



# **Regulation AT: Overview and Implications**

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# Background to Regulation AT

- **2012 Requirements**

- Automated order screening by futures brokers and swap dealers for compliance with certain risk-based limits
- Certain financial risk control requirements for exchanges offering direct market access

- **2013**

- Concept Release on Risk Controls and System Safeguards for Automated Trading Environments

- **2015**

- Numerous statements on algorithmic trading risk from CFTC Chairman Massad
- Regulation AT Notice of Proposed Rulemaking

# Regulation AT Measures

- **Regulation AT seeks to:**
  - Reduce risk
  - Increase transparency of “Algorithmic Trading”
    - Electronic trade matching platforms and the use of self-trade prevention tools
    - Market maker and trading incentive programs

# **Regulation AT in a Nutshell: Key Definitions**

- **Algorithmic Trading**
- **Direct Electronic Access**
- **AT Person (and Floor Trader)**
- **Algorithmic Trading Event**
- **Algorithmic Trading Disruption**
- **Algorithmic Trading Compliance Issue**

# Key Definition: 'Algorithmic Trading'

- **Trading (i) in any commodity interest (ii) on or subject to the rules of a designated contract market, where:**
  - A *computer algorithm* or system determines:
    - Whether to initiate, modify, or cancel an order, or
    - Otherwise makes determinations with respect to an order, including:
      - 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; and
  - Such order, modification or order cancellation is *electronically submitted* for processing on or subject to the rules of a designated contract market.

# **‘Algorithmic Trading’ Defined**

- **Two elements to ‘Algorithmic Trading’**
  - Algorithmic order creation (or determinations)
  - Electronic execution
- **Trading that is not algorithmic: ‘breaking the chain’**
  - Keying in order in the middle

# ‘Algorithmic Trading’ Defined

- **Electronically submitted**

- What is “DEA”?

- DEA vs. DMA

- Electronically transmitted orders, without the order first being routed through a clearing member

- Different from SEC and foreign regulator definition

- Is “High Frequency” defined?



# Exceptions

- **Just order routing?**
  - Manager algo formulates trades, broker algo executes
    - Is this “DEA”?
- **Other automated activity**
  - Incorporated electronic indicators notifying a trader of certain market activity
  - Electronic systems as part of business practices but not for order submission
  - Automated risk filters for manual orders

# Key Definition: 'Algorithmic Trading Event'

- **An event at an AT Person that constitutes:**
  - An Algorithmic Trading Compliance Issue; or
  - An Algorithmic Trading Disruption

# Key Definition: 'Algorithmic Trading Compliance Issue'

- **An event at an AT Person that has caused any Algorithmic Trading not to comply with:**
  - The Commodity Exchange Act;
  - CFTC rules and regulations;
  - The rules of any designated contract market;
  - The rules of any registered futures association;
  - **The AT Person's own internal requirements;** or
  - The requirements of the clearing member

# Key Definition: 'Algorithmic Trading Disruption'

- **An event originating with an AT Person that disrupts or materially degrades:**
  - The Algorithmic Trading of such AT Person;
  - The operation of a designated contract market; or
  - The ability of other market participants to trade a designated contract market

# Registration

# Key Definition: Are You an ‘AT Person’?

- **AT Person means:**
  - Any person *registered* or required to be registered as a *commodity pool operator* or commodity trading advisor:
    - That engages in “Algorithmic Trading”
    - On or subject to the rules of a DCM; or
  - A “floor trader”

# Key Definition: 'Floor Trader'

- **Any person:**
  - Who, in a contract market, purchases or sells solely for their own account a CFTC-regulated futures contract, option or swap
  - **Who uses Direct Electronic Access, in whole or in part, to access such other place for Algorithmic Trading;** and
  - Who is not registered with the CFTC

# AT Person Registration

- **Proposed new § 170.18**
  - Requires AT Persons to become members of at least one registered futures association (the only RFA at the moment is the National Futures Association)
- **Proposed new § 170.19**
  - Requires RFAs to adopt rules relevant to algorithmic trading
  - Stated purpose is to allow RFAs “to supplement elements of Regulation AT as markets and trading technologies evolve over time”



# AT Person Registration

- **Non-registrants affected?**
  - Prop traders
  - Exempt (i.e., 4.13(a)(3)) managers
  - Family offices
  - Non-U.S. managers

# Ongoing Requirements

# AT Person Obligations

- **AT Persons are required to implement the following:**
  - *Risk controls* to address the risks of Algorithmic Trading
    - Pre-trade risk controls
      - Maximum order message and execution frequency per unit time
      - Order price and maximum order size parameters
    - Order cancellation systems
    - “System Heartbeat” connectivity

# AT Person Obligations

- **AT Persons are required to implement the following:**
  - Standards for *development, testing and monitoring* of algorithmic trading systems
    - Keeping the development environment separate from the production environment
    - Testing prior to implementation
    - A source code repository
    - Real-time monitoring of such systems
    - Standards to ensure that systems comply with the Commodity Exchange Act and Commission regulations

# AT Person Obligations

- **AT Persons are required to implement the following:**
  - *Designate and train* algorithmic trading staff
  - Includes
    - Trading strategy for the ATs
    - Risk controls in place

# AT Person Obligations

- **AT Persons are required to implement the following:**
  - Must submit
    - Annual *compliance reports* to DCMs regarding their risk controls
    - Copies of *written policies and procedures* developed to comply with testing and other requirements (proposed § 1.83(a))

# AT Person Obligations

- **AT Persons are required to implement the following:**
  - AT Persons must also keep books and records regarding their Algorithmic Trading procedures for inspection by DCMs

# Self-Trades

- **Self-trade prevention tools**
  - Tucked into release (p. 123)
- **Proposed § 40.23 requires DCMs to either apply, or provide and require the use of, self-trade prevention tools**
- **Proposed § 1.80(e)**
  - To the extent that implementation of a DCM's self-trade prevention tools requires calibration or other action by an AT Person,
  - Such AT Person must calibrate or take such other action as is necessary to apply such tools.



# Self-Trades

- **Proposed § 40.23(a) defines self-trading as the matching of orders for accounts that have:**
  - Common beneficial ownership; or
  - Are under common control.
- **The CFTC is requesting public comment in the questions below regarding:**
  - Whether it should define “common beneficial ownership” in any final rules arising from this NPRM, and if so,
  - How the term should be defined.
- **The Commission notes in its request for public comment that its aggregation rules in § 150.4 are a potential model for defining common beneficial ownership in any final rules. The Commission is also requesting public comment regarding whether the definition of common beneficial ownership for purposes of § 40.23 should be left to the individual discretion of each DCM.**

# Self-Trades

- **Proposed Self-Trading Rules**

- Wash trade CEA prohibitions vs. proposed self-trading rules
  - Self-trade rules are applicable even without intent
  - Intended as a complement to the CEA wash trade prohibition
- Wash trading: “entering into, or purporting to enter into, transactions to give the appearance that purchases and sales have been made, without incurring market risk or changing the trader’s market position”
  - Intentional self-trades could constitute wash trades

# Source Code Requirements

- **Written policies and procedures requirements**
  - Maintaining 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 such material change:
    - Who made it;
    - When they made it; and
    - The coding purpose of the change
  - Each AT Person shall keep such source code repository, and make it available for inspection, in accordance with § 1.31

# Source Code Requirements: Implications

- **What are the immediate implications of the source code requirements?**
  - Retention requirement – source code must always be available for inspection
  - Must turn over source code to any representative of the CFTC or DOJ on demand
  - Subpoena not required
  - Confidentiality requirement is not required

# Source Code Requirements: Trade Secrets

- **Factors that impact trade secret protection**
  - Extent to which the information is known outside the company
  - Extent to which information is known within the company
  - **Extent of measures taken by the company to guard secrecy**
  - Value of the information to the company and its competitors
  - Amount of effort or money expended to develop the information
  - **Ease or difficulty with which the information could be properly acquired or duplicated by others**

# Legal Protection: Trade Secrets

- **Federal law**
  - Allows U.S. Attorneys to prosecute those who steal trade secrets, but does not give trade secret owners a private right of action
- **State law**
  - Allows trade secret owners to file civil lawsuits against those who misappropriate trade secrets
- **‘Takings Clause’: 3 relevant factors**
  - Economic impact of the regulation
  - Interference with the interest holder’s “distinct investment-backed expectations”
  - Character of the governmental action

# Looking Ahead

# Proposed Rulemaking: Comments

- **Comment period ends mid/late February**
- **Industry groups typically submit comments**
  - SIFMA
  - MFA
  - FIA
- **Potential issues**
  - Cost of compliance (Administrative Procedures Act)
  - Broad scope of who is covered
  - Source code requirements and impact on trade secrets