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via fax

Christopher Kirkpatrick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581  
202-418-5521, fax

Re: RIN 3038–AF04, Electronic Trading Risk Principles

Dear Mr. Kirkpatrick,

Commenting on the above referenced Notice of Proposed Rulemaking (the “NPRM”) concerning the Commodity Futures Trading Commission’s (“CFTC” or “Commission”) principles regarding electronic trading risks.

In this NPRM, the Commission rejects the more active regulatory approach to electronic trading taken in the previous Reg AT (withdrawn simultaneously with the introduction of this NPRM) and instead delegates the core elements of electronic trading oversight to for-profit exchanges under a “principles-based” approach. This is reminiscent of the way in which the Commission recently moved to delegate the power to define crucial elements of its position limits regime to for-profit exchanges, although this case is even more extreme.

The core assumption in these and other cases appears to be that the incentives of trading facilities (DCMs) are fully aligned with those of public regulators in limiting speculative and trading practices that could threaten market integrity. We strongly dispute this assumption. It is true that DCMs have incentives to police themselves sufficiently to appear reliable and avoid some of the worst kinds of market disruption. But they are also economically dependent on the order flow provided by large traders and are in direct competition with other venues to capture that order flow. This creates a conflict of interest in which DCMs may be motivated to accommodate the interests of large brokers and traders even when such interests involve excessive risks to market integrity. Managing this conflict requires significant public regulatory oversight of DCM market practices. Pure self-regulation is not enough.

The “electronic trading principles” framework laid out here is dangerously close to pure self-regulation. The NPRM begins by assuring the reader that “the Risk Principles may not necessitate the adoption of additional measures by DCMs”, that they are based “largely on existing DCM and industry practices”, and that they “would not create any form of strict liability for the exchanges in the event that...disruptions or anomalies occur notwithstanding such rules or controls”. So the message is that the Principles will likely not require changes in DCM practices and that even if the claimed implementation of the Principles is ineffective in preventing electronic trading market disruptions the DCM will not be liable. The statement

regarding liability is especially concerning since it seems to offer up the existence of this new principles-based framework as a defense against legal liability under common law. Stating that DCMs will not be liable for failed implementation of the Principles also appears to reject systematic outcomes-based assessment of DCM practices in the electronic trading area. This seems to signal that the Commission is not committed to effective enforcement of the principles, since outcomes-based assessment is one of the few potentially effective ways to enforce compliance with a principles-based approach.

The NPRM does not contain any systematic analysis demonstrating that current DCM practices are effective in controlling the risks of market disruptions due to electronic trading, nor even a systematic assessment of the current costs of such disruptions. The Commission has previously established that "flash crash" type disruptions are common.

In Section II.A footnotes 9, 11, and 15 the NPRM does give three examples out of the past decade of the CME group levying penalties for electronic trading violations on its platforms. Yet these scattered instances hardly constitute proof that such penalties are effective in deterring misconduct. The NPRM does not mention that the exchange-imposed fines for these violations were in each case well under \$100,000, nor does it attempt to compare these fines to the magnitude of gains that might have been created due to the misconduct.

An examination of the Principles themselves deepens the impression that they are essentially self-regulatory. The three principles state that the DCM must:

- 1) Adopt and implement rules governing market participants subject to its jurisdiction to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading;
- 2) Subject all electronic orders to exchange-based pre-trade risk controls to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading;
- 3) Promptly notify Commission staff of any significant disruptions to its electronic trading platform(s) and provide timely information on the causes and remediation.

The rule further provides that in order to comply with these principles the DCM must "adopt and implement rules that are reasonably designed to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading" and "must subject all electronic orders to exchange-based pre-trade risk controls that are reasonably designed to prevent, detect, and mitigate market disruptions or system anomalies."

The sole content here appears to be a mandate that the DCM must somehow address electronic trading risks using some type of pre-trade risk controls and must inform the Commission when these controls fail to prevent a "significant" disruption to trading. The only way in which the Commission will judge the actual substance of the controls is by assessing whether they are "reasonably designed" to prevent market disruptions. Otherwise, the Commission remains entirely agnostic as to the nature of risk controls, and even as to what might constitute a "significant" disruption to trading.

This level of delegation in an area of central importance to today's markets is simply inappropriate. I support the recommendations of the Institute for Agriculture and Trade Policy (IATP) as to creating more substantive guidance for the enforcement and nature of risk controls. If the Commission does not currently have the capacity to issue such substantive guidance, it must engage in an iterative process of monitoring and required reporting, including reporting of concrete outcomes, to determine and enforce best practices in a far more specific way than the vague principles described in this NPRM.

However, the vagueness of these principles and the lack of content in the NPRM beyond references to already existing law and DCM practices is such that it is difficult to offer specific recommendations for improvement. We concur with the judgement of Better Markets in their comment that this NPRM reads more as a pretext for the withdrawal of Reg AT than as a concrete set of recommendations for substantive regulation of electronic trading. We urge the Commission not to simply rely on these vague placeholder principles and assurances of DCM self-regulation in an area of such importance to 21st century markets. At the very least, the public has a right to expect that the Commission will hold DCMs strictly liable for the success or failure of their self-regulation in preventing market disruptions, and that the Commission will develop standards for automated trading risk controls that go beyond whether such controls are "reasonably designed" to prevent market disruptions.

Thank you for the opportunity to comment on the NPRM.

Yours sincerely,  
Robert E. Rutkowski

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