BETTER MARKETS

May 1, 2017

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

Re: Regulation Automated Trading RIN 3038–AD52

Dear Mr. Kirkpatrick,

Better Markets Inc.[1] appreciates the opportunity to file this comment on the above-captioned Supplemental Proposal Regulation Automated Trading ("Supplemental Proposal" or "Supplemental"), issued by the Commodity Futures Trading Commission ("CFTC" or "Commission").

INTRODUCTION

The shift to a world of primarily electronic trading is causing major changes in the way markets operate. The many resulting benefits of this shift, in speed of execution and streamlining of market operations, are tempered by the significantly increased risk of major market disruptions and the potential for systematic exploitation of retail and other investors. As they become able to facilitate greater volumes of trades faster than ever before, exchanges and Designated Contract Markets ("DCMs") and their most powerful customers may find their interests aligned against those of the rest of the market, and short-term profit may be prioritized over the long-term stability and fairness of the financial markets.

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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, one that protects and promotes Americans' jobs, savings, retirements, and more.

The Commission has taken a number of regulatory steps to begin addressing these concerns. The Commission initially proposed a rule on automated trading in November of 2015, which had essentially three parts: 1) registration requirements; 2) compliance standards; and 3) source code access requirements ("Initial Proposal"). The Initial Proposal is an important step towards modernizing regulation to account for the electronic developments in the markets. While it does not seek to fundamentally alter current market practice, it succeeds in serving as a broad framework for identifying market participants and collecting data, which lays the foundation for a more robust regulatory regime in the future.

The basic elements of the Initial Proposal are sound, as we have discussed in our prior comment letters.[2] The requirement for registration of Automated Trading firms is common sense and straightforward. Additionally, the implementation of a quantitative threshold for identifying AT Persons will capture the firms that are responsible for substantial amounts of automated trading in our markets. Furthermore, we were pleased to see the focus on several important safeguards that we have advocated for in the past,[3] such as the access to algorithm source code.

The Commission followed its Initial Proposal with a roundtable in June of 2016 to further explore issues surrounding automated trading, and it solicited additional comment on the specific topics discussed at the roundtable. In November of 2016, the Commission issued the Supplemental Proposal. As explained below, it included some changes that weakened the Initial Proposal in some respects, and it failed to include some still-missing elements. Finally, it extended the comment period an additional ninety days until May 1, 2017.

SUMMARY OF COMMENTS

The Supplemental Proposal has significant drawbacks. The single most important and disappointing aspect of the Supplemental is that it weakens the source code provisions. Additionally, it does not make some of the important changes that are necessary with respect to source code access and which we have previously advocated for. Moreover, while we support the Supplemental's volume-threshold test as an appropriate means of identifying those market participants who should qualify as AT Persons, we argue that there is room for improving this test. Finally, we urge the Commission to adopt the Proposal's multi-layered approach, as opposed to the Supplemental's two-tiered approach.

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[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 Better Markets "Comment letter on proposed regulation automated trading," *available at* https://www.bettermarkets.com/rulemaking/better-markets-comment-letter-cftc-regulation-automated-trading.

[3]   *See* Better Markets Comment letters cited *supra* n. 2.

COMMENTS

The Commission should require that source codes be more readily accessible, archived, updated, and appropriately translated.

Perhaps the most important and effective provision in the Initial Proposal is the requirement that firms maintain their source code and make it available to the Commission upon request. Source codes are trading instructions that firms routinely include in their books and records. Therefore, it would be unreasonable and inappropriate to require the Commission to first obtain a subpoena to obtain access to those codes, as some have advocated.

Unfortunately, the Supplemental Proposal removes the Initial Proposal's requirement that source codes be maintained in a repository.[4] And it requires the Commission itself to make the decision to require firms to provide source code access.[5] In other words, no staff member can do so without Commission approval. This is a significant departure from the standard practice, which allows staff to seek access to information that registrants are required to preserve without a subpoena or specific Commission authorization. The Commission could authorize the staff to seek such access either by means of a subpoena or a special call.[6] Thus, the process could be designed to require the same level of Commission review that comes with the issuance of a subpoena, even if the information is sought for general surveillance purposes.

We urge the Commission to retain the provisions in the Initial Proposal. Those favoring the change raised concerns about potential risks to intellectual property, but those fears are unfounded and alarmist because under the Initial Proposal, no firm would be required to make any part of their code public or submit it for unsolicited examination or approval. Importantly, baseless claims aside, the clear and many benefits arising from the Commission's ability to perform post-mortems quickly and efficiently after disruptive market events far outweigh any legitimate concerns, which have not been proffered. One need only consider the inordinate time it took market regulators to investigate, assess, and report on the causes of the Flash Crash. Taking any action that would hamper the ability of regulators to reconstruct market events 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 conventionally reported market data. Bids, offers, and—crucially—order cancellations may be required in concert to reconstruct the manipulative behavior such as the type of front-running conducted by predatory high frequency trading ("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

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4   Release at 85349.
5   *Id.*
6   *Id.*

participants are making baseless objections to the Commission's need for this carefully controlled, very limited, and wholly justified access to source codes.

Moreover, the Commission should require that the source code information be made available real time and also 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 historical snapshots of all algorithms. In addition, firms should be required to translate their codes into plain language and face stiff penalties for misrepresenting the design or operation of the algorithms.

This would not only facilitate investigating market anomalies as well as potential misconduct, but 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 having 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.

<u>The Commission should strengthen the method for applying the quantitative threshold test for AT Person registration, and it should retain the important anti-evasion provision.</u>

The requirement for registration of Automated Trading firms is common sense and straightforward. More specifically, we believe that the Supplemental's requirement of implementing a volume-threshold test for AT Person registration is appropriate because this threshold test would identify those market participants responsible for substantial amounts of automated trading in the derivatives markets. Moreover, it is appropriate that the firms responsible for a substantial portion of trades in the derivatives markets should have heightened regulatory requirements relative to small firms only entering a handful of trades a day. Finally, this would ultimately make the proposal more akin to a supervisory regulation over high frequency trading, as we have advocated for in the past.[7]

Under the Supplemental Proposal, the volume-threshold test would require potential AT Persons to determine whether they trade an aggregate average daily volume of at least 20,000 contracts for their own account, the accounts of customers, or both.[8] The Commission notes that this requirement would also capture those currently unregistered market participants who primarily trade for themselves.[9] Additionally, the Supplemental Proposal clarifies that a potential AT Person would be required to calculate their aggregate daily volume across all products of all DCMs on which they trade.[10] Moreover, the Supplemental specifies that the average daily volume would be calculated in six-month

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[7] *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.

[8] Release at 85342.

[9] *Id.*

[10] *Id.*

periods.[11] The average daily value would be calculated based on all trading days in that period, as opposed to the market participants' specific trading days.[12] Further, the Supplemental Proposal specifies that a potential AT Person must aggregate contracts conducted by all entities controlled by the trader.[13] Finally and notably, the Supplemental Proposal contains an anti-evasion provision intended to prevent persons from trading through multiple vehicles in an effort to avoid having to register as an AT Person and, thus, being subject to the requirements applicable to AT Persons.[14]

While we support the Supplemental's volume-threshold test as an appropriate means of identifying those market participants who should be treated as AT Persons, there is room for improving the test. The Supplemental's proposed volume-threshold test requires a potential AT Person to determine whether it trades an aggregate average daily volume of at least 20,000 contracts over a six-month period.[15] Instead, we urge the Commission to require calculation only over the days the potential AT Person actually trades during the six-month period. This would result in also capturing those market participants who trade in large amounts, but infrequently over the course of a six-month period. This is fundamental because it takes only one day of excessive risky trading for the derivatives markets to crash. Any person engaged is such trading volume, albeit infrequently, therefore poses the very type of risk that the AT threshold test is intended to address.

Additionally, assuming the final rule is effective before July 1, 2017, we urge the Commission to establish the first measurement period as July 1 through December 31, 2016. That way, market participants will not have the opportunity to design trading schemes to avoid the threshold. As a result, the final rule would truly capture those entities that satisfy the minimum 20,0000 daily average of trading contracts threshold, based on prior, unalterable data.

Furthermore, as with any substantial change in regulatory policy, any future changes to the volume threshold deemed appropriate by the Commission should remain subject to the Administrative Procedures Act's notice and comment requirements. The public should have the opportunity to weigh in on any potential changes to the volume-threshold test to ensure that the public interest is adequately protected in the process.

Finally, we would like to commend the Commission for its decision to add an anti-evasion component to this Supplemental Proposal. We are pleased with the Commission's proactiveness in preventing market participants whose trading volume would otherwise fall within the threshold from evading registration requirements by shifting trades to multiple entities it controls. It is very important that algorithmic and electronic trading are properly

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11   *Id.*
12   *Id.*
13   *Id.*
14   Release at 85343.
15   Release at 85342.

supervised and that those market participants that do conduct substantial amounts of such trades are subject to the CFTC's heightened supervisory and regulatory requirements.

<u>The Commission should retain the three-tiered approach to pre-trade risk controls set forth in the Initial Proposal, and it should adopt a one-second resting period for all orders.</u>

While the proposed pre-trade risk controls are essentially a codification of the most broadly-used current industry practices, they represent a strong foundation for ensuring that the most obvious safeguards are in place and mandated to protect markets from the risks of automated execution.

Ultimately, however, the Commission must move beyond principles and establish a more prescriptive regime governing risk controls. The Initial Proposal and the Supplemental Proposal generally adopt a "principles-based approach,"[16] only specifying that firms develop and employ the enumerated controls, and do 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 ensure that these limits or practices are effective, both on an individual firm level and in terms of the collective effect of those individual levels on the market as a whole. Stronger and more prescriptive requirements, such as minimum resting periods, should ultimately be required to ensure stability in these markets.

Turning to more specific concerns about the risk control provisions, unlike the Initial Proposal, the Supplemental would require that pre-trade risk controls be implemented at only two levels: 1) at the AT Person **or** FCM level; and 2) at the DCM level.[17] This is a departure from the Initial Proposal's required three distinct levels of controls: 1) The AT Person level; 2) the FCM level; and 3) the DCM level. Specifically, under the Supplemental Proposal, AT Persons would have the option to delegate pre-trade risk control responsibility to an executing FCM.[18] If this approach is adopted, then pre-trade risk controls might not be established at the AT Person level.

We urge the Commission to restore the Initial Proposal's three-layered approach, as opposed to the Supplemental's two-tiered approach. We believe that the multi-layered approach outlined in the Initial Proposal, which imposes unavoidable requirements at the AT Person, FCM, and DCM levels, is the most prudent way to reduce the potential risks of algorithmic and electronic trading. First, it is more consistent with the basic rationale underlying any multi-layered approach. As the Release explains, it is important to have "backstops" in place "to mitigate the possibility" of trading disruptions[19]—which can have severe consequences on investors, on the stability of the markets, and on investor

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16   Release at 85353.
17   *Id.*
18   *Id.*
19   *Id.*

confidence. A third layer simply provides an additional backstop. A number of commenters have made this point.[20]

Second, the added layer is important because the Commission's basic approach to risk controls is heavily principles-based. As explained in the Release, the "Supplemental proposed rules continue to provide discretion in how entities design and calibrate the controls."[21] Given this degree of discretion, the added layer becomes all the more important to help ensure that risk controls are adequate even though their content is not mandated.

Finally, the three-tiered approach is optimal from the standpoint of information access and expertise. As observed in the Release, DCMs do not have sufficient information to set controls at the market participant level.[22] It is reasonable to conclude that **each** category of market participant—AT Persons, FCMs, and DCMs—brings a unique data set and perspective to the task of setting risk controls, and each has something valuable to contribute to that process.

In short, removing one layer of risk controls through the delegation to FCMs envisioned in the Supplemental results in an incomplete regulatory supervision of the algorithmic and electronic trading market.

Finally, we urge the Commission to adopt regulations that 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 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.

The Commission should eliminate the exclusion for trades conducted on swap execution facilities from the provisions of the Initial Proposal, or at least reconsider its position periodically as the swaps markets evolve.

While not discussed in the Regulation AT Supplemental Proposal, we remain concerned at the exclusion of trades executed on Swap Execution Facilities ("SEFs") from the provisions of the Initial Proposal. Therefore, we continue to urge the Commission to revisit the SEF exclusion at least periodically to reassess its appropriateness as the swaps markets continue to evolve.

[20] Release at 85354 (citing two commenters arguing that "multiple risk filters across different entities may reduce the probability that a wrong message reaches the market").
[21] Release at 85353.
[22] Release at 85355; *see also id.*at 85356 (contrasting the different levels of information, capacity, and focus that FCMs and DCMs apply when addressing risk controls).

CONCLUSION

We commend the Commission for carefully weighing its approach to the oversight and regulation of automated trading. A strong and effective rule that protects the markets, eliminates flash-crashes, and ensures fairness for all market participants is what the Commission should continue to strive for. We hope these comments are helpful.

Sincerely,

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