of the lack of common understanding and application regarding the definitions. The Commission, the industry, and the public need to arrive at a commonly understood meaning of electronic trading, automated trading, and algorithmic trading. This Rulemaking begins by describing issues with automated trading[6], but the actual proposed rules seem oriented around algorithmic trading.[7]

MGEX believes this is the wrong approach. The Commission should initiate more conversations, including roundtables, on the definitional components of the Rulemaking before proceeding to another version of this Rulemaking.

For example, MGEX believes that the Commission's use of the term "Algorithmic Trading" is misleading, and should not be used as the underlying concept for any rules on pre-trade risk controls.

MGEX understands electronic trading to be an umbrella term, under which automated trading resides. Any electronic trading systems, and therefore any automated trading systems, will always utilize algorithms as they are commonly understood[8], but not all electronic trading systems are automated trading systems.

Moreover, MGEX views automated trading on a spectrum. On one extreme are systems that make decisions about whether to trade and then cause orders to be submitted to a matching engine without any manual intervention by a natural person. Systems on this end of the spectrum are often called "black box" trading systems. On the other end are simplistic tools such as auto-spreaders that are used by natural persons to "automate" the construction of orders. While certain functions are "automated" these tools do not cause an order to be submitted to a matching engine without a natural person making that decision. Both these black box systems and simplistic tools such as auto-spreaders are supported by algorithms.

It is important that the definition and use of these terms or concepts are uniformly agreed upon within the industry, as it will help ensure that we get this Rulemaking (and further rulemakings) right. MGEX believes that there are many types, categories, understandings, usages, and terms that fall under the general meaning of automated trading. As described above, there is a spectrum of automated trading that is based on the extent and degree that a natural person is involved in the process of determining

[6] For instance, section B. of the Introduction is titled "Risk and Potential Benefits Associated with Automated Trading". See Regulation AT at 78827.

[7] There is, for example, no definition of automated trading. Only algorithmic trading has been defined, and all the proposed rules are oriented to algorithmic trading.

[8] In the most general sense, an algorithm is simply a series of steps that are executed to complete or perform a process.

whether and how to trade, and then causing an order to be submitted to a matching engine. It is too unwieldy to capture the scope and nuance of automated trading in a single, broad definition. While MGEX does not believe it is necessary to have codified, defined terms, MGEX does believe the Commission and industry need to have a common understanding of electronic and automated trading. Focusing exclusively on this subject and pre-trade risk controls will help ensure that we reach a mutual understanding of what electronic and automated trading mean.

Also, while MGEX supports the Commission's conclusion that pre-trade risk controls are needed to mitigate and prevent market disruption risk, there are serious questions about the proposed rules on pre-trade risk controls that need to be worked through before this Rulemaking is final. These questions are not trivial. Indeed, they are technologically perplexing and in many respects novel. One question that has yet to be addressed is the role of independent software vendors (ISVs) and the extent to which they are or are not captured by this Rulemaking. Under the proposed rules, only DCMs, FCMs, and AT Persons are contemplated; therefore, it appears that the Commission views only a DCM or a FCM as the gatekeeper of an order entering a matching engine. But, ISVs can be gatekeepers too, as orders that are routed through their servers go directly to the matching engine. This is just one example of why MGEX believes it is important to focus on pre-trade risk controls, and to tackle one subject matter at a time.

MGEX also believes that by first implementing a final Rulemaking that addresses pre-trade risk controls, the Commission will be able to observe the effects of the increased use of such controls in the real world. This should provide useful data and metrics that will further elucidate whether the Commission should promulgate subsequent rulemakings to address the other subjects of this Rulemaking. For example, it may reemphasize that increasing the pool of persons who must be registered is unnecessary to effectively mitigate the market disruption risk posed by electronic and automated trading.

Ultimately, it is critical that the Commission get pre-trade risk controls right. To be sure, the more subjects that are included in a rulemaking, the more challenging it is for a DCM, let alone a market participant, to digest it within a ninety-day review and comment period. Indeed, the Commission is soliciting responses to one-hundred-sixty-four questions in this Rulemaking, which by itself demonstrates its breadth. By combining all these proposals in a single Rulemaking, the Commission has placed a tremendous burden on DCMs, industry participants, and the public to understand them and address all aspects.

This creates a serious likelihood that DCMs, industry participants, and the public will remain overwhelmed by this Rulemaking prior to the deadline to submit comments. If the desire is to get all the components of this Rulemaking right, the time-compressed comment period and the approach the Commission has taken has increased the risk that they will be flawed. Everyone would be best served by taking one bite at a time rather than trying to swallow a whole meal at once. For the reasons articulated above, the Commission should first separate pre-trade risk controls from this Rulemaking and address those before moving onto the remaining topics, provided there remains any merit

to do so.

2. Pre-Trade Risk Controls

MGEX agrees with the Commission that pre-trade risk controls are an appropriate means to prevent or mitigate the market disruption risk posed by electronic trading. MGEX offers the following comments and recommendations to the Commission's approach on pre-trade risk controls. MGEX requests that the commission further embrace a principles-based approach to pre-trade risk control by simply applying pre-trade risk controls to electronic trading, and not specific types of automated or "algorithmic trading".[9] MGEX further requests that the Commission remove prescriptive elements of the proposed rules.

The Commission should also reconsider the utility of creating new defined terms to support its proposed rules on pre-trade risk controls. MGEX believes that the definition of Algorithmic Trading is unnecessary and misleading.

Furthermore, the Commission should consider whether it is appropriate to place so much of the regulatory burden on DCMs for the ongoing development and implementation of pre-trade risk controls.

a. Principles-Based Approach

MGEX appreciates that the Commission has provided flexibility with respect to its proposed rules on pre-trade risk controls; however, the Commission should fully embrace a principles-based approach.[10] The Commission has accurately diagnosed the principal risk of automated trading: market disruption.[11] MGEX supports required use of pre-trade risk controls and the role of DCMs providing such controls. But, MGEX believes that market disruption risks exists for all electronic trading (and not just automated trading). Therefore, MGEX supports the following principle: any order that is electronically submitted must go through pre-trade controls at some stage before it reaches the matching engine, and that some controls must, at minimum, reside at the matching engine. MGEX believes this will sufficiently redress the risk of market disruption.

Applying pre-trade risk controls to all forms electronic trading rather than automated trading is a simpler approach to preventing and mitigating market disruption risk. Under this approach, for instance, it becomes unnecessary for the Commission to introduce the new proposed defined terms, determine if additional persons should be registered with the CFTC, have a DCM review compliance reports of persons that engage in "algorithmic trading", or resolve any perceived issues with selftrading in order to implement sound

[9] As described above, MGEX believes "algorithmic trading" is a misleading term.

[10] While the Commission's proposed rules on self-trade controls are prescriptive because they explicitly require the use of certain controls at certain granular levels, the Commission notes that it is providing flexibility to encourage AT Persons, clearing member FCMs and DCMs to independently calibrate controls. See Regulation AT at 78871.

[11] See Regulation AT at 77871

rules on pre-trade risk controls.

This approach would also resolve concerns the Commission observed in proposed rule 40.20(d), where it requires that pre-trade risk controls also be applied to orders that do not originate from algorithmic trading.[12] Indeed, the Commission has proposed applying pre-trade risk controls to so-called manual orders because it recognizes they also pose market disruption risk. That is because any order, regardless of origination or interaction with an algorithm, will still be submitted electronically to a matching engine. Moreover, these orders will hit the matching engine and correspondingly will have the potential for introducing risk. Modifying the underlying principle for pre-trade risk controls to that of electronic trading will allow the Commission to provide the public and others with increased clarity, while also mitigating market disruption risk on a global basis (i.e., all orders regardless of access or type).

In addition, the Commission should remove prescriptive requirements for pre-trade risk controls. Under the proposed rules, DCMs are to provide certain minimum pre-trade risk controls in addition to others that are reasonably designed to prevent market disruption risk.[13] The Commission should let DCMs determine which minimum controls are needed on the matching engine. If anything, the Commission should only list certain controls as illustrations of what may be minimally required to satisfy this proposed requirement.

Removing prescriptive requirements not only provides each DCM with the discretion it should have over pre-trade risk controls, but more importantly it avoids a potential situation where the minimum controls required under this Rulemaking become the ceiling. By explicitly codifying certain controls instead of taking a more principles-based approach, MGEX is concerned that what are deemed minimums will effectively become maximums. This is because when there is a regulation that has explicit minimum requirements, there is a potential incentive to do just the bare minimum. MGEX questions whether this is the approach that should be taken with respect to pre-trade risk controls.

Furthermore, the Commission should remove prescriptive requirements for the granularity of pre-trade risk controls as it applies to DCMs. Under the proposed rules, not only are DCMs to provide pre-trade risk controls, but they must provide the controls at least at the level of AT Person.[14] As described below, the Commission should remove the definition of AT Person. Accordingly, the Commission should provide discretion to DCMs to determine the minimum granular level at which pre-trade risk controls should be applied.

Additionally, MGEX believes another benefit for removing this prescriptive requirement is easier and more efficient coordination among DCMs. MGEX expects there may be some coordination needed for DCMs that share matching engines and have customers trading

[12] See Regulation AT at 77871 ("In this regard, the Commission recognizes that natural person traders manually entering orders also has the potential to cause market disruptions.").
[13] See proposed rules 38.255 and 40.20.
[14] See proposed rule 40.20(a)(2).

on several markets.

b. New Defined Terms

The Commission should reconsider the utility and purpose of introducing new defined terms. Some terms, like Algorithmic Trading, are misleading and confusing. Other terms, such as AT Person, may not even be needed. And, other terms, like Direct Electronic Access (DEA), are actually overly-inclusive. MGEX generally believes that these terms need not be defined to address the underlying concern of this Rulemaking: market disruption risk. MGEX respectfully makes the following comments on these defined terms.

i. Algorithmic Trading

As stated before, *any* order that is electronically submitted should be subject to pre-trade risk controls at some or multiple levels. Consequently, it becomes unnecessary to define "algorithmic trading." Accordingly, the Commission should remove the definition of Algorithmic Trading and simply require that pre-trade controls be required for all electronically submitted orders prior to entering a match engine.

Alternatively, if a definition is needed, it should be partitioned into different categories or types of "algorithmic trading." It is unworkable to capture all the types of "algorithmic trading" in a single definition.

Additionally, an exception is needed to exclude commonly-used off-the-shelf functionality such as auto-spreaders from being deemed Algorithmic Trading.

Algorithmic Trading has been defined to include virtually any type of electronic and automated trading. This is perhaps best captured by the definition of Algorithmic Trading – in particular by what is *not* Algorithmic Trading: "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*."[15] This overly broad definition captures commonly used functionality that have not demonstrated any particularized or heightened risk of market disruption.

For example, with respect to many off-the-shelf order-entry systems that are widely used by market participants, settings are used to restrict how a natural person may construct and submit orders to a matching engine, either directly or routed through an FCM. In other words, the software or trading technology is providing discretion regarding an order, and therefore it would be deemed Algorithmic Trading.

Another example is auto-spreaders, which operate to take advantage of price differential anomalies and other legitimate purposes. Auto-spreaders are another widely used software feature that alone poses no inherent market disruption risk, but would be deemed Algorithmic Trading.

[15] See proposed definition (zzzzz) (emphasis added).

If something is deemed Algorithmic Trading, it would potentially subject a person to registration requirements, and would certainly require additional compliance obligations with respect to recordkeeping. These increased burdens on market participants are discussed more in Sections 3 and 4.

The question arises whether the Commission even needs to define Algorithmic Trading. For what purpose does this definition (along with AT Person and Direct Electronic Access) serve? If the goal is to have a DCM offer pre-trade risk controls and require that market participants utilize them, then the Commission could simply require that a DCM provide pre-trade risk controls for any order that is submitted electronically and that DCMs require that they be used. As described in Section 2.a., this principle seems practical and logical. Under such a principle, it becomes even more unnecessary to define Algorithmic Trading.

That said, it appears Algorithmic Trading has been defined partly to articulate the scope or breadth of the Rulemaking, and also to support the registration of some AT Persons as Floor Traders. Unfortunately, introducing this definition (as well as that of AT Person and Direct Electronic Access) creates confusion. But, more importantly, it muddles the market disruptive risk that the Commission is seeking to redress. By broadly defining Algorithmic Trading, an impression is created that all types of software or technology assisted trading are the same and should be given equal treatment. This creates an environment where the practices that pose heightened risk are not given the appropriate attention and treatment that they warrant. Surely, some types of electronic and automated trading require different approaches and tools than others to prevent or mitigate their attendant risks.

Alternatively, if the Commission desires to maintain a definition of Algorithmic Trading in its final Rulemaking, it should first endeavor to categorize the types of electronic and automated trading currently being used.[16] There is a great deal of nuance and diversity with respect to electronic and automated trading. As described above, algorithms will always be present with any electronic or automated trading technology. An algorithm could receive one input or thousands; it could execute one calculation or formula or thousands; it could produce one output or thousands. Due to human creativity and ingenuity, there is virtually no limit how one could write an algorithm to support trading or enter an order on a match engine. The complexity only grows if a market participant is active on multiple markets and trades multiple products.

Fundamentally, Algorithmic Trading is a misleading term, since algorithmic trading may be automated or unautomated, and could encompass virtually any type of trading technology.[17] It is not feasible to have a single definition that accurately reflects what is

[16] As advocated for above, MGEX supports the Commission facilitating more conversations to further explore the different types and categories of automated or "Algorithmic Trading".

[17] MGEX is cognizant that some in the industry refer to algorithmic trading in several ways. Some use it as synonym to automated trading. Some use it to describe only black box systems. Some use it to describe high-frequency trading. Some use it to refer to strategies

meant by “algorithmic trading”. To avoid a one-size-fits all outcome, the Commission should consider a different approach. While the Commission does not need to codify a definition at this time, it may be that several definitions would be warranted to adequately reflect the different types or levels of “algorithmic trading”.

In addition, better understanding the different types of electronic and automated trading that currently exist will allow the Commission to craft more tailored rules where appropriate to address the particular risks that certain types of electronic and automated trading pose. MGEX believes that one type of electronic and automated trading that may warrant its own definition and treatment is what has been commonly referred to as “black box systems”.

Black box systems make decisions whether to trade, they select all the attributes of an order, and then cause the order to be sent to a matching engine. All this often occurs without a natural person making any decisions whatsoever. These systems are also often designed or configured to operate at high-frequency, which compounds the risks that these systems otherwise present. Their physical location may also be strategically chosen so as to speed up the messaging to a matching engine. These black box systems are different than commonly-used software tools such as auto-spreaders that simply make it more efficient for natural persons to enter and submit orders. Fundamentally, black box systems pose exponentially more risk to a market’s integrity than off of the shelf electronic trading tools. Therefore, MGEX supports having additional rules specifically tailored for different types of electronic or automated trading. This, as indicated, may require more nuanced, category-based definitions of “algorithmic trading”.

Furthermore, the Commission should not overlook that there is existing software functionality that would be deemed Algorithmic Trading but does not pose market disruption risk. The Commission provided several examples where algorithms malfunctioned and resulted in market disruption.[18] For example, the Flash Crash of May 2010 was the result of an algorithm not taking price or time variables into account. Other cited examples were likewise the result of faulty code relating to the automated transmission of messages. Notably, none of the disruptive events were caused by off-the-shelf functionality that many market participants use on a daily basis. Any regulations promulgated by the Commission should take into account the myriad of software tools and features that exist in the electronic and automated trading universe, and should not lump all types together as “algorithmic trading”.

Accordingly, if the Commission maintains a definition of Algorithmic Trading even after exploring in more detail the type of features that fall under “algorithmic trading”, it should exclude, or create a safe harbor to allow for the use of, basic off-the-shelf or DCM-provided features. This is because they that pose no proven disruptive market risk. The safe-harbor should cover features such as auto-spreaders and other tools that allows a user to place timed orders, trailing-limit orders, sweep orders, stop orders, and order-

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or models – in other words, the particular function for the algorithm, but divorced from the broader system.

[18] See Regulation AT at 78837.

cancels order. The impact of an overly-broad definition of Algorithmic Trading is profound: it would impose serious and duplicative compliance obligations, which have tremendous costs, on many participants who are using features that have not demonstrated serious, systematic risks to a match engine.

ii. AT Person

The Commission should also reconsider the need for the definition of AT Person. Alternatively, if the definition is maintained, it should be modified.

By fully embracing a principles-based approach to pre-trade risk controls, it becomes unnecessary for the Commission to define AT Person in this first step to modernize the Commission's rules in light of advances in electronic trading. Accordingly, the Commission should omit the definition of AT Person in a final Rulemaking.

Alternatively, since MGEX is requesting, in the alternative, that the Commission create a safe-harbor for certain off-the-shelf functioning from being deemed Algorithmic Trading, a similar modification may be needed to AT Person. That is, the Commission may need to modify the definition of AT Person such that a market participant who utilizes well-vetted off-the-shelf and DCM-provided order entry tools are not deemed to be AT Persons.

iii. Direct Electronic Access

Next, the proposed term of DEA is unnecessary for this Rulemaking as it relates to a DCM providing and requiring the use of pre-trade risk controls. Whether a market participant has DEA or not would have no bearing on a DCM's ability to require that all market participants use pre-trade risk controls.[19]

Also, DEA is used to determine a new category of persons to register as Floor Traders. Since additional registration is not required (see Section 3.d.), this is another reason why the Commission need not introduce this new defined term.

That said, MGEX observes that the proposed definition of DEA may be overly inclusive *if* the goal is to provide specific attention to the types of electronic and automated trading that poses greater risk of market disruption. Specifically, the greatest threat of market disruption appears to be proprietary, black box type systems that cause orders to be sent to a matching engine without the order first routing through a system under the control of a FCM.

The Commission defines, in relevant part, DEA to be "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

[19] Nor would it prevent controls from residing at the matching engine; any order that is electronically submitted, regardless of access, should pass through controls prior to hitting the matching engine.

submits transactions for clearing."[20] "Routing" refers to the process of an order physically moving from a market participant to a central limit order book and clearing system.[21]

This definition does not capture all the mechanisms or technologies that are used to route orders to a DCM. While third-party FCMs have infrastructure that is often used to route orders to a DCM, there are additional configurations that have been overlooked by the proposed definition. For instance, there may be infrastructure owned and operated by a DCM. CME Direct is one such example. There are also infrastructure that is owned, operated, or leased from ISVs. TT and Bloomberg are examples of this arrangement. And, there are some infrastructure that is developed and owned by market participants. These have their own APIs that are used to interface with a matching engine.

If the Commission maintains a definition of DEA, it should be tailored to market participants that use their own technology, including proprietary APIs, to directly link their order entry systems with the matching engine, bypassing any infrastructure or technology that is owned or controlled by a FCM. As explained above, MGEX supports a broad principles-based approach for pre-trade risk controls, for which defining access is not needed. But, MGEX also identified that if "algorithmic trading" is further categorized, it may be necessary to have tailored rules to address particularized risks posed by certain categories of "algorithmic trading". A more tailored definition of DEA may be needed for such rules.

c. Responsibility for Pre-Trade Risk Controls

Other actors in addition to DCMs should have some responsibility for the development and implementation of pre-trade risk controls. As a DCM, MGEX appreciates its role in the industry, and expects to play a significant role in shaping the scope and characteristics of pre-trade risk controls that are needed as electronic and automated trading evolves. Under this Rulemaking, the Commission has, in part, codified existing pre-trade risk controls that have been offered by DCMs.[22] DCMs developed these controls in part for financial risk mitigation but more recently to address operational risks on their matching engines. They were logically derived and have been widely utilized and proven to work well. But, there will be circumstances that should require other actors to develop controls.

If, for example, a market participant develops a trading technology that has direct market access, and the DCM-provided pre-trade controls would not prevent or mitigate the market disruption risk posed by such technology, then the firm should be obligated to develop additional controls or take additional measures to prevent or mitigate market disruption risk.

MGEX also believes that FCMs may have ongoing responsibility to develop additional pre-trade risk controls. FCMs know their customers and accounts much better than a DCM does it. For similar reasons as with a trading firm, a FCM should be responsible for

[20] See proposed definition (yyyyy).
[21] See Regulation AT at 78844.
[22] See Regulation AT at 78850-51.

developing additional controls to address any unique risks it presents that are not adequately mitigated or prevented by DCM-provided pre-trade controls.

It is also true that a DCM will not necessarily always be the proper entity to develop minimum pre-trade risk controls for its matching engine. The rulemaking asserts that a DCM has deep knowledge of all strategies and technologies that market participants rely on.[23] That, however, is unrealistic. A DCM can be expected to use its knowledge to identify risks posed by electronic and automated trading, but it is also true that a DCM lacks the prescience to ascertain all the particularized risks posed by market participants that use electronic and automated trading software or technologies. Rather, an FCM (or in some cases an ISV) would be better positioned to understand the actual risks posed by certain software or technologies, and should therefore have responsibility to address those risks through additional controls.

MGEX observes that there are other parties that should be responsible for developing controls. Under the proposed rules, only a DCM is required to continue developing controls. While it is true that others could choose to develop additional controls, if they can rely exclusively on DCM-provided controls, there is no regulatory incentive to do independent development. As a general proposition, it is better to have more actors involved in developing pre-trade risk controls than fewer. The Commission should consider requiring others to develop controls, especially if their activities introduce particularized risks that would not be effectively mitigated by exclusively using DCM-provided controls.

3. Ancillary Contents

MGEX believes this Rulemaking is overly broad and contains proposals that do not even tangentially relate to pre-trade risk controls or preventing or mitigating market disruption risk. There are serious concerns with these unrelated proposed rules that need to be addressed. Even though these other topics should be addressed in separate rulemakings, MGEX nonetheless uses this opportunity to note some of its concerns.

MGEX is concerned that this Rulemaking could be the start of a paradigm shift in expectations of a DCM and its relationship with market participants. Next, MGEX does not see a cost-effective benefit for each DCM reviewing compliance programs of AT Persons. MGEX disagrees with the Commission's proposed rules regarding selftrading because they are premised on an erroneous assumptions of the types, purposes, and levels of selftrading that is occurring. MGEX does not believe additional persons need to be registered in order for the Commission to redress issues of market disruption or abuse that are potentially caused by electronic or automated trading. While MGEX supports the use of self-trade prevention tools, changes to the proposed rules are needed. Finally, changes are needed to the proposed rule on market maker or trading incentive programs. MGEX has detailed its concerns on these ancillary proposed rules in greater detail below.

[23] See Regulation AT at 78876.

a. The Role of a DCM

The Commission should be mindful of the historic and present role of a DCM. MGEX has witnessed increased regulatory burdens over the past several years, especially originating with Dodd-Frank. The Commission should be careful about further paradigm shifts as to the expectations of a DCM. MGEX observes that while the Commission has authority to make this Rulemaking, there is no independent legislative impetus for it. As detailed below, the Commission should balance this Rulemaking against what can be reasonably required of a DCM to perform.

A DCM is limited in its ability to prevent or mitigate all market abuse and disruption. If a DCM could devise its order entry system and match engine so that no market participant could submit an erroneous order or engage in abusive or disruptive practices, it would have been accomplished by now. The environment DCMs and the industry live in, however, is defined by rapid and complex change. Not only has the industry been grappling with implementation of Dodd-Frank, but it has been responding to technological advances and global changes across all commodity markets.

The Commission must consider not only the technological challenges that this Rulemaking imposes, but also the extent to which a DCM should be responsible for preventing actors from engaging in all forms of bad conduct. Historically, DCMs addressed prohibited conduct by drafting clear rules and enforcing them. With the advent of electronic and automated trading, DCMs have to do more than have rules and a robust surveillance capabilities. MGEX agrees that there will be common-sense software and technological features, which are practical and useful to implement, and that a DCM should be responsible for helping ensure market integrity. But, there will be conduct for which it will be incapable or impracticable to prevent through the use of software or technology. No amount money and labor resources will overcome this enduring fact.

MGEX views this Rulemaking, in part, as a shift in expectations as to what a DCM can reasonably be expected to perform. As discussed below, the proposed rules on selftrading and a DCM review of compliance programs of an AT Person illuminates this point.

In addition, each time a DCM takes a step to create systems and controls to prevent prohibitive or potential market disruption, it also creates a potential barrier for trading. The more barriers to trading, the more likely it is that markets will experience decreased liquidity and increased cost to trading. This is particularly concerning for smaller contract markets and less liquid contracts, both of which perform vital price-discovery and risk mitigation functions.

MGEX also views the proposed rules requiring a DCM to evaluate a remediate a participant's compliance program as a transformation of the relationship between a DCM and market participant. A DCM should be expected to set clear rules, monitor its market, and take enforcement action when needed. But, a DCM should not be expected to hand-hold sophisticated entities and walk them through changes to their internal policies and

procedures.

Further, a DCM does not have the type of relationship with each market participant to allow a DCM to appropriately perform this remediating function. While a DCM has a relationship with each market participant, it is not necessarily a direct relationship. This is brought into sharp focus when comparing the relationship between an FCM and market participant. A market participant opens an account directly with an FCM and the FCM therefore has a direct relationship with the market participant. A DCM is, in many ways, the safety net. It is another layer of needed protection should the FCM fail to properly manage one of its customers. There is more of a rational basis for an FCM to remediate a market participant's compliance program than a DCM.

Viewed differently, this Rulemaking signals a shift in focus of a DCM from after the fact enforcement to before actions even occur. There will always be persons who find creative ways to circumvent rules and technology. As much as DCM would like to, it cannot prevent actors from attempting to make nefarious decisions, and it cannot hardcode its rulebook into the match engine.

DCMs can and should perform surveillance to identify actors who have acted contrary to CFTC Regulation or Exchange rules, and then pursue enforcement actions as needed. Aspects of this Rulemaking, notably requiring DCMs to remediate compliance programs and implement new rules and tools to stop all forms of selftrading, seem oriented to prevent actors from being able to even make a poor decision. While that is an aspirational goal, the Commission must consider the practical limitations of DCMs, and also the historic purpose of DCMs. For these reasons, the Commission must carefully balance its goals to prevent market all abuse and disruption against what the proper role of a DCM is and should continue be.

b. Compliance Programs

Under this proposed rule, each DCM would be required to review and then remediate an AT Persons' Compliance Program. This means a DCM would have to carefully assess whether the Compliance Program satisfies regulatory requirements, and then recommend changes to make it compliant. As demonstrated below, there is virtually no cost-effective benefit for having each DCM review compliance programs of AT Persons. Accordingly, the Commission should remove this requirement from its final Rulemaking, or modify it so a DCM review is only required as part of an investigation. Alternatively, the Commission should modify this requirement so that an FCM or DSRO has the obligation to review and remediate such compliance programs, since they know their customers best.

Requiring each DCM to review compliance programs of AT Persons trading on its market would not achieve the Commission's stated benefit.[24] The commentary to this Rulemaking provides that such review is needed because it "is the most effective method to ensure

[24] The proposed rule also require that a DCM review FCM reports. See proposed rule 1.83(b).

that all market participants are implementing measures that are reasonably designed to prevent an Algorithmic Trading Event or Algorithmic Trading Disruption".[25] MGEX respectfully disagrees with the Commission that reviewing an AT Person's compliance program would achieve this outcome. Instead, experience demonstrates that the most effective and time-tested method for ensuring that market participants are adhering to practices that are designed to prevent misconduct or deleterious events is by having clear rules coupled with robust surveillance. Market participants understand that departures from expected conduct will be discovered and enforcement action will follow. Reviewing compliance programs will not ensure that AT Persons are, in practice, utilizing measures that are reasonably designed to prevent an Algorithmic Trading Event or Algorithmic Trading Disruption.

Furthermore, a DCM is not in the best position to referee or judge an AT Person's compliance program. The Commission asserts that a DCM is in the best position because a DCM has or will have expertise in market participants' technological systems and trading systems.[26] While DCMs may be knowledgeable about commonly used trading tools and strategies, it is impracticable to expect DCMs to understand all unconventional or proprietary trading strategies or the varied technological systems that market participants employ. Put differently, because there is great diversity with respect to how market participants trade, as well as implement and configure technological systems, a DCM cannot be expected to be experts of the varied technological systems and trading systems that are in use.[27]

Also, smaller DCMs will be disproportionally impacted with respect to this new DCM program to review compliance programs because they will be required to hire additional staff (see Section 4). This is even more true with the recent agreement between ESMA and the CFTC on CCPs. It is possible some DCMs will have more participants, using more varied technologies and strategies. Not only does this hurt smaller DCMs, but it is another barrier to entry for new DCMs. The industry has already seen much consolidation for purposes of economics, and MGEX is particularly concerned that this proposed rule will further reduce competition.

Next, the Commission should not set a precedent that a DCM should be reviewing and then suggesting changes to a market participant's internal structure and design. Market participants are usually sophisticated entities and should have the discretion and independence to formulate internal compliance programs. This is the approach that the Commission has taken in the past, and should continue to take. For example, with respect to risk management requirements for FCMs, a DCM is to prescribe that an FCM has a program in place. A DCM verifies that a program is in place. But, the DCM does not remediate the plan for an FCM. The Commission should take this approach for review of compliance programs, if it maintains this proposed requirement at all.

MGEX proposes alternatives to review of compliance programs, if this program should

[25] See Regulation AT at 78876.
[26] See Regulation AT at 78865.
[27] Let alone review source code.

even exist at all. One alternative would be to require a DCM to perform such review on a limited basis: as part of an investigation involving a market disruption type of event and without the requirement that the DCM make recommendations. Another alternative is to keep this requirement, but instead of a DCM performing the review, it would be the FCM or DSRO. It would be more cost effective and efficient to have the DSRO review compliance programs of FCMs, as well has for FCMs to review an AT Person's compliance program. If a DSRO performs this function, there would be efficiencies because there would only be filings with a single entity, rather than all DCMs. That would reduce any regulatory filing burdens, as well as removing the redundancy that may occur by having each DCM reviewing similar information. Moreover, with respect to knowledge of an actor and their business, a DSRO already has a direct relationship with FCMs (and FCMs have a direct relationship with AT Persons, or market participants), and therefore would be best positioned to review and remediate compliance programs.

c. Selftrading

MGEX concurs with the Commission that selftrading has the potential to jeopardize the health and integrity of a contract market by disrupting the price discovery process. There need to be sufficient rules and tools that are reasonably designed to prevent market participants from engaging in certain types of selftrading.[28] The industry has been confronting this issue for many years. MGEX, like many other DCMs, has witnessed selftrading migrate from pit-trading to electronic trading platforms. In response, DCMs and others developed self-trade prevention tools.[29] In fact, the Commission recognizes that most DCMs already offer self-trade prevention controls and that they are widely utilized by participants.[30]

In addition, MGEX, as other DCMs, perform extensive market surveillance and have experience detecting prohibited forms of selftrading. MGEX and other DCMs have codified Exchange-based rules against selftrading, and have had occasion to enforce them. In fact, MGEX already has five (5) rules that relate to selftrading and performs daily reviews of any trade that is flagged as potentially being a self-trade. Some of these rules have their roots in the pit-trading world. Moreover, MGEX knows that market participants routinely rely on software features (including Exchange-provided tools), in addition to internal policies, to prevent selftrading. DCMs, as well as market participants, have been working together to address this issue.

MGEX believes that the industry will continue to address selftrading, without the requirements proposed in this Rulemaking. The Commission should reconsider the need for this proposed requirement. In the alternative, changes are needed to protect legitimate trading activity that falls under "selftrading".

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[28] See Regulation AT at 78877.

[29] MGEX notes that it has read of instances where self-trade prevention tools have been abused to facilitate spoofing. This is just an example that, as well intended as a software feature may be, it may have unintended consequences.

[30] See Regulation AT at 78918.

Additionally, the Commission should reevaluate its assessment of current levels of selftrading. The Commission posits that because selftrading constitutes a meaningful percentage of daily volume, it is justified in imposing new regulations to prevent the deleterious effects that selftrading may cause. The data the Commission relies on, however, is limited and does not reflect MGEX's experience.

Furthermore, the Commission should exclude some market participants from using self-trade prevention tools, and permit other market participants to use their own self-trade prevention tools in lieu of DCM-provided ones. While most market participants should use self-trade prevention tools, it should not be forced on all. In addition, some participants have already developed their own tools, and should be permitted to continue using them, provided they are demonstrated to be effective. Allowing participants to use their own tools will foster additional, ongoing development. As a general proposition, it is preferable to have more actors developing self-trade prevention tools than fewer.

The Commission should also consider an additional carve-out or exception to selftrading, to allow for instances where a market participant unintentionally trades opposite without degrading the competitive nature of the market whatsoever. This may occur, for instance, during less liquid contract months.

Next, MGEX does not see a practical, let alone material, benefit to require a DCM to report the volume of self-trades along with other metrics if the volume is nominal. If selftrading is only nominal matter, then the value of the data to the public and market participants is also nominal. There is, in other words, no cost-effective material benefit for this requirement.

The Commission demonstrates an opinion about selftrading that is not supported by data from all DCMs. The volume of selftrading that occurs on MGEX's market is nominal. On average, self or cross-trades account for a fraction of total daily volume. The occurrence of selftrading is nominal in part because market participants are using self-trade prevention tools in addition to internal policies prohibiting selftrading. Put another way, since selftrading is already prohibited (except for accidental or certain exceptions), actors have been encouraged to take reasonable steps to remain in compliance.

This is markedly different from the data reported in the Rulemaking. The Commission states that "in February 2015 intra-firm self-trades in one examined futures contract were almost 10 percent of all trades in that contract, increasing to almost 15 percent on individual days. Self-trade rates for a few other contracts were around 5 percent of total activity."[31] The problem with this data is that it is limited to just "several large DCMs, focusing primarily on the most active products."[32] It should not be assumed that the experiences on those DCMs and products translates equally to all other DCMs and products. Also, the Commission acknowledges that its data likely includes "trading between accounts controlled by separate independent decision makers."[33] This means

[31] See Regulation AT at 78879.
[32] Id.
[33] See Regulation AT at 78879, footnote 542.

that some of the self-trades included in the Commission's data would be permitted under proposed rule 40.23(b). Because the Commission did not rely on comprehensive data concerning selftrading, the Commission's assumptions and analysis about the level and effects of selftrading appear to be skewed to support the proposal.

It is also important to perform more analysis on selftrading so that the Commission can better identify and quantify the relationship between selftrading and price discovery. Only then will the Commission and others be able to evaluate whether the costs imposed by any new requirements relating to selftrading are justified. Without identifying an actual harm, MGEX can only speculate that the remedies the Commission is proposing will actually produce a material benefit. There are serious questions that the Commission should explore. For example, is there a correlation between the level of selftrading and the price at which a contract is trading? If so, does selftrading distort price discovery at any level of selftrading, or does it only occur once a certain threshold is achieved? These are just a sampling of inquires that should be explored using more holistic data from all DCMs.

Next, MGEX strongly believes that all market participants should have access to self-trade prevention tools, but DCMs and market participants should have more discretion over whether and how such tools are utilized should be utilized. The Commission should re-evaluate the benefit of requiring that *all* market participants utilize self-trade prevention tools. The Rulemaking provides commentary that "the Commission preliminarily believes that the proposed rule would protect market participants;" that it *may* "promote the efficiency of the markets;" that it *may* "promote financial integrity;" that it *may* "protect and enhance the price discovery process."[34] MGEX acknowledges that selftrading has the *potential* to hamper competitiveness and price discovery. As discussed above, additional analysis is required before a determination can be fairly made that all market participants must use self-trade prevention tools. MGEX does not want small participants to be unfairly swept into this compliance obligation if their orders are not currently resulting in selftrading despite the non-use of self-trade prevention tools.

In addition, it is important to be mindful that market participants may desire to utilize their own systems and procedures to prevent selftrading, and therefore may prefer to not use DCM-provided features. In fact, some market participants have already developed such tools, in addition to creating internal policies and procedures to prevent selftrading from happening. While this Rulemaking seeks standardization of use across all DCMs and market participants with respect to self-trade prevention tools, MGEX disagrees that such standardization is needed. The Commission should modify proposed rule 40.23 such that a DCM is required to provide self-trade prevention tools, but allow for market participants to opt to use its own tools instead. This will produce better outcomes because more actors will be encouraged to continue to develop self-trade prevent tools.

MGEX applauds the Commission for recognizing that there are certain types of selftrading that should be permissible. Under proposed rule 40.23(b), a DCM may permit selftrading subject to certain requirements. MGEX has long recognized that not all self-trades are

[34] See Regulation AT at 78920 (emphasis added).

the same, and that some should not be prohibited outright. Many self-trades, for instance, are the product of large commercial hedgers that regularly trade on its market. Further inquiry into this has found that there was no intent to trade opposite and that there was sufficient volume of trading occurring such that the market was functioning in a highly competitive manner despite the occurrence of some self-trades.

It is also commonly observed that if a market participant enters an outright and a spread, selftrading sometimes results.[35] This is particularly true with some contracts and contract months; whenever there is lower volume and there is a need for someone to be opposite an order, selftrading is more likely to occur. MGEX wants to ensure that its market participants can continue trading on its market without fear that some unintentional selftrading will subject them to violation of CFTC regulation or DCM-based rule. As such, the Commission should at least allow for a safe-harbor for self-trades that are unintentional and have no material impact on the competitive nature of the marketplace, in addition to the exceptions provided under proposed rule 40.23(b).

Next, the Commission should drop the requirement that each DCM publish data on selftrading. MGEX does not see a material benefit to the public for knowing the percentage of trades that are self-trades (particularly if it is so nominal as to be obviously inconsequential). Also, it is possible publishing such data actually causes depressive effects. This is because market participants or potential market participants could misinterpret the data, and make decisions not to trade based on an erroneous understanding. As indicated above, until the relationship between price discovery and selftrading is better understood, one can only speculate as to the true benefit that would be realized by providing such data.

Even if the Commission decides to maintain a requirement for each DCM to publish data on selftrading, the Commission should create an exemption if the level of selftrading is nominal. After accounting for excluded types of selftrading, a DCM should only report data it exceed a certain level of volume for the contract month. MGEX proposes a ten percent (10%) threshold.

All said, the Commission should take a more comprehensive review of selftrading and then modify its proposed rules accordingly, preferably in a subsequent rulemaking. Any new proposed rules on selftrading should provide exclusions for some participants to not use self-trade prevention tools, and to allow market participants to use their own tools instead of DCM-provided ones. DCMs also should be excused from publishing metrics or data on selftrading if the level of selftrading is nominal. Finally, MGEX observes that while it is beneficial to prevent, to the extent possible, harmful selftrading, it is ultimately the responsibility of market participants to avoid engaging in prohibited conduct.

d. Registration

It is unnecessary to require additional persons to register if there is a requirement that all

[35] This is partly because the match engine recognizes the orders as different instrument types.

market participants utilize pre-trade risk controls. As advocated above, if the Commission fully embraces a principles-based approach to pre-trade risk controls, it becomes easier to have a more simplistic approach to mitigating and preventing market disruption risk. In any event, MGEX, as well as other DCMs, have the legal ability to enforce its rules against persons who participate on its markets, regardless of the person's registration. Registration would have no bearing on MGEX's ability to fulfill its obligation of providing and then requiring the use of pre-trade risk controls, or its ability to take enforcement action against bad actors, including those who fail to use pre-trade risk controls.

Under this Rulemaking, the Commission proposes to change the definition of Floor Trader in addition to the new proposed term of AT Person. The change to Floor Trader and the introduction of AT Person are used, in part, to require additional persons to register with the Commission. The Commission explains that it desired to have these new terms "in order to identify which entities are subject to the proposed regulations …."[36] Also, the Commission articulates that registration is needed to "help ensure that all market participants that actively trade on Commission-regulated markets implement appropriate controls …."[37]

While MGEX believes that these definitions and additional registration are not beneficial or necessary, there is another problem with the Commission's approach: it alters a well-established, historic term. It does not make sense to force the concept of AT Person into the definition of Floor Trader. The definition of Floor Trader currently serves a purpose, in addition to being a historic term. From a drafting perspective, it is perplexing to shoehorn a term like AT Person into Floor Trader. To facilitate a new entrant's ability to access markets and understand what obligations they must meet, the Commission's rules should be clear.

All said, as proposed, this definition and registration requirement appear to be more burdensome than useful.

e. Order Cancellation Systems

While MGEX is hopeful the Commission will first focus on pre-trade risk controls in its final Rulemaking, and save all other aspects including order cancellation systems for subsequent Rulemakings, MGEX nonetheless wants to provide the Commission with its concerns regarding proposed rule 40.20(b).

MGEX's principal concern is that the required use of order cancellation systems by a DCM may expose the DCM to potential liability, either by using or failing to properly use the order cancellation system. Second-guessing after the fact decisions about activation of order cancellation systems allows for liability concerns. MGEX does not want to be exposed to potential liability simply because it makes a reasonable determination to activate an order cancellation system. Conversely, MGEX does not want to be exposed to liability for making a reasonable determination to not activate the order cancellation

[36] See Regulation AT at 78843.
[37] See Regulation AT at 78845.

system. Accordingly, the Commission should provide an immunity to DCMs, protecting them from liability for their reasonable determinations to utilize or not utilize an order cancellation systems in response to certain events, such as potential market disruption.[38]

The Commission should also provide more discretion to DCMs to design and implement order cancellation systems. Under the proposed rule, a DCM's system must be able to cancel selected or up to all resting orders when system or market conditions require it, and when a person's trading system disconnects with the trading platform.[39] This does not provides a DCM with the explicit latitude it needs to decide whether it should be the DCM or the FCM or market participant who activates the order cancellation system. MGEX believes that there will be some events where the DCM should initiate the system and cause orders to be cancelled. But, for many events, it may well be the FCM (and in some cases a market participant with direct market access) to utilize the system. Accordingly, MGEX requests that proposed rule 40.20(b) be modified to read that a DCM has the discretion to determine who is responsible for utilizing the order cancellation system and under which circumstances.

MGEX is concerned that a DCM, FCM, or a market participant might reach different conclusions as to whether an event is occurring on a match engine that would warrant use of the order cancellation system. If a FCM or market participant becomes aware or perceives issues on its own systems *or* the match engine, and desires to respond by cancelling orders, then it should so act. Indeed, a market participant's own systems could be functioning improperly and may provide them with a false signal of market disruption or other deleterious events. In contrast, a DCM might be looking at the same facts and circumstances, and determine that that use of the order cancellation system is unwarranted.

One reason the Commission should provide additional discretion over the use of order cancellation systems is to avoid thwarting or second-guessing a market participant's intent. MGEX is concerned that under the proposed rules, a DCM will be asked to implement systems that will lead to bona fide orders being inappropriately cancelled. Under the proposed rule, a DCM's system must cancel selected or up to all resting orders when system or market conditions require it, and when an AT Person disconnects with the trading platform. If, for instance, bona fide orders are transmitted and then technical issues occur that cause even momentary disconnection, a DCM would be required to cancel orders. It would seem unfair to suspend or cancel those orders; if an order was entered, there should be a presumption that there was intent to place the order and it was bona fide.

f. Matching Engine

MGEX is generally supportive of proposed changes to rule 38.401, requiring additional disclosure of material attributes of a matching engine. There are two concerns with this

[38] There is a question as to how such immunity would be provided. It may require legislative action.

[39] See proposed rule 40.20.

new requirement, however. First, more guidance on "materially" is needed. Second, while the Commission states it does not believe such disclosure obligations would extend, it might and therefore a DCM may seek confidential treatment as permitted under rule 40.8.

Under this new requirement, a DCM would be required to disclose to the public any attribute that "materially affect the time, priority, price, or quantity of execution, or the ability to cancel, modify, or limit display of market participant orders".[40] The Commission should provide certain guidance for what "materially" means. The Commission notes that it would "look to substantial case law on the issue of materiality".[41] A final rule could have an explicit reference to substantial case law, or, alternatively a final rule could include examples of what "materially" means. This would provide more guidance to the public.

Next, the Commission should be considerate of trade secrets, or proprietary information, which may be implicated by this proposed requirement. Not only would each DCM be required to disclose material attributes of a matching engine, but the Commission writes that proposed rule 38.401(a)(1)(iii) and (iv) "are intended to apply to various aspects of how an electronic platform operates, beyond the technical process of how any order is actually matched."[42] This is a very broad requirement, and there may be aspects of the matching engine and associated infrastructure, technology, and software that are simultaneously "material attributes" and trade secrets or proprietary information. The Commission states that it does not intend for this proposed rule to require the disclosure of trade secrets or proprietary information, and notes that a DCM could seek confidential treatment under rule 40.8.[43] MGEX believes that DCMs will seek such treatment, given the broad nature of this proposed rule, and hopes that the Commission will take seriously those requests.

g. Test Environments

MGEX supports the Commission's requirement that a test environment be available for market participants to verify the proper functioning of pre-trade risk controls. That said, proposed rule 40.21 should be modified to provide a DCM with reasonable discretion over the availability and use of the test environment. A DCM should be able to impose reasonable limitations concerning when the test environment will be available for use and how much historical data is available. Since there are costs associated with maintaining these environments, permitting a DCM to impose reasonable limitations helps make this requirement a more cost-effective benefit to market participants.

h. System Heartbeats

MGEX largely supports the Commission's proposed rule 40.20(c) to provide what are known as system heartbeats so that persons that interface directly with a DCM's platform can detect connectivity. This proposed regulation should be saved for a subsequent

[40] See proposed rule 38.401(a)(1)(iii).
[41] See Regulation AT at 78869.
[42] See Regulation AT at 78869.
[43] See Regulation AT at 78868 and 78870.

Rulemaking because it is unrelated to the issue of pre-trade risk controls; however, if the Commission chooses to maintain such a rule in its final Rulemaking it should make adjustments. As advocated above, it is unnecessary for the Commission to introduce any new defined terms, including Direct Electronic Access, to achieve its goals. Since this proposed regulation is tied to DEA, it will need to be modified. MGEX would support requiring that a system heartbeat be made available to any person that has a direct connection with an Exchange's platform. This would extend to FCMs in addition to firms that use APIs and other methods to directly interface with a DCM or match engine. This approach would achieve the Commission's desired goals.

Next, changes are needed to proposed rule 40.20(c)(1)(ii). MGEX supports the idea that systems used to provide market data should also have system heartbeats; however, since MGEX is requesting the removal of the definition of AT Person because it is unnecessary, the Commission will need to modify proposed rule 40.20(c)(1)(ii).

Currently, this proposed regulation requires a system heartbeat for systems used by the DCM to provide an AT Person with market data.[44] MGEX supports a rule that requires a system heartbeat for a DCM's system that provides real-time market data, but not for any downstream recipients or for delayed data. As such, the Commission should exclude a DCM from making a system heartbeat available for downstream or delayed recipients of market data from the DCM's market data system.

i. Market Maker or Trading Incentive Programs

Under the Rulemaking, a DCM would be required to publicly disclose details of its market maker or trading incentive program. MGEX concurs that this would provide a benefit to the public. MGEX notes one issue with respect to proposed rule 40.27. Under the proposed rule, a benefit or payment would not be permitted for self-trades. MGEX believes that there are be legitimate circumstances where a benefit or payment should be permitted for trades between accounts that are deemed to be under common beneficial ownership, as described in proposed rule 40.23(c). As discussed earlier, the Commission should expand the exceptions for selftrading under rule 40.23 to include nominal levels of unintentional selftrading. If the Commission adopts MGEX's proposal with respect to rule 40.23(c), it will remedy MGEX's concern with this proposed rule.

j. Source Code Repository

MGEX suspects many impacted persons will allocate much of their comment letter to the proposed requirement that obligates an AT Person to maintain a source code repository.[45] As will surely be explained in detail by other commenters, source code is proprietary and confidential information. It represents valuable intellectual property, containing strategies, modeling, and other functions that influence the trading activities of an AT Person.

Under the proposed rule and along with CFTC rule 1.31, the Commission or the

[44] See proposed rule 40.20(c)(i)(ii).
[45] See Proposed Rule 1.81.

Department of Justice ("DOJ") could access this information without a subpoena. While MGEX observes there may be very legitimate needs for the Commission or the DOJ to access such information, it should do so only under subpoena. This would be more consistent with established legal norms, as a federal governmental entity cannot generally obtain unfettered access to information of this type without a subpoena.

Accordingly, the Commission should modify this proposed requirement. The Commission should require maintenance of source code, but the Commission's or DOJ's access to source code must occur only after a subpoena is secured.

4. Cost-Benefit Analysis

MGEX believes that the Commission's estimates of the implementation and ongoing costs of the proposed rules are incomplete, and in some aspects the Commission's cost-benefit analysis misses the mark. This is most plainly observed by the requirement that DCMs review, analyze, and remediate compliance programs of AT Persons. MGEX believes that the Commission has significantly underestimated the costs to each DCM. There are also other indirect costs that cannot be ignored. MGEX believes that if this Rulemaking were made final, it is more likely to result in additional costs without measurable public benefit, and perhaps lead to less competition. It could even force some participants from the marketplace and create new barriers of entry.

a. DCM Review of Compliance Programs

As explained below, establishing a new DCM program to comply with the CFTC will have serious costs to MGEX and all other DCMs, which the Commission has underestimated. As discussed above in Section 3.b., there is no material benefit for this new DCM program. When combined with the high cost it imposes, this proposed rule has little cost-effective benefit.

The Commission understates the costs to perform such reviews on an annual basis. The Commission estimated it would cost each DCM $133,000 annually to review the reports and provide remediation, as needed.[46] The Commission estimates that a DCM would spend fifteen (15) hours reviewing each AT Person Report (five hours each for a Tester, Developer, and Senior Compliance Examiner), at a cost of $925 per report.

MGEX anticipates, based on other activities performed by its Audits & Investigations Department, it would spend more than fifteen (15) hours reviewing each report. Furthermore, since there will not be consistency in the format and content of an AT Person's Report, MGEX expects that such review would have to occur, in part, by comparing and contrasting programs. This is indeed encouraged by the rulemaking.[47] Reviewing an AT Person's Compliance Reports would be a new activity for MGEX's A&I

[46] See Regulation AT at 78907 & 78925-78926.

[47] See Regulation AT at 78876 (The Commission notes that a DCM will be able to "identify outliers that may not have implemented adequate measures." This would not be possible unless a DCM compares and contrasts all reports).

professionals, and therefore there would be a learning curve that would result in increased time reviewing reports during at least the initial year. Altogether, MGEX reasonably and conservatively estimates that reviewing each AT Person Report would take significantly more than fifteen (15) people hours, which means the cost estimate for reviewing each report is understated.

In addition, MGEX anticipates the need to hire additional staff to perform such reviews. Due to the unique nature of MGEX and the current skill sets of its department, MGEX estimates it would have to hire at least two additional full time employees. The cost associated with that would be equivalent to, and could possibly exceed, the annual cost estimate provided by the Commission.

For these reasons, the Commission should review its cost-benefit analysis for this new DCM program.

b. Self-Trade Prevention

MGEX respectfully disagrees with the Commission's conclusion that the requirement that a DCM determine which accounts should be prohibited from trading with each other, or require that market participants identify to the DCM which accounts should be prohibited from trading with each other "will not impose additional costs on DCMs".[48] It would be an incredibly time-consuming process for MGEX to assess market data and market participants to determine all the accounts that should not trade with each other, and then maintain that on an ongoing basis. MGEX would either have to spend many people hours manually analyzing data, or develop additional features on its systems so that it could make such determinations programmatically (if possible). Any decision made, whether manually or programmatically, would need to be reviewed by senior staff, since these decisions are not trivial. And, if MGEX were to make these decisions, it would want to provide an opportunity to market participants to verify the conclusion of MGEX. The costs attendant with these activities is not nominal, and only increases if more participants trade.

Even if MGEX were to opt to force market participants to identify all accounts that should be prohibited from trading with each other, there would still be costs to MGEX. MGEX would still need to modify entries in its surveillance systems so that it could monitor accounts to verify that such accounts are not trading opposite with each other. And, since few aspects of a marketplace are static, it should be expected that there will regularly be changes to which accounts should be prohibited from trading with each other. Every time a market participant makes a change, it would need to notify MGEX. In turn, MGEX would have to make appropriate updates in its surveillance system in addition to adjusting the self-trade prevention tools. The Commission should not overlook these costs.

While MGEX does see benefits to the Commission's proposed rules on self-trade prevention, this aspect of the proposed rule is not justified by its cost.

[48] See Regulation AT at 78918.

c. Indirect Costs and Barriers to Entry

As described below, some aspects of this Rulemaking impose indirect costs to DCMs and may result in placing additional barriers for the formation of new DCMs. In addition, they may discourage new market participants. The Commission should be mindful of these potential costs and effects.

The derivatives industry has seen drastic market consolidation over the past decades. There are fewer DCMs today than in the past. Indeed, DCMs are not the only actors that have seen consolidation either, as there has been a dramatic decline in the number of FCMs. MGEX believes that the public and market participants do not realize any benefits by having fewer DCMs and FCMs.

The costs associated with new compliance obligations disproportionally impacts existing DCMs. With every new compliance obligation, there are new costs. For smaller DCMs, the cost are often more severe. This is because smaller DCMs do not have the benefit of large staffs and resources to leverage. Put differently, it is more likely smaller DCMs will have to hire additional staff to meet new compliance obligations, and therefore their cost assessment is fundamentally different than larger DCMs. A prime example of this is the proposed requirement to have DCMs review compliance programs of AT Persons.

Not only do these new compliance obligations hit existing DCMs disproportionally, but they make it more difficult for new DCMs to form. This is because it will require more capital to have the adequate level of staff to meet all the compliance obligations. Barriers to entry hampers competition in a time when more competition would benefit the public and market participants.

This Rulemaking does not only affect DCMs – the many new requirements directly impact existing market participants. For instance, an AT Person would be required to submit a report to each DCM on which it trades.[49] There are also additional obligations relating to providing source code and having natural person monitors. Many of MGEX's smaller market participants actively trade on several markets, and therefore would have to allocate time and resources preparing multiple AT Person Reports. They might have to hire additional staff to act as a natural person monitor, as well. It is likely that some will conclude that it is too costly to engage in multiple markets, and, consequently, will stop trading on certain DCMs as prudent business decisions are made to avoid duplicative tasks and expenses on multiple DCMs. This will result in real harm to the marketplace as traders leave.

Further, some will look at these new obligations as insurmountable hurdles, and will decide to not engage in derivatives markets altogether. Discouraging new entrants, either DCMs or market participants, will make it more difficult to maintain healthy liquidity.

While it is difficult to put an exact price on these indirect costs, MGEX hopes the Commission takes seriously the concern of further market consolidation and barriers to

[49] See proposed rule 1.83.

entry. MGEX believes that the Commission could prevent further consolidation and new barriers to entry by opting to move forward on a Rulemaking that only concerns pre-trade risk controls.

While it is difficult to put an exact price on these indirect costs and effects, the Commission should be mindful of them, particularly given the scope of this Rulemaking. The many component pieces only compound the indirect costs and effects.

Conclusion

MGEX is grateful for this opportunity to comment on this Rulemaking. MGEX agrees that the Commission should be thinking about how to modernize Commission rules in light of advancements in trading technologies. It is true that the manner by which trading is occurring has been fundamentally changed, but the purpose of DCMs and the derivatives industry remains the same. But, just as these changes did not occur overnight, the Commission should not make comprehensive changes in one swoop. MGEX believes that the Commission should proceed on a rulemaking that first addresses pre-trade risk controls, after which the Commission should further investigate the complex and nuanced nature of electronic and automated trading. The focus should be to arrive at sensible, streamlined rules that ensure practical pre-trade risk controls are being utilized.

If you have any questions or concerns regarding this letter, please feel free to contact me at (612) 321-7141 or awysopal@mgex.com. Thank you for your attention to this matter.

Sincerely,

Adam Wysopal
Assistant Corporate Counsel

cc: Mark G. Bagan, President & CEO, MGEX
Layne G. Carlson, Treasurer & Corporate Secretary, MGEX
Chairman Timothy G. Massad, CFTC
Commissioner Sharon Y. Bowen, CFTC
Commissioner J. Christopher Giancarlo, CFTC