

Overview of Proposed CFTC Regulation AT



Katten

KattenMuchinRosenman LLP

Lance A. Zinman, Moderator

Global Co-Chair, Financial Services Practice

Christian T. Kemnitz

Co-Chair, Financial Services Litigation Practice

Gary DeWaal

Special Counsel, Financial Services Practice

Janet M. Angstadt

Chicago Chair, Financial Services Practice

Introduction – What is Regulation AT?

- Proposes to federalize the futures industry's best practices for algorithmic trading and existing self-regulatory organization requirements
- Follows the CFTC's September 2013 Concept Release on Risk Controls and System Safeguards for Automated Trading
- Proposed rules standardize risk controls, transparency measures and other safeguards
- Principles-based regulatory scheme
- Three principal categories of participants are regulated by the proposal: AT Persons, FCMs, and DCMs (i.e. three levels of oversight)

Agenda

- Overview of Regulation AT
- Comparison: Regulation AT with the status quo
- Potential consequences of Regulation AT
- Securities regulation comparison
- Questions
- Conclusion

Overview: AT Persons

- Who is an AT Person?
 - Specified CFTC registrants engaged in algorithmic trading
 - Persons required by Regulation AT to register as floor traders (proposed § 1.3(xxxx))
- What constitutes “Algorithmic Trading”?
 - Broad scope of futures trading activity (proposed § 1.3(ssss))
 - Includes use of algorithmic and automated trading systems

Overview: Floor Traders

- Who is a “Floor Trader” under Regulation AT?
 - Any non-CFTC registrant using an algorithmic trading system (“ATS”) to route electronic orders directly to a DCM, rather than first through a clearing member FCM
 - “without the order first being routed through a separate person who is a member” of a DCO (§ 1.3(yyyy))
 - Once registration is required for direct access, the firm is an AT Person for all algorithmic trading – direct and non-direct
 - No minimum activity threshold that might exclude potential AT Persons from registering with the CFTC as floor traders
 - Existing floor traders are not AT Persons (proposed § 1.3(xxxx))

Overview: AT Persons

- Must comply with all Regulation AT requirements
- Must implement pre-trade risk controls and other measures “reasonably designed” to avoid an “Algorithmic Trading Event”
- What is an “Algorithmic Trading Event”?
 - Compliance breach **of any magnitude** (an “algorithmic trading compliance issue”)
 - Operational breakdown that is disruptive at any level (an “algorithmic trading disruption”)
 - “disrupts or materially degrades” (§ 1.3(uuuu))

Overview: AT Persons (continued)

- AT Persons must put in place:
 - Maximum order message and execution frequencies
 - Order price parameters and maximum order size limits
 - Written policies/procedures that address:
 - Development and testing of an ATS
 - The designation and training of staff responsible for algorithmic trading
 - Escalation and communications procedures in the event of an Algorithmic Trading Event
 - Annual report filed with each relevant DCM which must include:
 - Description of pre-trade risk controls
 - CCO or CEO Certification

Overview: AT Persons (continued)

- Significant requirements for AT Persons include:
 - Maintaining copies of the source code used in a live environment (including all changes)
 - “[m]aintaining a source code repository to manage source code access, persistence, copies of all code used in the production environment, and changes to such code” (§ 1.81(a)(1)(vi))
 - Complying with the CFTC’s five-year record-retention requirements
 - Making source code available for inspection by the CFTC/DOJ without subpoena or legal process (proposed § 1.81(a)(1)(vi))

Overview: FCMs

- Proposed rules would affect any FCM that:
 - Is a clearing member of a DCM
 - Carries accounts for customers who use an ATS
- This is in addition to FCMs who are AT Persons themselves

Overview: FCMs (continued)

- Policies/procedures to prevent Algorithmic Trading Events:
 - Ensure natural person employees are promptly informed when pre-trade risk controls are breached
 - For direct access clients, clearing member FCMs must implement the pre-trade risk controls and order cancellation systems provided by the DCMs
 - For other clients, DCMs should establish and maintain their own pre-trade risk controls and order cancellation systems (proposed § 1.82)
 - Must file an annual report with each relevant DCM that includes:
 - Description of how the FCM complies with the maintenance of pre-trade risk controls
 - Description of CCO or CEO Certification

Overview: DCMs and RFAs

- Proposed rules would affect
 - DCMs
 - NFA
- SEFs are not affected

Overview: DCMs and RFAs (continued)

- DCM policies/procedures to prevent Algorithmic Trading Events:
 - Must adopt risk controls for orders submitted through Algorithmic Trading to include pre-trade risk controls and order cancellation systems (proposed § 40.20)
 - Must maintain parallel controls for orders not originating from Algorithmic Trading (i.e., manually submitted)
 - Must require the submission and review of compliance reports from AT Persons and their clearing member FCMs
 - Must implement rules to reasonably prevent self-trading by market participants. Must apply, or provide and require the use of, self-trade prevention tools to prevent self-trading
 - DCMs must also disclose attributes of their matching systems that materially affect market participant orders, as well as information regarding market maker and trading incentive programs

Overview: DCMs and RFAs (continued)

- Regulation AT also requires NFA to implement and maintain:
 - “a program for the prevention of fraudulent and manipulative acts and practices, the protection of the public interest, and perfecting the mechanism of trading on designated contract markets...”
- The CFTC expects NFA to adopt rules “as deemed appropriate” that require its members to establish:
 - Pre-trade risk controls and other measures for ATS
 - Standards for developing, testing and monitoring ATSs and compliance
 - Designation of algorithmic trading staff and the provision of training for such persons
 - Operational risk management standards for FCMs whose orders originate with ATSs

Comparison: Status Quo – AT Persons

- FIA PTG Best Practice Principles
 - Market Access Risk Management Recommendations, April 2010
 - Recommendations for Risk Controls at Trading Firms, November 2010
 - Software Development and Change Management Recommendations, March 2012
 - Order Handling Risk Management Recommendations for Executing Brokers, March 2012
 - Drop Copy Recommendations, September 2013
 - Guide to the Development and Operation of Automated Trading Systems, March 2015

Comparison: Status Quo – AT Persons (continued)

- Pervasive futures exchange requirements (Traders):
 - Entities connecting to Globex through CME iLink Gateway
 - Must create and maintain an audit trail for all orders for five years
 - Must ensure all orders include an appropriate identifier – Tag 50 (CME Rule 536.B)
 - Requires certification (CME Rule 536.B)

Comparison: Status Quo – AT Persons (continued)

- Futures exchanges have fined firms for trading system breakdowns that disrupt or could have disrupted the marketplace
 - 2014: A Proprietary Trading Firm
 - CME Group - \$35,000
 - Third-party-purchased system caused 3,540 one-lot round-turn transactions in Canadian dollar futures contracts within two minutes on November 10, 2011
 - 2014: A Proprietary Trading Firm
 - CME Group - \$75,000
 - System breakdown caused 27,000 resend messages within two seconds on May 8, 2013

Status Quo – FCMs

- Clearing members must “suspend or terminate” a non-member’s Globex access if the member:
 - Poses a threat to the exchange
 - Fails to cooperate in an investigation (CME Rule 574)
- A clearing members may be found to have committed an “act detrimental to the interest or welfare of the Exchange” if it has “actual or constructive notice” of a rule violation by a non-member that has a direct connection and it fails to take “appropriate action” (CME Rule 574)(Equivalent ICE Futures U.S. Rule 27.04(d))

Status Quo – FCMs

■ EFS and Tag 50s

- If an entity is required to be registered with the Exchange, “it is the duty of the clearing member to ensure that registration is current and accurate at all times” (CME Rule 576)
- Each individual must use a unique identifier when entering an order to Globex (CEM Rules 536B.1, 576) (May be team IDs)
- Clearing members guaranteeing connections to Globex “are responsible for maintaining or causing to maintain electronic audit trail” for five years unless another clearing member or corporate equity member
- Clearing members “must have the ability to produce this data in a standard format” to CME Group (CME Rule 536.B.2)

Status Quo – FCMs (continued)

- See other futures exchange equivalent requirements:
 - ICE Futures Rule 27.12A
 - CFE Rule 403
- FCMs may have audit trail retention requirements (maintain or causing to be maintain required records) for direct access clients (CME Rule 536.B.)
 - Even where maintaining requirement can be delegated (e.g., equity members), CME will now obligate sponsoring FCMs to produce required records to CFTC when requested (MRAN RA1520-5 (December 14, 2015))
- CFTC Rules 1.73 (risk management), 166.3 (supervision)
- NFA Interpretive Notice 9046 to Rule 2.9 (Supervision of the Use of Automated Order-Routing Systems)

Chief Compliance Officers

- An AT Person's CEO or CCO must certify that the annual report information is accurate and complete
- For FCMs, another annual report to file
- What is the potential liability of compliance officers?

Potential Consequences of Regulation AT - Difficulties

- AT Persons will be exposed to enforcement risks for failing to comply with their own written policies and procedures
- AT Persons might hesitate before adopting internal requirements beyond the minimum CFTC requirements
- Cost of implementing will have a deleterious effect on at least some FCMs

Potential Consequences of Regulation AT - Difficulties

- Burdensome for CFTC registrants to have their source code available for inspection by the CFTC or DOJ
- Third parties may inadvertently obtain access to information obtained by the government
- Unclear whether NFA could adopt such a program without amending its articles of incorporation

Potential Consequences of Regulation AT - Benefits

- Newly registered Floor Traders may avoid Swap Dealer registration
- Higher confidence in algorithmic trading by FCMs

Securities Regulation Comparison

- SEC Rule 15c3-5 requires broker-dealers to have pre- and post-trade risk controls for direct access to exchanges and dark pools (i.e., where a broker-dealer uses its own MPID):
 - Risk controls must cover prescribed financial and regulatory risks
 - Annual compliance certification
- Regulators take an expansive view of the rule
- Routinely added by regulators to address garden-variety trading violations

Securities Regulation Comparison (continued)

- Financial Risk Controls
 - Must be reasonably designed to limit the financial exposure of the broker or dealer that could arise as a result of market access
 - Prevent orders exceeding pre-set credit or capital thresholds in the aggregate by rejecting orders if they would exceed the threshold
 - Prevent the entering of erroneous orders by rejecting orders that exceed appropriate price or size parameters or that would indicate duplicate orders

Securities Regulation Comparison (continued)

- Regulatory Risk Controls
 - Reasonably designed to ensure compliance with all regulatory requirements
 - Prevent order entry unless compliance with all regulatory requirements that must be satisfied on a pre-order basis (e.g., order origin codes, Reg SHO order marketing, etc.)
 - Prevent order entry for securities if a firm is restricted from trading those securities
 - Restricted access to trading systems and technology that provide market access to persons pre-approved and authorized
 - Ensure that appropriate personnel receive post-time execution reports

Securities Regulation Comparison (continued)

- Related FINRA and SEC Proposals
 - FINRA proposal to register lead developers of algorithms
 - SEC proposal to modify SEC Rule 15b9-1 (eliminating the exemption from FINRA membership for proprietary broker-dealers)
 - Possible proposal from SEC for a disruptive trading rule

Conclusion

- Economic self-interest to implement risk controls
 - Prevent the loss of capital
 - Much of the proposal is reiteration of market practice
- Implementation costs will have a deleterious impact on at least some FCMs
- Source code issue must be resolved
- Comments due on or before March 16, 2016



Lance A. Zinman

p +1.312.902.5212 | lance.zinman@kattenlaw.com

Lance Zinman serves as global co-chair of Katten's Financial Services practice and sits on the firm's Board of Directors and Executive Committee. Lance is a Registered Foreign Lawyer and a non-practicing partner in Katten Muchin Rosenman UK LLP. He represents hedge funds and commodity pools in all asset classes, private equity funds, investment advisers, commodity trading advisers and other asset managers. He also advises a broad cross section of proprietary trading firms—large and small—including many of the major firms in the industry. Lance's multidimensional skill set is unique, combining a deep understanding of corporate, regulatory, intellectual property and tax law, along with broad knowledge of the securities and derivatives markets. His extensive experience with these interconnected areas enables him to apply creative solutions to legal challenges, while also providing practical, common sense counsel.

Lance provides comprehensive legal services to institutional and emerging asset managers and proprietary trading firms in need of a single advisor who can assist them with all aspects of their business. He counsels them on a wide range of issues, including corporate formation structure, futures, derivatives, securities and other regulatory matters, trading issues, brokerage and derivatives documentation, tax planning, intellectual property matters, labor issues, equity and debt financings, mergers and acquisitions, joint ventures and seed deals. Originally a corporate attorney, Lance later joined the firm's Financial Services group, creating an efficiently integrated transactional and regulatory practice.

As a Chicago-based attorney, Lance has significant experience with volatility, algorithmic, low-latency and other trading strategies involving the use of futures, options and other derivatives. In addition, he counsels clients in other sectors of the financial markets, including domestic and foreign exchanges, brokerage firms, swap counterparties and other participants in over-the-counter transactions. Lance also advises clients that are looking to establish a presence internationally or trade directly on foreign exchanges.

Separately, he represents clients in the entertainment and sports industries as well, including the Chicago Bulls, Chicago White Sox and Oakland Athletics.

Lance is frequently tapped to speak at events on topics relating to hedge funds and proprietary trading, including Managed Funds Association (MFA) conferences and the SkyBridge Alternatives conference (SALT). *Crain's Chicago Business* selected Lance for its prestigious 2012 "40 Under 40" list describing him as "a rare lawyer under 40 atop a big firm practice." Lance was also named one of "40 Under 40 to Watch" in 2008 by the *Chicago Daily Law Bulletin* which noted that his "breadth and depth of experience have led his clients to describe him as one of the city's top business lawyers." In 2009, he was one of six attorneys to be named the "Next Generation of Leaders" by *Chicago Lawyer* magazine.

Lance is also on the global board of directors of Hedge Funds Care, an international charity supported by the hedge fund industry dedicated to the prevention and treatment of child abuse.



Janet M. Angstadt

p +1.312.902.5494 | janet.angstadt@kattenlaw.com

Janet M. Angstadt is the head of Katten's Chicago Financial Services practice. She focuses her practice on broker-dealer and exchange compliance issues and advises companies on matters regarding compliance with the regulations of the US Securities and Exchange Commission (SEC) and self-regulatory organizations (SROs).

Janet represents clients in a wide range of legal and regulatory matters, including mergers and acquisitions, SRO investigations, compliance issues related to registrations, sales practice, short sales, Regulation NMS, market-making and options and equities order handling. She advises on alternative trading systems, including dark pools and electronic communication networks, policies and procedures for trading systems development and testing and exchange-traded funds (ETFs).

Janet counsels large, full-service broker-dealers, exchanges and clearinghouses as well as firms with market-making, proprietary trading and algorithmic models. She also advises market centers on equities and derivatives market structure initiatives, including market access, market data, new products and SEC policy initiatives. In addition, Janet conducts independent compliance and technology reviews and audits related to enforcement action settlements.

Before joining Katten, she served as general counsel to NYSE Arca, Inc., an electronic equities and options exchange. As general counsel of NYSE Arca, Janet worked extensively on market structure and regulatory compliance issues and managed the company's membership and registrations departments. Prior to the merger of the New York Stock Exchange and Archipelago, she served as the deputy general counsel of Archipelago, where she created and implemented key company policies, including the company's procedures for development and testing of exchange technology. Janet also managed the compliance programs for Archipelago's four affiliated broker-dealers and played an integral role in legal and regulatory matters involving human resources, intellectual property and mergers and acquisitions, including Archipelago's acquisition of the Pacific Exchange and its merger with the New York Stock Exchange.

Earlier, Janet was senior vice president and counsel to the capital markets group of EVEREN Securities, Inc. She also was senior counsel for the SEC's Division of Market Regulation where she was a member of the three-person study team for the *Market 2000 Report*.



Gary DeWaal

p +1.212.940.6558 | gary.dewaal@kattenlaw.com

Gary DeWaal focuses his practice on financial services regulatory matters. He counsels clients on the application of evolving regulatory requirements to existing businesses and structuring more effective compliance programs, as well as assists in defending and resolving regulatory disciplinary actions and enforcement matters.

Previously, Gary was a senior managing director and group general counsel for Newedge, where he oversaw the worldwide Legal, Compliance, Financial Crimes Prevention (including AML) and Regulatory Developments departments. He also worked for the US Commodity Futures Trading Commission's Division of Enforcement in New York. For several years, Gary taught a course in derivatives regulation as an adjunct professor at Brooklyn Law School. He currently serves as a practitioner faculty and mentor for the State University of New York Buffalo Law School's New York City Program on Finance & Law.

Gary is frequently quoted in the media for his thoughts on the international financial services industry and has published numerous articles on futures and securities industry issues. He regularly lectures or appears as a speaker at futures and securities industry conferences or in training sessions for international regulators. Gary is the sole author and publisher of [Bridging the Week](https://www.bridgingtheweek.com), a blog addressing issues in the financial services industry (sign up at: <https://www.bridgingtheweek.com/Subscribe>).



Christian T. Kemnitz

p +1.312.902.5379 | christian.kemnitz@kattenlaw.com

Christian T. Kemnitz is co-head of the firm's Financial Services Litigation practice and focuses on disputes relating to the financial services industry. He is experienced in pre-litigation counseling and all aspects of litigation, including trial, arbitration, and mediation. In addition, Chris handles complex commercial disputes, antitrust and trade regulation, white collar criminal matters and internal investigations.

Chris's financial services experience includes litigation, enforcement proceedings, internal investigations and regulatory actions relating to securities, options, derivatives, commodities and futures. He represents broker-dealers in civil disputes, including arbitration claims brought by customers. In this work, Chris has an extensive and successful record resolving matters at hearings. He also handles class action litigation brought under the securities laws or relating to the financial services industry. Chris counsels diverse parties at various exchanges, and in enforcement proceedings before the Securities Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), self-regulatory bodies, and at stock, option and futures exchanges.

His commercial litigation experience includes the litigation of complex contracts, employment matters, product liability claims, disputes within partnerships and closely held corporations, and complex financial matters. Clients seek his counsel in class action disputes in industries ranging from manufacturing to financial services and involving alleged violations of the antitrust and securities laws or state law product liability claims. Chris also advises corporate and individual clients in many industries in white collar criminal matters, including governmental investigations involving the Department of Justice (DOJ), the SEC and the CFTC. Often those investigations are preceded by comprehensive internal investigations. Chris has participated in or run internal investigations for manufacturing companies, investment banks, broker-dealers and hedge funds.

Chris is experienced in all aspects of antitrust law and state and federal antitrust litigation, including pre-merger regulatory review, criminal investigations and class action civil litigation relating to claims of conspiracy, monopoly and Robinson-Patman violations by direct and indirect purchasers.

Before joining the firm, Chris was a law clerk for the Honorable Charles L. Levin of the Michigan Supreme Court. He serves as the treasurer of the Board of Directors of the Cabrini Green Legal Aid Clinic in Chicago.

Katten Muchin Rosenman LLP Locations

AUSTIN

One Congress Plaza
111 Congress Avenue
Suite 1000
Austin, TX 78701-4073
+1.512.691.4000 tel
+1.512.691.4001 fax

HOUSTON

1301 McKinney Street
Suite 3000
Houston, TX 77010-3033
+1.713.270.3400 tel
+1.713.270.3401 fax

LOS ANGELES – CENTURY CITY

2029 Century Park East
Suite 2600
Los Angeles, CA 90067-3012
+1.310.788.4400 tel
+1.310.788.4471 fax

ORANGE COUNTY

100 Spectrum Center Drive
Suite 1050
Irvine, CA 92618-4960
+1.714.966.6819 tel
+1.714.966.6821 fax

WASHINGTON, DC

2900 K Street NW
North Tower - Suite 200
Washington, DC 20007-5118
+1.202.625.3500 tel
+1.202.298.7570 fax

CHARLOTTE

550 South Tryon Street
Suite 2900
Charlotte, NC 28202-4213
+1.704.444.2000 tel
+1.704.444.2050 fax

IRVING

545 East John Carpenter Freeway
Suite 300
Irving, TX 75062-3964
+1.972.587.4100 tel
+1.972.587.4109 fax

LOS ANGELES – DOWNTOWN

515 South Flower Street
Suite 1000
Los Angeles, CA 90071-2212
+1.213.443.9000 tel
+1.213.443.9001 fax

SAN FRANCISCO BAY AREA

1999 Harrison Street
Suite 700
Oakland, CA 94612-4704
+1.415.293.5800 tel
+1.415.293.5801 fax

CHICAGO

525 West Monroe Street
Chicago, IL 60661-3693
+1.312.902.5200 tel
+1.312.902.1061 fax

LONDON

Paternoster House
65 St Paul's Churchyard
London EC4M 8AB United Kingdom
+44.0.20.7776.7620 tel
+44.0.20.7776.7621 fax

NEW YORK

575 Madison Avenue
New York, NY 10022-2585
+1.212.940.8800 tel
+1.212.940.8776 fax

SHANGHAI

Suite 4906 Wheelock Square
1717 Nanjing Road West
Shanghai 200040 P.R. China
+86.21.6039.3222 tel
+86.21.6039.3223 fax

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