

August 24, 2020

VIA ELECTRONIC SUBMISSION

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

**Re: Notice of Proposed Rulemaking, *Electronic Trading Risk Principles*,
RIN 3038-AF04**

Dear Secretary Kirkpatrick:

I. INTRODUCTION.

On behalf of The Commercial Energy Working Group (the “**Working Group**”), Eversheds Sutherland (US) LLP hereby submits this letter in response to the request for public comment set forth in the Commodity Futures Trading Commission’s (the “**CFTC**” or “**Commission**”) Notice of Proposed Rulemaking, *Electronic Trading Risk Principles*, published in the *Federal Register* on July 15, 2020, which proposes to amend Part 38 of the CFTC regulations for purposes of adopting a flexible, principles-based approach designed to detect, prevent and mitigate “market disruptions” and “system anomalies” resulting from electronic trading activities (the proposed “**Risk Principles**”).¹

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. Among the members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

¹ Notice of Proposed Rulemaking, *Electronic Trading Risk Principles*, 85 Fed. Reg. 42,761 (July 15, 2020) (“**ET NOPR**”).

The Working Group supports the Commission's continued efforts to develop a suitably-tailored framework for regulating electronic trading activity that is intended to preserve market integrity, in part, by ensuring the implementation of appropriate pre-trade risk and other controls throughout the futures transaction chain. The Working Group members participate in commodity futures markets primarily as commercial hedgers. In this capacity, members use futures contracts to protect against exposure to price volatility and risks associated with their respective obligations to produce, process, purchase, merchandize, and deliver physical energy commodities to others.

As commercial hedgers, Working Group members utilize various types of order management functionality to electronically route orders to designated contract markets ("DCMs"), whether through the use of manual point and click or more basic forms of automated order management functionality including, but not limited to, the use of excel spreadsheets, auto-spreaders, iceberg/reserved quantity orders, and order cancels order functionality. This electronic trading activity is distinguishable from proprietary, order generation systems that automatically generate and send orders to a DCM using software configurable only through the manipulation of source code where parameters regarding time, price, quantity, and how the model can be employed are not subject to the system owner's discretion. Further, similar to other commercial firms, Working Group members access DCMs' electronic trading platforms using order routing infrastructure provided by the DCMs themselves, independent software vendors ("ISVs") or futures commission merchants ("FCMs"), which, at all times, are subject to multiple layers of pre- and post-trade risk and other controls throughout each segment of the transaction chain (*i.e.*, over the lifecycle of a trade).

The Working Group has been an active participant in prior rulemaking proceedings focused on the regulation of automated trading activity and appreciates the Commission's willingness to withdraw its Prior Proposals in favor of a principles-based approach that utilizes DCMs, in their role as self-regulatory organizations, to provide oversight of trading on their electronic platforms.² Subject to certain limited clarifications requested herein, the Working Group believes the ET NOPR will complement and enhance current and future DCM practices addressing electronic trading risks by reducing the risk of market disruptions and building on the industry's continuing efforts to mitigate the evolving set of risks associated with the use of electronic trading. With this in mind, the Commission should act to issue a final rule implementing the ET NOPR as soon as possible.

² See Notice of Proposed Rulemaking, *Regulation Automated Trading*, 80 Fed. Reg. 78,824 (Dec. 17, 2015) ("**Reg. AT Proposal**"); Supplemental Notice of Proposed Rulemaking, *Regulation Automated Trading*, 81 Fed. Reg. 85,335 (Nov. 25, 2016) ("**Reg. AT Supplemental Proposal**"). Collectively, the Reg. AT Proposal and Reg. AT Supplemental Proposal are referred to as the "**Prior Proposals**." See also The Commercial Alliance, Comments on Regulation Automated Trading, Notice of Proposed Rulemaking, RIN 3038-AD52, (Mar. 16, 2016); The Commercial Energy Working Group, Comments on Regulation Automated Trading, Supplemental Notice of Proposed Rulemaking, RIN 3038-AD52 (May 1, 2017) ("**May 2017 Comments**").

II. COMMENTS OF THE COMMERCIAL ENERGY WORKING GROUP.**A. THE PROPOSED RISK PRINCIPLES ALLOW FOR THE APPLICATION OF A WORKABLE REGULATORY FRAMEWORK THAT CAN EVOLVE WITH FUTURE TECHNOLOGICAL AND MARKET DEVELOPMENTS.**

The Working Group fully shares the sentiment expressed in the ET NOPR that the Commission, DCMs and market participants all have a mutual and common interest in adopting a regulatory paradigm that facilitates equitable and orderly trading on electronic platforms. Consistent with its May 2017 Comments, the Working Group continues to believe that DCMs are best positioned to (i) develop best practices for implementation of appropriately-tailored risk controls for electronic trading activities, (ii) assess potential risks from electronic trading activities, and (iii) modify the best practices in a timely manner to account for rapidly changing technologies and markets.³ In this respect, the ET NOPR and proposed Risk Principles largely capture prior recommendations of the Working Group that the Commission pursue a DCM-centric, principles-based approach to regulating electronic trading guided, at a minimum, by the following precepts:

- A minimal set of principle-based standards should be adopted that reflect the Commission's policy objective of protecting market integrity, while leaving the actual compliance with such standards to the discretion of the different persons in the futures transaction chain;⁴
- Existing risk controls utilized by the different persons in the futures transaction chain should be recognized and the imposition of duplicative requirements should be avoided;
- Flexibility in tailoring and updating specific policies and procedures to address the unique sets of risks faced by different persons in the futures transaction chain should be provided;
- Proactive adaptation to changing technological developments in electronic trading and industry efforts to protect markets through further innovation in risk controls and system safeguards should be encouraged; and
- DCMs should be utilized to establish and oversee electronic trading activity within their markets and, as deemed necessary and appropriate, the DCMs' authority under their Core Principles to facilitate such oversight of automated trading should be expanded.⁵

³ May 2017 Comments at 9.

⁴ See FIA, Principle Traders Group, Recommendations for Risk Controls for Trading Firms (Nov. 2010), <https://fia.org/articles/fia-ptg-recommends-risk-controls-trading-firms> ("FIA Risk Control Paper").

⁵ May 2017 Comments at 9-10.

DCMs are particularly well equipped to identify the controls needed to mitigate evolving risks on their markets and ensure that all market participants interconnecting with the DCM's Application Programming Interface or submitting orders through their central limit order book have adopted such controls. Pursuant to regulatory obligations under the existing DCM Core Principles set forth in Part 38 of the CFTC regulations, DCMs have developed a baseline of risk control systems for their markets and require as a condition of participation in their markets the implementation of such controls.⁶

With this in mind, the Working Group agrees with the Commission that the DCMs currently address most, if not all, of the electronic trading risks presented to their platforms through the implementation of pre-trade risk controls, due diligence and testing requirements prior to utilizing certain connectivity methods, and risk mitigation measures designed to respond to real-world events, including actual or potential disruptions to their markets.⁷ Because many market participants across the futures transaction chain currently employ pre-trade risk and operational controls, such as order size limits, outbound order message rate limits, automated execution throttles, effective trade monitoring, stop logic functionality, kill switches, and cancel on disconnect functionality, DCMs are and will continue to be uniquely positioned to leverage and build upon these best practices and controls. The amendments to Part 38 proposed in the ET NOPR will only further enhance the ability of DCMs to facilitate a collaborative process to develop and update industry best practices for electronic trading.

B. THE COMMISSION SHOULD PROVIDE FURTHER HIGH-LEVEL GUIDANCE WITH RESPECT TO EVENTS CONSTITUTING "MARKET DISRUPTIONS" OR "SYSTEM ANOMALIES" TO MINIMIZE THE POTENTIAL FOR REGULATORY UNCERTAINTY.

The ET NOPR declines to adopt static regulatory definitions for terms "market disruptions" and "system anomalies." The decision to forego such definitions makes sense in the context of the policy objectives of the ET NOPR which, in part, are intended to provide DCMs with flexibility to apply the Risk Principles in manner that evolves over time with related technological and market developments.⁸ Specifically, the ET NOPR states that a "market disruption" would include "an event originating with a market participant that significantly disrupts the (i) operation of the DCM on which such participant is trading; or (ii) the ability of other market participants to trade on the DCM on which such participant is trading."⁹ Whereas the ET NOPR describes "system anomalies" as including "unexpected conditions that occur in a market participant's functional system which cause a similar disruption to the operation of the DCM or the ability of market participants to trade on the DCM."¹⁰

⁶ For example, existing CFTC regulation 38.255 (Risk Controls for Trading), which falls under DCM Core Principle No. 4, and Appendix B to Part 38 provide principles-based regulation that allows DCMs the authority and flexibility to protect their markets as they deem appropriate. Consistent with existing CFTC regulation 38.255, DCMs have established many of their current risk controls and safeguards for automated trading on their markets.

⁷ ET NOPR at 42,764.

⁸ ET NOPR at 42,765.

⁹ ET NOPR at 42,765. For purposes of the Risk Principles, the guidance clarifies that the phrase "operation of the DCM" specifically refers to a DCM's order processing and execution functions.

¹⁰ ET NOPR at 42,765.

Although the general preamble discussion serves as very high-level guidance related to the application of the proposed Risk Principles in the context of today's electronic markets, further direction as to the type and nature of events is needed to mitigate the creation of potential uncertainty with respect to the interpretation of these terms by DCMs and market participants alike. The Working Group recognizes that it is neither practical nor feasible for the Commission or the DCMs to provide black letter guidance setting forth an enumerated list of examples that would definitively constitute "market disruptions" and "system anomalies." However, the gap between events identified in the ET NOPR that are potentially viewed as disruptive and those that are not is so broad it makes consistent interpretation difficult.

Specifically, the ET NOPR states that a malfunction of a market participant's automated trading system, on its own, would *not* be considered disruptive, **unless** there is some significant consequence that materially impacts the ability of other market participants to execute trades, engage in price discovery, or manage their risk.¹¹ While the Working Group appreciates the need for flexibility in order to apply the Risk Principles to evolving market developments, the ET NOPR does not appear to recognize that, given operational nuances between different forms of electronic trading functionality, a disruptive event could have a significant and material impact on the market in one context, but not in another. For example, events causing a one to two second delay in the processing and execution of orders on a DCM could be deemed to constitute a market disruption by firms utilizing ultra-low latency, algorithmic trading functionality, but may not be viewed in the same way by firms utilizing manual, point and click trading or more basic forms of automated order management functionality and, by extension, the required pre-trade and other risk controls intended to prevent such types of disruption events would be viewed differently.

Given that the policy objective of the Risk Principles is to detect, prevent or mitigate events that can disrupt the order processing and execution functions of DCMs, as well as downstream impacts on the ability of other market participants to transact, any final rule issued in this proceeding should, at a minimum, take notice of the diversity of market perspectives with respect to what types of events may constitute a market disruption.¹² Such recognition will help promote uniformity in the interpretation of these terms among different classes of market participants and, by implication, in the implementation of appropriate pre-trade and other risk controls and enforcement of applicable standards.

C. A STANDARD OF CARE SHOULD BE APPLIED TO SIGNIFICANT DISRUPTIONS THAT ARE REPORTABLE BY DCMs UNDER PROPOSED RISK PRINCIPLE 3.

Risk Principle 3, which is embodied in proposed CFTC regulation 38.251(g), requires that a "DCM must promptly notify Commission staff of a significant disruption to its electronic trading platform(s) and provide timely information on the causes and remediation."¹³ As proposed, Risk Principle 3 appears to apply a *per se* standard for the reporting of certain significant market disruptions to the CFTC by DCMs which would leave market participants open to potential enforcement risk, including civil penalties, for violations that were neither (i) the result of knowing and willful conduct, (ii) negligent in some capacity, or (iii) the result of reckless behavior.

¹¹ ET NOPR at 42,765.

¹² ET NOPR at 42,765. The Working Group requests that such guidance more clearly distinguish between the type of disruptive trading events that would fall within the Commission's prohibition on disruptive trading practices under Section 4c(a)(5) of the Commodity Exchange Act ("CEA") and related DCM rules (*i.e.*, CME Rule 575 and ICE Futures US Rule 4.02).

¹³ ET NOPR at 42,768.

The adoption of a standard of care for events that are reportable to the Commission is appropriate given the comprehensive and continuing oversight of electronic trading activity provided to DCMs through the proposed amendments to CFTC regulation 38.251(e)-(g).¹⁴ The ET NOPR explicitly recognizes that DCMs are presently addressing most, if not all, of the electronic trading risks on their platforms through the implementation of pre-trade risk controls, due diligence and testing requirements prior to utilizing certain connectivity methods, and risk mitigation measures designed to respond to real-world events, including actual or potential disruptions to their markets.¹⁵

Accordingly, the Working Group recommends that the text of Risk Principle 3 as set forth in proposed CFTC regulation 38.251(g) be revised as follows:

(g) Promptly notify Commission staff of any significant disruptions to its electronic trading platform(s) resulting from grossly negligent or reckless conduct with respect to a market participant's obligations to implement and maintain pre-trade risk controls, conduct due diligence or testing, as well as appropriate risk mitigation measures consistent with applicable DCM rules or accepted industry practices related to electronic trading activity and provide timely information on the causes and remediation of such significant disruptions.

D. MARKET PARTICIPANTS SHOULD NOT BE HELD RESPONSIBLE FOR DISRUPTIONS CAUSED BY ERRORS OR MALFUNCTIONS OF TRADING SYSTEMS LICENSED FROM THIRD-PARTY PROVIDERS.

The ET NOPR's discussion of proposed Risk Principle 1 and 2 focuses on DCM rules and requirements that apply to market participants. In addition, the broad discussion of "market disruption" or "system anomalies," including the reporting requirement under proposed Risk Principle 3, are directed solely at events that occur on trading systems operated by market participants. However, the ET NOPR does not recognize that a substantial number of commodity market participants, including commercial energy firms, utilize trading software or order management functionality licensed from third-party vendors, such as DCMs, ISVs or FCMs ("Third-Party Systems") to facilitate trading on electronic platforms operated by DCMs.¹⁶ Often, commercial energy firms and other market participants do not have rights to access source code to modify or otherwise customize the operation of such Third-Party Systems.

¹⁴ Market participants' operating their electronic trading systems with appropriate risk controls in place and consistent with industry best practices should not be exposed to potential enforcement risk resulting from an outage or some form of technical malfunction whose occurrence is simply outside of their immediate control – and not the result of a negligent or reckless act or omission. To illustrate this point, a malfunction of an otherwise properly operated trading system resulting in a large volume of non-actionable messages to a DCM central limit order book caused by an error in a version of an existing software application resulting in significant market disruption should not be subject to mandatory reporting under Risk Principle 3. However, if a similar incident is triggered not by a software error or malfunction, but by negligent or reckless conduct of the market participant (whether through system modifications that failed to meet best practices or the wholesale failure to implement certain risk controls), then conduct should be brought to the Commission's attention by DCMs.

¹⁵ ET NOPR at 42,762.

¹⁶ Such Third-Party Systems may include, but are not limited to, DCM-licensed software or functionality such as CME Direct or ICEWeb, as well as order management functionality systems licensed by ISVs such as Bloomberg, Trading Technologies or Quick Screen Trading.

Accordingly, any final rule issued in this proceeding should clarify that market participants without access rights to source code used to operate these systems should not be subject to (i) any DCM-imposed requirements to implement updates, test or monitor the operation of such software, or (ii) DCM-imposed requirements under Risk Principle 3 to implement remediation measures for software.¹⁷ Rather, the owners of Third-Party Systems (e.g., the DCMs or ISVs) should be subject to DCM-imposed requirements adopted under proposed Risk Principles 1 and 2.

E. ALL DCM RULES APPLICABLE TO MARKET PARTICIPANTS ADOPTED PURSUANT TO RISK PRINCIPLES 1 AND 2 SHOULD BE SUBJECT TO COMMISSION REVIEW AND APPROVAL UNDER CFTC REGULATION 40.5.

As proposed, the ET NOPR states that any new market rules intended to facilitate compliance with proposed Risk Principles 1 and 2 must either be (i) submitted for Commission review and approval under CFTC regulation 40.5, or (ii) subject to a DCM self-certification process under CFTC regulation 40.6. Given the vast difference in types of market participants, asset classes, and electronic trading functionality utilized on DCM markets, it is imperative that a transparent regulatory process be implemented for purposes of ensuring new market rules proposed by DCMs are appropriately tailored in their scope and applicability (*i.e.*, pre-trade risk controls applicable to high-frequency, low latency algorithmic trading systems would not be appropriate for more basic types of automated trading management systems). Any final rule issued in this proceeding should recognize the need for such transparency and direct that new market rules be submitted for prior CFTC review and approval pursuant to CFTC regulation 40.5.¹⁸

III. CONCLUSION.

The Working Group appreciates the opportunity to provide comments on the ET NOPR and requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding. The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

If you have any questions, or if we can be of further assistance, please contact the undersigned.

Respectfully submitted,
/s/ R. Michael Sweeney, Jr. _____

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¹⁷ The Working Group notes that market participants would still be responsible for pre-trade risk controls that are internal to their trading operations and would have responsibility for any modifications made Third-Party System source code intended to customize such electronic trading functionality to their own trading operations and strategy.

¹⁸ In the alternative, the Working Group recommends that the Commission consider requiring DCMs to implement a stakeholder process prior to self-certification under CFTC regulation 40.6