AFR Americans for Financial Reform

March 16, 2016

Melissa D. Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

**RE: Comments on Regulation AT (Automated Trading)**

Dear Ms Jurgens,

Americans for Financial Reform ("**AFR**") appreciates the opportunity to comment on the Commodity Futures Trading Commission ("**CFTC**" or "**Commission**")'s Proposed Rule on Regulation Automated Trading ("**Proposed Rule**").[1]

As the Proposed Rule points out, CFTC-regulated markets have transitioned from a manual to an overwhelmingly automated trading environment, in which orders are generated, transmitted, executed, and confirmed by algorithmic computerized systems. This development brings significant new risks of market disruption as well as investor exploitation through predatory trading. A few of the most prominent disruptions, such as the 2010 'Flash Crash' or the October 15, 2014 events in the Treasury market, have received most of the media attention. But in a recent speech Commission Chair Tim Massad presented evidence of dozens of significant market disruptions in CFTC-regulated futures and derivatives markets over the past several years.[2]

This proposal lays out a principles-based regulatory framework intended to ensure that market participants follow current industry best practices and maintain a set of risk controls reasonably designed to prevent a market disruption due to algorithmic trading (an 'AT disruption'). The proposal specifies a number of parameters which must be set as part of these risk controls. These include maximum order messaging and execution limits, price parameters and size limits, and also limits on self-trading. Entities using algorithmic trading ('AT Persons') must also develop various technical capacities necessary to create and implement these limits, including the capacity for development and testing of AT systems in a simulation environment that does not involve actual trading and the capacity for real-time monitoring of algorithmic trading.

[1] Americans for Financial Reform is a coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/.

[2] Massad, Timothy, "Remarks of Chairman Timothy Massad Before The Conference on the Evolving Structure of the US Treasury Market", October 21, 2015; available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-30

Accompanying these requirements to set technical standards are requirements for policies and procedures to implement AT standards and risk controls.

The Proposed Rule also includes a range of requirements necessary for the Commission to monitor its execution. These include a requirement that AT persons register with the Commission, an annual reporting requirement, a requirement to maintain books and records that can be examined by the Commission to determine compliance with these rules, and a requirement that AT data and source codes for trading algorithms be maintained in a data repository for possible examination by the Commission or law enforcement authorities.

We view these rules as a basic minimum step for initial oversight of AT markets. The Proposed Rule asks only that automated traders and exchanges have limits in place and the realistic capacity to monitor and enforce these limits. It does not direct what those limits must be. Likewise, the requirements to register with and report to the Commission represent a minimum for the Commission's oversight of compliance with the proposed rule. The Proposed Rule takes an essentially self-regulatory approach by permitting AT persons to select their own quantitative levels for risk limits, without any apparent bounds set on these levels by Commission action.

It is striking that the Commission has permitted the large-scale conversion of the derivatives markets it oversees to an automated environment without putting in place these elementary requirements for automated traders to limit and monitor risk, or even in many cases to register with the Commission. In this sense, the proposed Reg AT is long overdue. At the same time, however, the self-regulatory approach taken here falls far short of a clear set of limits on the most dangerous and predatory practices made possible by automated trading technology.

In our comment on the Concept Release on automated trading, AFR set out a detailed case that the current speed 'arms race' in automated markets creates substantial social costs without any clear corresponding social benefit.[3] Academic commenters also laid out a comprehensive case that the current pseudo-continuous market design is deeply flawed, harms liquidity, and creates arbitrage opportunities for market insiders to exploit customers, and also described an alternative healthier market design.[4]

Reg AT makes little effort to address these issues with socially damaging high frequency trading. Indeed, the Proposed Rule does not even define 'high frequency trading' or make any effort to distinguish and limit the automated trading practices that could be riskiest to markets and most damaging to customers. (A partial exception is self-trading, which the Proposed Rule directs automated traders to directly limit, although even here the limit is far from absolute). We are

[3] Americans for Financial Reform, "Comment Letter on Concept Release On Risk Controls and System Safeguards for Automated Trading Environments", December 11, 2013, available at http://ourfinancialsecurity.org/wp-content/uploads/2013/12/AFR-CFTC-High-Frequency-Trading-Comment-Letter-12.13.13.pdf

[4] Budish, Eric, Peter Cramton and John Shin, "The High Frequency Trading Arms Race: Frequent Batch Auctions As A Market Design Response", Quarterly Journal of Economics, Vol. 130. Issue 4, November 2015. Available at http://faculty.chicagobooth.edu/eric.budish/research/hft-frequentbatchauctions.pdf

disappointed that the Commission has not taken stronger action at this time, and we are concerned that if the Commission limits its standards to the self-regulatory approach laid out here that markets may continue to evolve a direction that creates excessive social risks due to the pursuit of private gains from high-speed trading.

At the same time, we recognize that many of the steps taken here will improve the technological and monitoring infrastructure necessary for oversight of automated trading markets. Given the long record of Commission inaction on these issues, basic steps such as required registration and reporting for AT persons are a necessary first step. Likewise, developing capacity at the trader and exchange level for testing, monitoring, and control of AT systems is also necessary. We therefore favor the steps laid out in this proposal. However, we urge the Commission to consider them the first step and not the last word in addressing the issues created by automated trading. We hope that the extensive information that should become available through the required reporting and documentation in this proposal can support a more informed analysis of automated trading and eventually stronger limits on the most dangerous practices in automated markets.

In terms of specific elements of the rule, we strongly support the provision mandating that AT persons maintain a source code repository and audit trail, and make it available for inspection upon request by the Commission and the Justice Department. Without access to trading source code the actual causes of trading events are likely to remain opaque to market regulators, and it will be difficult to make progress in better understanding the emerging risks of automated trading. The difficulties that even large teams of government experts have had in retrospectively fully determining the causes of market events such as the 2010 Flash Crash and the October 15th bond market disruption show the great need for better understanding is in this area.

More fundamentally, any exemption from routine source code inspection would be an unjustified exemption from regulatory oversight that is routine for other types of traders in the financial markets. Automated trading source code is effectively a set of instructions for carrying out trades. At any brokerage, instructions to a human trader, such as an email to an employee asking for them to carry out a trade, including the conditions under which such a trade would be carried out (e.g. a limit order) would be part of the books and records open to inspection by FINRA or the SEC. Trading instructions must not be exempt from inspection simply because they are automated. They should be part of the books and records of the organization, just as other order-related documents are. Source code can equally be viewed as an investment or trading strategy; trading strategies have always posed investor protection concerns and been a subject for regulatory inspection and oversight.

Without the ability to examine source code, forms of oversight and risk management that are routine in other areas of the financial markets, such as stress testing, would be impossible to carry out. Automated trading should not be exempt from this kind of routine regulatory risk oversight and analysis.

AFR opposes the exclusion of Swaps Execution Facilities (SEFs) from the basic requirements of this Proposed Rule. This exclusion is justified by noting that SEFs are a newer type of exchange, and the claim that automated trading is less prevalent on SEFs and that their market is less liquid.

We believe that these factors, even if true, do not justify excluding SEFs from the proposal. It is dangerous to permit SEFs to develop their trading practices, policies, and procedures without basic risk controls and monitoring capacities for automated trading. Trying to add these controls later in the process may well be more difficult and expensive than incorporating them from the start, as such later incorporation will require modifying practices that have already become routine. SEFs should incorporate best practices in their automated trading from the start.

In their comments on the Proposed Rule, several Commissioners expressed concern as to the potential impact of the rule on smaller entities. We believe such concerns are misplaced. Especially if credit limits and order limits are not consistently enforced, automated trading technologies can permit small trading entities to cause disruptions in financial markets that are far out of proportion to their size. If not subject to risk limits, a single automated trading program can generate vast numbers of orders or create imbalances at key points in the trading ecosystem. Navinder Sarao was an extremely small scale actor, and while we do not believe he was the major factor in creating the 2010 Flash Crash, the evidence certainly indicates that even this very small trader played a real role.[5] Just as with large entities, small entities must also be held responsible for controlling the risks of the trading tools they choose to use.

Thank you for the opportunity to comment on this Proposed Rule. If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform

[5] http://www.telegraph.co.uk/finance/financial-crime/11553433/British-trader-Nav-Sarao-charged-with-triggering-global-markets-flash-crash-in-2010.html