BETTER MARKETS

June 24, 2016

Mr. Christopher Kirkpatrick
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Regulation Automated Trading (CFTC RIN: 3038-AD52)

Dear Mr. Kirkpatrick,

Better Markets Inc.[1] appreciates the opportunity to comment again on the above-captioned proposed Regulation Automated Trading (Proposal, Proposed Rule), issued by the Commodity Futures Trading Commission (CFTC, Commission).

INTRODUCTION

The Commission's decision to fine-tune its proposed regulation on automated trading is an important step towards modernizing regulation to account for the electronic developments in the markets. While the proposed rule does not seek to alter current market practice, it succeeds in serving as a broad framework for identifying market participants and collecting data, which may inform a more robust regulatory regime in the future.

The requirement for registration of Automated Trading firms is common sense and straightforward, and furthermore we are pleased to see the focus on several important safeguards that we have advocated for in the past,[2] such as the message

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[1]   Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2]   See Better Markets "Comment letter on concept release on risk controls and system safeguards for automated trading environments," available at https://www.bettermarkets.com/sites/default/files/documents/CFTC-%20CL-%20ATS-%2012-11-13.pdf and see Better Markets "Comment letter on proposed regulation automated trading," *available at* https://www.bettermarkets.com/rulemaking/better-markets-comment-letter-cftc-regulation-automated-trading.

throttles and Commission access to algorithm source code. Similarly, the focus on plain language descriptions and narratives regarding the behavior and activity of algorithms is an important element for comprehensive oversight. Furthermore, we are supportive of the special measures for Direct Electronic Access contemplated in the rule.

DISCUSSION

While the enumerated Pre-Trade Risk Controls are simply a codification of the most broadly-used current industry practices, they represent a strong foundation for ensuring the most obvious safeguards are in place to protect markets from the risks of automated execution. It is important to note, however, that the Proposed Rule generally only specifies that firms develop and employ the enumerated controls, and does not dictate the specifics of such controls, such as the levels at which certain limits should be set. This may be appropriate as a starting point, but such self-regulatory regimes require diligent oversight by the Commission to constantly oversee and ensure that these limits or practices are effective, both on an individual firm level and the collective effect of those individual levels on the market as a whole. Stronger defenses, such as minimum resting periods and/or a quantitative threshold, should ultimately be required to ensure stability in these markets.

Regarding minimum resting periods, the CFTC must stipulate that all orders placed on registered platforms must be valid for at least one second. This is a wholly appropriate standard, independent of any abusive automated trading practices. For instance, it prevents spoofing and greatly reduces the likelihood of flash crash-style cascades, in which prices can suffer massive swings almost instantaneously before automatic circuit breakers can kick in. At the same time, a one second floor would curtail the ability of predatory high frequency traders (HFT) to ping the order book to gain an informational advantage over other traders. Therefore, it would end the privileged status afforded to HFTs, who are permitted "immediate or cancel" orders unlike other market participants.

Regarding a quantitative threshold, the CFTC must adopt a threshold using a metric that sets limits on volume and frequency. Moreover, this metric must be calibrated across to market activity across products and across DCMs. Furthermore, all trades should be weighed equally regardless of whether a firm sends the messages on an agency basis or principal basis. For registration purposes, FCM's should be tasked with monitoring proposed metrics and communicating these metrics to the CFTC because their "know your customer" rules make them the most fit.

Source Codes

Perhaps the most important and effective provision in the proposed rule is the requirement that firms maintain their source code, and make it available to the CFTC upon request. Source codes are merely trading instructions which are routine for firms to include in its books and records. Therefore, it would be unreasonable and inappropriate to require the Commission to first obtain a subpoena as some have advocated.

As is clear from the Proposed Rule, the outcry over claimed potential risks to intellectual property are unfounded and alarmist because no firm is required to make any part of their code public or submit it for unsolicited examination or approval. Importantly, hysterical and baseless claims aside, the clear and many benefits arising from the Commission's ability to perform post-mortems after disruptive market events far outweigh any legitimate concerns, which haven't been proffered. One must only consider the inordinate time it took market regulators to investigate, assess and report on the supposed causes of the Flash Crash. Taking any action that would result in regulators piecing together market data post hoc would be irresponsible.

There are also regulatory benefits to source code access beyond crash or crisis scenarios. Many types of predatory or manipulative behavior may be simply unidentifiable using most conventional reported market data. Bids, offers, and – crucially – order cancellations can all be required in concert to reconstruct the manipulative behavior such as the type of front-running conducted by predatory HFT firms. Such behavior cannot be easily monitored and likely would not be found unless the regulator knew what to look for. Hence, it is crucial that regulators have access to HFT algorithm source code, rather than facing the impossible task of reconstructing manipulative algorithms from market data alone. This is likely the real reason why some industry participants are making baseless objections to the Commission's need for this very limited and wholly justified access to source codes.

Moreover, the Commission should require that the source code information be made available real time, but also be archived upon any material update. By proceeding in this way, the CFTC would not face the Sisyphean task of deciphering algorithms from a standing start after a disaster has happened. Instead, the firms themselves would be required to maintain historic snapshots of all algorithms, which would also ideally be required to be translated into plain language with severe penalties for misrepresenting the design or operation of the algorithms.

This would not only facilitate investigating market anomalies as well as potential misconduct, but it would also enable the CFTC to make informed, data-driven decisions about appropriate regulation without having to rely on self-interested markets participants talking their book or without an adequate data set. Notably, there has not been a single instance where regulators have abused this type of oversight. Our markets and investors deserve no less. And, they deserve it before the next computer driven market calamity.

Direct Electronic Access

The Commission's proposed definition of direct electronic access (DEA) does encompass all types of access commonly understood in Commission-regulated markets as "direct market access." The Securities and Exchange Commission (SEC) uses a definition generally broader than the Commission's definition of DEA, but the proposed definition benefits from the consistency with the definition used in numerous other CFTC regulations. Accordingly, the Commission need not define sub-categories like the SEC.

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However, the content in footnote 202 of the Proposal must be included in the "DEA" definition because the content clarifies the Commissions analysis when categorizing DEA. As such, the definition of DEA should read as follows:

"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 DCO to which the DCM submits transactions for clearing.

The analysis hinges on the following factors, with the first factor being controlling and the remaining factors not determinative alone to satisfy the definition:

  a.   submission of an order to a DCM without the order first being routed through a separate person who is a member of a DCO to which the DCM submits transactions for clearing;

  b.   Co-location; or

  c.   Use of FCM-provided software"

Moreover, the Commission should explicitly define the term "routed" in the "DEA" definition to provide regulatory certainty for market participants and prevent regulatory arbitrage when the rule is finalized. The concept of routing is so fundamental to the precise meaning of DEA that it is important for the Commission to define the term.

Furthermore, we agree with the Commission that the proposed 1.3(yyy) DEA definition is more technical than § 38.607 and § 48.2(c). As such, all existing definitions should be harmonized with the proposed definition.

Whether or not the Commission agrees with the exact definition above, failing to adequately monitor automated trading would contradict its expressed goals and commitments. For this reason, all automated trading persons – under some workable definition – ought to be required to register with the CFTC. This would not be particularly burdensome for the firms in question. Therefore, the Commission should require them to do so for transparency and orderly markets.

Exclusion of Trades Conducted on Swap Execution Facilities

While not discussed at the Regulation AT Roundtable, we remain concerned at the exclusion of trades executed on Swap Execution Facilities ("SEFs") from the provisions of the Proposed Rule. Therefore, we continue to urge the Commission to revisit the swaps execution facility exclusion in this Proposal periodically to reassess its appropriateness as the swaps markets continues to evolve.

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CONCLUSION

We hope these comments are helpful.

Sincerely,

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