



## HOUSE AG COMMITTEE HEARING

### OVERVIEW

For questions please contact [Kwon Park](#) at (202) 547-3035.

Today, the House Agriculture Committee held a hearing entitled “Examining the CFTC’s Proposed Rule: Regulation Automated Trading.”

### Key Takeaways

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- All four witnesses declared that the source code provision is unprecedented and poses significant constitutional due process and confidentiality concerns. They said the CFTC should continue to issue a subpoena and impose safeguards before requiring access to source code.
- Gorelick (RGM) and Ryan (TT) expressed that the source code itself would be of little value in deciphering trading strategies, as source code is difficult to interpret and future trading events depend on many factors working in conjunction with the source code in the marketplace.
- Rather than proposing definitions (AT Person) in Regulation Automated Trading (Reg AT), Wood (FIA) and Gorelick proposed that the Commission focus on activities - to not create definitional boundaries on who should apply risk controls.
- Vrabel (CME) and Wood stressed that the size or complexity of a market participant had no bearing on the risk posed to the marketplace. They stated that all market participants pose the same risks and that every market participant should go through some degree of risk controls. Vrabel recommended a two-tier pre-trade risk control structure.
- Gorelick and Wood said that the CFTC’s cost benefit analysis is narrowly focused and does not address wider market impacts. They fear the rule’s impact on liquidity in U.S. futures markets and competition.

### SUMMARY

#### Opening Statement and Testimony

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##### [Chairman Mike Conaway \(R-TX\)](#)

- CFTC has significant work to do to harmonize its rules and to get the swap dealer *de minimis* level right.
- Requiring firms to provide the CFTC and the Department of Justice (DOJ) with on-demand access to sensitive intellectual property (IP) is fraught with danger. There is a legitimate fear among market participants that allowing more people, even regulators, to view and store their IP increases their cybersecurity risks.
- The rule does not have to be this complicated. The most confusing parts of Reg AT – the source code rules, the registration regime, the reporting requirements, and the inflexible risk controls –

are unnecessary to achieve the Commission's stated goals. Market participants already have incentives to police bad algorithms (algos), prevent disruptions, and plan for recovery.

- A more modest proposal by the Commission might start by leveraging these inherent incentives and requiring universal adoption of a flexible framework for best practices.
- I am heartened that Chairman Massad is open to finalizing the rule in phases and taking more time to get it right. I look forward to seeing the Commission's next proposal.

#### Ranking Member Collin Peterson (D-MN)

- Since the Flash Crash, there have been between 15 and 30 similar disruptions every single year in markets ranging from Treasuries to crude oil and ag futures.
- With Reg AT, the CFTC has proposed some rules to try to prevent future market disruptions caused or made worse by automated and algo trading. This rulemaking is still open and the CFTC continues to work to get it right.

#### Greg Wood, Chair, FIA Market Access Committee

- Reg AT poses concerns with regard to its source code provision and complications arising with the use of third party software.
- From an FCM perspective, the industry believes that:
  - Pre-trade risk controls are the responsibility of all market participants, and when implemented properly and appropriate to the nature of the activity, have been proven to be the most effective safeguard for the markets, and should be applied comprehensively to all electronic orders, not just for AT Persons.
  - Rules should not focus on any one specific type of market access, but rather, should recognize the appropriate application of pre-trade risk controls to protect market integrity.
  - Regulation should build on and leverage the very successful risk controls and safeguards currently in place instead of proposing new and untested systems or procedures that would require significant investment by the industry.
  - Requirements should not be one-size-fits-all. Distinctions should be based on the business structure, business model, operational size, and technical sophistication of market participants.
  - Rules should not be prescriptive, but principles-based.

#### Richard Gorelick, CEO, RGM Advisors

- The proposal, as it currently stands, is overly complicated, costly, and confusing. Some aspects of the proposed rule are too broad, while others are too narrow to adequately address risks.
- For any regulation of automated trading to be successful, it is critical to recognize and leverage the substantial risk controls and safeguards that have already been put in place by the industry, to be effective and relevant to dynamic market conditions and practices (requirements should not be overly prescriptive), and to apply pre-trade risk controls on all electronic orders – not just from certain types of market participants.
- We support the idea of simplifying the rule by breaking it up into separate components in the following order:
  - Pre-trade and other risk controls.

- Policies and procedures for the development, testing, deployment, and monitoring of algo trading (including third-party software).
- Registration of certain market participants, if necessary.
- The topics below are specific concerns regarding Reg AT as proposed:
  - The scope of the proposal is too broad in some parts and too narrow in others.
  - The registration requirements are unnecessary.
  - Source code should only be available to the government with due process.

**Andrew Vrabel, Executive Director of Global Investigations, CME Group**

- CME has pioneered innovative risk controls and system safeguards, and continually employs substantial human resources and technological capabilities for the development, implementation, and enhancement of these controls.
- Much of Reg AT's framework is overly broad in scope, unworkable, and could be counterproductive - our comment letters urge the CFTC to re-focus its proposal on the essential area of flexible, not mandated, market risk controls that can be tailored to the different business operations and roles of traders, intermediaries, and exchanges to best protect market integrity.
- Instead of requiring exchanges to prevent algo trading disruptions and algo trading compliance issues, we urge the CFTC to adopt a standard that requires exchanges to implement tools to mitigate the effects of an algo trading disruption.
- The requirement that certain algo traders prepare and submit extensive annual compliance reports to exchanges creates an unnecessary administrative burden and substantial costs on all parties involved without providing significant benefit to market integrity.
- CME proposes that two layers of pre-trade risk controls would apply to all algo trading orders:
  - The first layer would be administered by either the algo trader itself or its clearing member that granted access to the exchange.
  - The second layer would be developed and administered by the exchange.
- Both layers of market risk controls must be reasonably designed to mitigate the effects of algo trading disruptions, and set at a level of granularity appropriately tailored to the underlying nature of the algo trading activity such that the risk mitigation standard is met.
- All algo traders should be subject to market risk controls. Reg AT leaves a control void for some algo traders by only requiring market risk controls for AT Persons - the reason for this gap is that the CFTC has focused primarily on attempting to capture a set number of new registrants.
- We believe registration is a secondary concern - the first aim of any rule in this area should be establishing a blanket of market risk controls that applies to all algo trading in a consistent manner.
- The source code provision raises serious concerns regarding the confidentiality of proprietary information. Currently, if the Commission has reason to believe that it needs access to a market participant's source code, it can obtain the code subject to adequate confidentiality protections via the subpoena process and they should maintain that process.

**Michael Ryan, Executive VP and General Counsel, Trading Technologies International, Inc.**

- As an independent software provider (ISV), we are focused on three aspects of Reg AT:
  - The definition of direct electronic access (DEA) should be clarified to indicate that there is no DEA where the orders are routed to an exchange through a clearing member's trading system where pre-trade and other risk controls can be controlled by the

member, even where a trading firm or third party maintains the physical location of the systems.

- Without clarification, DEA will likely cause many single traders, small trading groups, and even larger companies like energy firms and ag co-ops and merchants who hedge on futures exchanges, all of whom trade through DCO members and are often substantial liquidity providers to have to register as Floor Traders (FT).
- TT believes that the source code provision and the CFTC and DOJ's inspection authority are unnecessarily and extraordinarily broad, not likely to provide helpful information, likely amount to an unconstitutional taking of individuals' property, and are generally unnecessary to achieve the goal of the proposed regulations.
  - Source code is highly proprietary, trade secret information that could expose the fundamental aspects of a business that provide economic advantage over competitors. Making such valuable IP readily available to the Commission is unnecessary to fulfill the intent of the regulations.
  - Source code is complicated and the breadth of the relevant code might also be so expansive that it is hard to fathom how it would be compiled, stored, or used effectively.
- Testing should focus on the output of an Algorithmic Trading system (ATS) rather than the source code underlying such systems.

## Discussion

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### Source Code

*Conaway (R-TX):* Can the CFTC anticipate future market events by studying source code? *Gorelick:* No, it is highly implausible. Determining future market events depend on hardware, network characteristics, etc. – not source code.

*Peterson (D-MN):* Does the Division of Market Oversight (DMO) have subpoena authority? *Wood:* Not sure, but the enforcement division does; *Gorelick:* The best way to figure out a trading strategy is to analyze the data and readily available (to CFTC and exchanges) audit trail information. Electrification has allowed for a complete audit trail and allows an unprecedented level of transparency over the market; *Ryan:* Over 17 years, TT has often been contacted by the CFTC and DOJ about technology questions and cooperated.

*Goodlatte (R-VA):* Any security concerns with the source code provision? *Gorelick:* Yes, but also due process concerns. Firms exercise their own precautions (i.e. network, access requirements), but once the code is with a third-party, the firm loses its ability to manage those controls.

*Scott (D-GA):* Is Reg AT unprecedented in demanding source code without a subpoena? *Ryan:* Yes, we are unsure how source code will actually be useful.

*Lucas (R-OK):* Is there a definition of source code, if not, is there a need for a universal definition? *Ryan:* Source code is not really defined.

*LaMalfa (R-CA):* Is the source code provision harmful, any alternatives? *Gorelick:* The CFTC should maintain its subpoena process when asking for source code. As an alternative, we recommend a

principles-based retention policy to allow access following existing processes and appropriate security safeguards.

*Neugebauer (R-TX)*: What happened when the Chinese government tried to access source code of U.S. firms doing business in China? *Gorelick*: The Chinese backed down from their proposal because the it was demonstrated to be unprecedented. The CFTC would set precedent that will be detrimental to other industries (i.e. IP).

*Scott (R-GA)*: With recent breaches into the government, do you have any comfort with the government's access to source code? *Gorelick*: No; *Ryan*: No, and source code is not easy to interpret and unlikely that the CFTC can do anything with code.

### **Definitions**

*Conaway (R-TX)*: Under the proposal, what percentage of market participants would qualify as AT persons? *Wood*: Automated trading is used by different types of market participants in various ways. The proposal would capture a high percentage of the marketplace; *Vrabel*: In ag markets, roughly 50-53% of total volume comes from automated strategies. Every type of market participant uses some form of automated trading strategy (i.e., simple auto spreader).

*Scott (D-GA)*: Should the AT definition separate out automated execution versus algo strategies that drive trading decisions? Is it better to regulate the activity as opposed to the entity (AT Person)? *Vrabel*: Not sure separating the definition will protect markets. We need to include protections for both simple applications and highly sophisticated programs; *Wood*: CFTC should not adopt a strict definition of AT Persons, and instead focus on the activities. Creating an arbitrary categorization of AT Persons does not protect the overall integrity of the marketplace.

*Crawford (R-AR)*: Are there concerns in the proposed FT and DEA definitions? *Gorelick*: Registration should be proposed in a separate rulemaking. DEA is irrelevant if risk controls are appropriately applied.

*Adams (D-NC)*: How can we prevent and protect the marketplace from faulty algos? What is the best way to correct the proposed definitions? *Wood*: FCMs already have risk controls in place to protect against market events; *Gorelick*: The CFTC must focus on appropriate risk controls rather than creating definitional boundaries.

### **Pre-Trade Risk Controls**

*Conaway (R-TX)*: Is CME's proposed two tier pre-trade risk control model already in place? *Vrabel*: Yes, every market participant has and goes through some degree of risk control. Risk controls and protections must be placed adequately – CME has done that.

*Thompson (R-PA)*: Where should risk controls be placed? *Vrabel*: Simple automated trading poses the same problems as would a sophisticated program. We need to protect the entire market, not just a subset of traders; *Wood*: When FCMs provide access to the marketplace we provide risk controls. If a firm bypasses our systems and connects directly to the exchange, they have a responsibility to ensure appropriate risk controls are in place. The Commission is going one step further by requiring registration based on the type of access, but this is going too far. We have conceded that if someone chooses not to use existing risk controls of the FCM that they register.

*Neugebauer (R-TX)*: What new risk controls are required on market participants? *Wood*: Reg AT proposes a prescriptive list of controls at the AT Person, FCM, and DCM levels. Several controls are used at all three levels and some are not. Generally, the rules are too prescriptive on the controls applied at the various levels of the marketplace. Controls should be appropriate to the type of activity and by market participant.

### **Development and Testing**

*DelBene (D-WA)*: How does the market currently test source code? *Ryan*: Throughout the development phase, we test the function, security, written code, and how it all interacts with the market. The source code itself is irrelevant; *Gorelick*: Internally, we perform component level testing (review a particular code), system level testing (simulated environment), and live market testing (in smaller scale before actual trading) to see if the code performs as designed. Studying the source code itself does not show how it operates in a real-life marketplace; *Wood*: There are many factors that influence how the software interacts with the marketplace. Source code itself is irrelevant. The only way to protect the marketplace is to ensure appropriate risk controls are in place to mitigate market disruption.

### **Cost Benefit Analysis**

*LaMalfa (R-CA)*: Are there any benefits of Reg AT to commercial end-users? Does the cost benefit take into account the cost of FT registration and ongoing compliance costs? *Gorelick*: There are no measurable impacts to commercial end-users. Costs are not just borne to market professionals, but it will lead to higher transaction costs and reduced liquidity. The proposal's cost benefit analysis takes a narrow view of costs.

*Davis (R-IL)*: Does the cost benefit analysis take initial and ongoing compliance costs into account? *Wood*: The cost benefit is narrowly focused and ignores wider impacts. Compliance will impose a large burden on all market participants, from those classified as FT, those already registered (i.e. CPO, CTA) but classified as an AT Person, FCMs, and DCMs. The cost of compliance will ultimately be passed onto the entire marketplace (i.e. pensions, asset managers, commercial end-users). Our main concern is the rule's impact on liquidity in U.S. futures markets; *Gorelick*: The Commission does not take into account competitive impacts (smaller firms leaving the market) and source code.

### **Reporting**

*Davis (R-IL)*: Will proposed reporting requirements help prevent algo disruptions? *Vrabel*: The proposed requirement only obligate exchange review of compliance reports every four years. This creates a huge gap and participants will think exchanges are endorsing their practices when in fact they have inadequate risk controls. The root cause of algo disruptions will not be discovered in a routine examination of compliance reports.

### **Certification**

*Conaway (R-TX)*: What will AT Person certification look like? *Vrabel*: We already require firms to maintain an audit trail for 5 years. Firms not 100% certain on whether they are in compliance will not certify. CME will then interrogate the data to find out why. The current certification process works.

### **Third-Party Service Providers**

*Lucas (R-OK):* How many vendors are currently out there? *Ryan:* About a dozen companies; *Wood:* Some firms use third party service providers and some develop their own systems.

### **Electronic Trading**

*Lucas (R-OK):* What are the benefits of automated trading? *Gorelick:* Trading is more efficient on a computer and the end result is lower costs for end-users.

*Allen (R-GA):* What keeps you up at night? *Gorelick:* Competition and keeping up with changes in the marketplace. New regulations such as Reg AT may distort things that are working well right now. Reg AT will take time and energy away from the core functions of risk management and the competitive environment of the marketplace. Proprietary traders manage their own money so their risk management goals are aligned with the marketplace. We share the government's goal to ensure a marketplace that is transparent, well regulated, and instills confidence to the public.