Americans for Financial Reform

May 1, 2017

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

RE: Comments on Supplemental Notice of Proposed Rulemaking, Regulation AT, RIN 3038-AD52

Dear Ms Jurgens,

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

CFTC-regulated trading markets have transitioned from overwhelmingly manual to 70 percent automated.[2] In examining two years of futures contract data, the Commission found extensive penetration of automated trading in every significant CFTC regulated futures market, ranging from almost 40 percent of agricultural futures transactions to 80 percent of foreign exchange futures transactions.[3] The increasing dominance of automated trading brings significant new risks of market disruption as well as investor exploitation through predatory trading. Disruptions in CFTC-regulated markets have received less attention than disruptions in securities markets, such as the 2010 'Flash Crash'. But such disruptions appear to be significant and increasing. In a 2015 speech Commission Chair Tim Massad presented evidence of dozens of significant market disruptions in CFTC-regulated futures and derivatives markets in recent years.[4]

AFR has previously commented on both the Commission's Concept Release on automated trading and the later NPRM issued in 2015.[5] In both of these cases, we urged the Commission to

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[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] Statement by then-chair Timothy Massad in support of the Supplemental NPRM; Federal Register (FR) Appendix 2, 85395

[3] Haynes, Richard and John S. Roberts, "Automated Trading in Futures Markets", Commodity Futures Trading Commission, March 13, 2015. Available at http://www.cftc.gov/idc/groups/public/@economicanalysis/documents/file/oce_automatedtrading.pdf

[4] 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

[5] Americans for Financial Reform, "Comment On Concept Release For Risk Controls and System Safeguards for Automated Trading", RIN 3038-AD52, December 13, 2013, available at

be more aggressive in laying out structural reforms to the markets and more specific limits on dangerous automated trading practices. We criticized the 2015 Reg AT NPRM as essentially principles-based and self-regulatory. The current Supplemental NPRM does not change our basic assessment, as it maintains the basic framework of the 2015 NPRM, with no movement toward additional specificity in risk limits or risk control requirements or reduced discretion for market actors in designing and implementing risk controls.

There are several more aggressive directions the Commission could take with regard to forms of automated trading that pose risks to the market. These could include direct limits on latency, a "speed limit" such as the frequent batch auctions methodology recently proposed by leading academics.[6] They could also involve a stronger role in dictating appropriate risk controls that was informed by extensive enforcement experience. The authority for aggressive enforcement in this area has been increased by Dodd-Frank changes that granted the Commission additional authority to pursue "spoofing" and other forms of market manipulation, including general anti-manipulation authority. The Commission could also pursue more comprehensive trade data reporting that allowed more detailed tracking of intra-day positions and inventories. This data would permit better monitoring of the capital positions and stability of market makers who rely on high-frequency automated trading.

There is little evidence of such forceful approaches in the current Supplemental NPRM. However, we realize, that current CFTC resources may be too limited to be able to implement a strong policy in this area even if the Commission had the will to do so. This lack of resources presents a serious danger to the needed oversight of these important markets. The Commission's director of enforcement during the Obama administration recently stated that the Commission lacked the technological and personnel capacity needed to carry out needed investigation of what he characterized as a "massive amount of misconduct" in futures, options and swaps markets.[7] The current Congressional majority has shown no sign of addressing this resource shortfall, proposing in the latest CFTC reauthorization legislation to freeze Commission funding at current levels for the next five years. In such an environment, it can be appropriate for the Commission to craft rules that economize on the use of highly limited enforcement and monitoring resources. But the Commission should do so in ways that maximize the impact of scarce resources, and do not restrict the ability to take more needed action in the future. We also urge the Commission to advocate for the resources needed to properly address technological developments in the markets.

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http://ourfinancialsecurity.org/wp-content/uploads/2013/12/AFR-CFTC-High-Frequency-Trading-Comment-Letter-12.13.13.pdf. Americans for Financial Reform, "Comment on Proposed Regulation AT", March 16, 2016, available at http://ourfinancialsecurity.org/wp-content/uploads/2016/03/Americans-for-Financial-Reform-Comment-on-Reg-AT-Proposed-Rule-March-16-2016.pdf.

[6] Budish, Eric, Peter Crampton 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

[7] Karen Freifeld, "Misconduct rife in derivatives—ex-CFTC enforcement chief," Reuters, March 24, 2017. http://www.reuters.com/article/us-cftc-enforcement-goelman-idUSKBN16V1D0

The Supplemental NPRM includes a number of changes to make the regime of registration and self-designed risk controls easier for industry participants, changes that will also reduce the number of entities directly monitored by the Commission. The changes include:

- shifting the risk control requirements from three levels, the Automated Trading (AT) person, the Futures Commission Merchant (FCM), and the Designated Contract Market (DCM) to two levels by permitting an AT person to delegate risk controls to its FCM,
- limiting registration as AT persons to those entities that exceed a volume threshold for transactions,
- allowing outside certification of third party trading systems, and
- limiting Commission access to algorithmic source code to cases where either Commission staff has obtained a subpoena or the Commission as a whole has voted for access pursuant to a special call, while still requiring such code to be maintained for potential access.

In order to maintain controls in cases where orders are submitted by traders who fall below the new volume threshold, the Commission also proposes to make the FCM responsible for risk controls for trades submitted by non-AT persons.

It would have been challenging for the Commission at its current funding levels to fully monitor all the AT persons required to register under the original 2015 proposal. We therefore do not object to the efforts in this Supplemental NPRM to reduce the number of AT persons and concentrate more of the implementation of risk controls at the FCM level.

However, as regards volumetric thresholds, we continue to be concerned that smaller entities which do not typically trade at high volume levels can create very significant disruptions to trading markets in a single incident. This concern, along with the concern that volumetric thresholds could be "gamed“, was also expressed by multiple industry participants at the 2016 CFTC staff round table on this issue.[8]

The fact that typically low-volume participants may severely impact markets, or that significant participants may “drop off the radar” temporarily by moving below volume limits, does not necessarily mean that it is unreasonable for the Commission to impose volume thresholds; such thresholds may be a practical measure given limited CFTC resources. But it underlines that it is absolutely critical that the Commission maintain and enforce the requirement in Proposed 1.82 of the Supplemental NPRM that the introducing FCM be responsible for risk controls on all orders introduced by non-AT persons. This requirement along with other provisions in the Supplemental NPRM allowing designation of risk controls to the FCM imply that the CFTC will encourage the concentration of technical expertise on risk controls at the FCM level. This is a

[8] Commodity Futures Trading Commission, “Transcript for Staff Round Table on Automated Trading”, June 10, 2016. Available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/transcript061016.pdf

reasonable way to narrow the range of entities the CFTC must monitor, but supervisory follow through is crucial.

The source code provisions in the Supplemental NPRM also raise important questions. We strongly support the requirement in Proposed 1.84 that firms maintain a source code repository and audit trail that is available for inspection 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.

Furthermore, as we pointed out in our response to the 2015 NPRM, any exemption from books and records maintenance for automated trading source code would be an unjustified exemption from regulatory oversight that is routine for other types of traders in the financial markets. 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, which have always been a subject for regulatory inspection and oversight.

The Supplemental NPRM differs from the NPRM in that it explicitly states that the Commission will not access source code unless it has obtained a subpoena or the Commission as a whole has voted for access pursuant to a special call. Limiting access to source code to cases where a subpoena has been issued would tend to limit source code access to cases where a significant market disruption has already occurred and regulators are seeking ex post the reason for the disruption. We hope that the CFTC's technical capacities and experience in the oversight of automated trading will increase and that the the Commission will be able to take advantage of source code in those cases where it would be helpful for forward-looking risk assessment. From this perspective, it is significant that the Commission specifies in the Supplemental NPRM that source code may be accessed as part of a special call that is not made pursuant to an enforcement action, and does not require any finding or implication that CFTC rules have been violated.[9] We strongly support the maintenance of CFTC authority to access source code through such special calls, independently of enforcement actions or subpoenas. Limiting source code access to enforcement actions or subpoenas only would significantly reduce the potential benefits from source code maintenance, as it would forfeit the considerable benefits that could be gained from preventing market disruptions before they occur.

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

Sincerely,
Americans for Financial Reform

[9] CFR 85373 and following