Ten Things You May Have Missed in the CFTC’s Proposed Regulation AT

On November 24, 2015, the Commodity Futures Trading Commission (CFTC) approved a notice of proposed rulemaking (the Proposal) designed to address various issues relating to algorithmic trading on Designated Contract Markets (DCMs). The Proposal, generally referred to as Regulation AT, runs more than 500 pages and contains 164 requests for comment from market participants. Once the Proposal is published in the Federal Register, the CFTC will allow 90 days for public comment.

The Proposal covers a lot of territory. It includes registration requirements, requirements covering pre- and post-trade risk controls, development, testing and monitoring of systems and training of personnel, and record-keeping and reporting requirements. It would impose requirements on market users, intermediaries and DCMs. While there are many important aspects of the Proposal, set out below are 10 things that we think may surprise you about the Proposal and may cause you to consider more closely its impact on your business and whether you should submit a comment letter to the CFTC before Regulation AT becomes final and effective.

1) Scope of New Registration Requirements. The proposed requirement for certain unregistered proprietary trading firms to now register as “floor traders” would cover those engaged in “Algorithmic Trading” (the definition of which is discussed in item 3 below) who have Direct Electronic Access (DEA) to a DCM. But the CFTC is seeking comments on the possibility of either broader or narrower registration requirements. The questions ask whether all those trading through DEA should be required to register, whether or not they engage in Algorithmic Trading. The questions also ask whether all those engaging in Algorithmic Trading should be required to register, whether or not they are using a DEA. On the other hand, they also ask whether the definition of a person required to register should be narrowed by de minimis standards for volume, order or messaging levels.

2) Registration of Principals. While the expectation is that these new registered floor traders will be entities, not individuals, the principals of these new floor traders would also have to register with the National Futures Association (NFA). The CFTC is seeking comments on whether its estimate of 10 principals for each new type of “floor trader” registrant is accurate. Principals include, but are not limited to: director, president, chief executive officer, chief operating officer, chief financial officer, chief compliance officer, or a person in charge of a business unit, division or function subject to regulation by the CFTC of a corporation, limited liability company or limited liability partnership; a manager, managing member or a member vested with the management authority for a limited liability company or limited liability partnership; and a person who is entitled to receive 10 percent or
more of a registrant’s net profits or has the power to exercise a controlling influence over a registrant’s activities that are subject to regulation by the CFTC.

3) **Scope of “Algorithmic Trading.”** The definition of “Algorithmic Trading” is quite broad, but could become much broader or somewhat narrower, depending on the path the CFTC determines to take. The proposed definition would include any “order, modification or order cancellation [that] is electronically submitted for processing” to a DCM, where

   one or more computer algorithms or systems determines whether to initiate, modify, or cancel an order, or otherwise makes determinations with respect to an order, including but not limited to: the product to be traded; the venue where the order will be placed; the type of order to be placed; the timing of the order; whether to place the order; the sequencing of the order in relation to other orders; the price of the order; the quantity of the order; the partition of the order into smaller components for submission; the number of orders to be placed; or how to manage the order after submission.

Indeed, the Proposal offers only solace in the following situation: “algorithmic trading does not include an order, modification, or order cancellation whose *every* parameter or attribute is manually entered into a front-end system, *with no further discretion* by any computer system or algorithm, prior to its electronic submission for processing” by the DCM. (Emphasis added.) Note that a computer program that simply determines order routing based on a choice of venues will bring the trading within the definition. The Proposal does ask whether computerized order routing should be sufficient to trigger the regulatory requirements. However, it also asks whether the definition should be expanded “to encompass orders that *are generated* using algorithmic methods (e.g., an algorithm generates a buy or sell signal at a particular time), but are then manually entered into a front-end system by a natural person, who determines all aspects of the routing of the orders.” (Emphasis added.)

4) **CPOs and CTAs as “AT Persons.”** Any entity already required to register as a Commodity Pool Operator or Commodity Trading Advisor that engages in Algorithmic Trading would be defined as an “AT Person” and required to meet extensive regulatory requirements related to risk management, development, testing and monitoring requirements, as well as compliance, training and reporting obligations.

5) **Staff Designation and Training Requirements.** Those obligations as proposed would include procedures for designating and training all staff involved in designing, testing and monitoring Algorithmic Trading.

6) **NFA’s Role.** All such AT Persons would be required to join a Registered Futures Association—namely, the NFA. The NFA, in turn, would be required to adopt standards for automated trading and algorithmic trading systems. At the same time, DCMs would also be required to put standards in place. While the CFTC is seeking comment on potential duplication between algorithmic trading requirements that the NFA may impose and similar requirements imposed by DCMs, as proposed it is hard to see how such practical difficulties will be avoided.

7) **Source Code.** Under the Proposal, AT Persons would be required to maintain “a source code repository to manage source code access, persistence, copies of all code used in the production environment, and changes to such code. Such source code repository must include an audit trail of material changes to source code that would allow the AT Person to determine, for each material change; who made it; when they made it; and the coding
purpose of the change.” This information would be required to be provided to the regulators, including the CFTC and the U.S. Department of Justice, on demand and without subpoena.

8) **Broader Record Keeping Issues.** If your firm is a member of a DCM, but previously did not have to register with the CFTC, but now would have to register as a “floor trader,” significant new record-keeping requirements that many view as onerous and burdensome would be triggered. Separately, the CFTC has a rulemaking underway relating to other record keeping obligations under Regulation 1.35. As Commissioner Giancarlo noted in his Statement regarding the Proposal, the interaction between Regulation 1.35 and Regulation AT could be important to the ultimate nature of the new record-keeping burdens imposed. Even aside from that rule, the underlying CFTC rule governing record-keeping (Regulation 1.31) is generally viewed as outdated and inconsistent with general practice.

9) **Annual Compliance Reports.** Among the reporting requirements that are proposed for AT Persons and Futures Commission Merchants (FCMs) that clear for them are annual reports to each DCM on which the AT Person does Algorithmic Trading. These reports would include a description of pre-trade risk controls and require a certification by the CEO or CCO that, “to the best of his or her knowledge and reasonable belief, the information contained in the report is accurate and complete.” It would not be surprising if any NFA rules applicable to AT Persons (see item 6 above) would also require submission of annual reports.

10) **Self-Trading.** Finally, the Proposal takes aim at “self-trading,” particularly “unintentional” self-trading. Each DCM would be required to adopt rules “reasonably designed to prevent self-trading by market participants” for all orders on the DCM’s electronic trade matching platform, not just algorithmic trades. Moreover, the Proposal expressly allows DCMs to require market participants to identify to the DCM which accounts should be prohibited from trading with each other. Exceptions to the self-trading prohibition could be permitted for (1) self-trades between accounts with common beneficial ownership where the orders are initiated by independent decision makers; and (2) self-trades between accounts under common control where the orders comply with the DCM’s cross-trade or similar rules, and the accounts are not under common beneficial ownership. Market participants would be required to make submissions to DCMs in order for such exceptions to apply. The Proposal has no *de minimis* exception for self-trades, but invites comment on whether one should be allowed. As for what would constitute “common beneficial ownership,” the Proposal suggests that a 10 percent ownership interest might be sufficient, but invites comment on that definition, as well as what would constitute common control and independent decision makers. Each DCM would be required to display certain statistics on their websites regarding self-trading that it has authorized and prevented. The Proposal also addresses what it sees as the risk of self-trading and other “abuses” incentivized by market maker and trading incentive programs, requiring additional disclosures concerning them and additional surveillance, policies and procedures designed to prevent the earning of such “benefits” through self-trading and other unidentified abusive practices.

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The Proposal promises to be subject to much comment and scrutiny. Its impact undoubtedly will be significant regardless of the exact details of the final rules. It warrants your continued attention and, in many cases, your active participation in the rule-making process, lest the CFTC act on limited information or misconceptions or create rules with unintended consequences.
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