

# big dust-up at Reg AT hearing

Last week the CFTC approved, by a 2 – 1 vote, a supplemental proposal (Reg AT Supplemental Proposal) that amends a 2015 proposed rule related to automated trading (Proposed Reg AT).

The vote was a formality; few believed that it would play out any differently. The two-Democrat to one-Republican commission spread, held fast and true.

As the hearing progressed last Friday, few even remotely considered that Trump would be the president-elect a few days later. We all anticipated chairman Massad to remain in his seat for years to come, and the two current Obama nominees would have likely been substituted for Clinton loyalists and run through the process later in 2017. From what we hear, the Clinton team had list upon list of potential appointees, for every imaginable position, in every agency and department, court and office, ready to hit the ground running in January. One potential appointee we know for a regulatory agency post, told us anonymously that he has been on an agency short list for a very long time – eight years since Hillary lost to Obama back in '08. From what we can ascertain, Trump has no such list, but fortunately, Rep. Paul Ryan and Sen. Mitch McConnell probably do. Nobody we know at the various white shoe law firms were avid Trump supporters, but many are loyal Republicans. Who knows, maybe that's enough for the new guys. Since energy policy and financial policy are on the reform short list for the new administration, we reckon filling empty agency slots may be somewhat of a priority, so we imagine Ryan and McConnell will be instrumental in the process.

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The lone dissenting vote, GOP Commissioner Chris Giancarlo made full use of the Q&A period to raise all number of issues, poking and prodding at staff language, raising many questions that will likely come

up with great regularity during the current 60-day comment period. Or perhaps the next CFTC chairman will make it a mission to 'fix' Reg AT before the rule gets a final look. Particularly if the next chairman is Giancarlo. Interestingly, the hearing drama last week began to build from the get-go; Commissioner Giancarlo opted to forgo an opening statement and instead waited to unleash his views after other commissioners' opening statements and staff presentations ended.

Giancarlo began his questioning by establishing that 1. The Division of Market Oversight has never sought access to source code and that 2. the current procedure for oversight staff access to a company's source code is much like the new rule, that is, staff must get a majority of the commission to sign off on the request. In the past only the division of enforcement has sought source code by way of a subpoena, which also required a majority of the commission to agree to issue a subpoena. So, one office requires a subpoena, by way of a majority vote by the commission, and one office simply requires a majority of commissioners to sign off on it. Giancarlo put it a different way, of course, but the question before staff was essentially, "What's up with that?"

"Automated traders who are asked to turn over their algo source code, right now, they are protected under the Fourth Amendment against unreasonable searches and seizures which means the right to a pre- decision review before a neutral decision maker, that's the subpoena process.," he said. This process basically allows the owner of the algo code to limit the scope or duration or other controls around the data being turned over. "Under this proposal, while it may remain the same procedurally for the CFTC, we take away the procedural rights of the property owner. They just have no choice if this rule is passed but to hand over their source code and basically shut up. How is that fair?"

Staff answered by largely reiterating what the chairman has said all along; source code is a record like any other. It isn't unique. "So with respect to the records that we are discussing, a point of this proposal is to clarify that the books and records requirements do extend to source code and the log files." Access and handling of the code and records shouldn't affect the algo firm, they said, since little has changed procedurally, "of course, unless and until some subsequent enforcement action occurs," staff said.

Giancarlo asked about confidentiality. He asked if the current confidentiality rules which now apply to records or data considered proprietary, also apply to source code, or are there new, additional protections? Staff said the current confidentiality rules would also apply to source code. Giancarlo followed with, "If we're really serious about confidentiality why wouldn't we have included some new heightened protections, for example, why would we not at least agree that when we are done with our review, we would either give back the source code or destroy it and not leave it in our premises; or why would we not put in other protections such as who has access or that perhaps it might be kept off line and not accessible on an online basis, why couldn't we build in some new protections?"

Good one. Staff answered, "Certainly the commission could consider where additional affirmative protections should be available for this type of trade secret. I would indicate that for market participants who view their information as confidential, there is an expectation that all information that the commission receives are treated confidentially but to the extent that there are additional restrictions or obligations for the manner in which staff access the information to assure compliance with the confidentiality provisions, that certainly makes sense ..."

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So, we expect a new provision that either puts a clock on stored source code records or a provision to destroy it after the investigation is over.

His next question dealt with global privacy requirements and the US government's current dust-up with China over a law that would force US high-tech firms (or any other firm) to hand over source code to the Chinese government, when requested. The current US government position largely tells the Chinese government to pound sand.

"Do you think that what we are trying to do here (agency access to source code) is at odds with our government's efforts to prevent the Chinese from obtaining source code of tech firms?" Giancarlo asked. Staff dodged the question, answering simply that the new rule is consistent with the agency's mission of ensuring "our markets operate in an orderly and safe" manner.

Next, Giancarlo read his full statement. You can download it here: <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement110416#SpTeMBR2>.

In short, he tore the supplemental rule to pieces. His written statement and his various questions at the hearing will likely serve as a crib sheet for near-term public comments, and very likely, as the next chairman's policy direction on the handling and access to source code by agency staff.

Though he opened with great praise for staff's hard work on the policy statement – he actually agrees with a good bit of the new rule – his view on staff access held fast: "I have warned that any public good achieved by the rule is in my mind undone by this provision that proprietary source code used in algorithmic trading be accessible at anytime, anywhere to the CFTC and to the Justice Department without a subpoena ... " He added that jettisoning the subpoena process "does not address the challenge of automated trading. It just strips the firms we regulate of their constitutional rights ... "

Chairman Tim Massad parried Giancarlo's line of questioning quite well. He directed staff to describe how the oversight process works now, when some sort of possible trading mischief is spot-

ted. Staff noted that they usually reach out directly to the trader and request various data, voice, phone or paper records, to get a better understanding of what's going on. Staff noted that typically, traders hand over stuff voluntarily, or, if they don't comply, the agency may sue for the data. Again, this is simply oversight-level stuff at this point, enforcement isn't part of the picture.

"So instead, let's say the trader is an algo trader," Massad began. "So the strategy, and again, it's not clear whether this is a strategy that's compliant with the

law or not, as the strategy is, you know, in an algo. And, of course, first there might be several things we would do, we might just call them up and talk to them, what were you doing? We might look at message data, you know, we might address our concerns through any number of ways. But if it came to it, and the trader has told us certain things, and we are still not so sure, and so we want to see the source code. Then what we're really saying here is, because nowadays, the strategy isn't in emails, it

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The graphic features a dark blue background with a light blue line graph at the top. Below the graph is a network of circular icons connected by lines. The icons represent various energy and trading concepts: a warning sign, a lightning bolt, a solar panel, a battery, a wind turbine, a power line tower, a pumpjack, a plug, and a smartphone. The NASDAQ OMX logo is in the bottom right corner.

isn't in phone calls, it isn't in these other old-world records, as we might even call them today. It's in ones and zeros and a computer code – (but) sorry, we can't have that? That's where we are. Unless, we decide to bring an enforcement action, obviously, which you know, the investigation itself implies, may give the appearance of wrongdoing, a lot of firms don't like to get subpoenas because of that ... but if we went that route, enforcement could seek a subpoena, of course enforcement might not even want subpoena ... sometimes enforcement calls rather than market oversight. So, traders get the call and say, 'Oh, gee, I'd better give it to them. ' So, a lot of times enforcement gets things even without subpoenas. So, in other words, if you trade in our markets under the old-world ways, you're subject to surveillance but if you trade in our markets under the new-world ways of algos, oh, no, that's a violation of the Constitution if we ask to see something that evidenced your trading strategy ... ”

“I guess to my mind, what we are trying to do here, is we are not changing our process. We are updating our rules for the fact that the way trading is conducted has changed,” Massad says.

We recommend you take the time to watch the replay of the hearing, the last 15 minutes anyway, that features Chairman Massad speaking specifically to the points raised in Commissioner Giancarlo's statement and questions to staff.

Giancarlo noted in his statement and in previous public statements that this relaxing of agency requirements for access to source code (that is, no longer requiring a subpoena for staff access) put the commission on a “slippery slope.” Massad took exception to the very idea.

“Finally, let me just say on the slippery slope point, it strikes me as the wrong metaphor. This is not a slippery slope. This is an uphill climb. It's an uphill climb because our markets have evolved much faster than our regulatory framework and we are trying to climb up a steep hill to catch up, to be able to see what is going on in our markets today and engage in adequate oversight, and this information (source code) could be critical,” he said, and that, “you should not be able to hide behind machines ... ”

In the end, Giancarlo wouldn't have any of it. Sticking to his guns, he countered Massad's position that the voice and paper records of the old days are akin to the “ones and zeros of source code today.”

“I just want to say for the record that comparing records of historic trades to the most valuable algorithmic systems that protect the firm's business strategies are comparing apples to oranges. Trades, historic trades, that's books and records. Firms and algorithmics that show what they will do in the future of certain market factors is an entirely different thing,” Giancarlo said.

“Let me just say, [we're] requiring the preservation of source code, because source code is changed all the time. What we are looking at, in any given instance, is the past. It is what they did, and it is the same thing, from the standpoint of our mission ... it's the same thing as if you wrote down exactly how you want to trade on a piece of paper,” Massad said. And so, he had the last word. He next entertained a motion to vote.

“Commissioner Giancarlo?”

“No.”

“Commissioner Bowen?”

“Aye.”

“Chairman Massad?”

“Aye.”

“Therefore the motion is adopted.”

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Below is a summary of the key points in the supplemental rule, courtesy of the good folks at Cadwalader.

Below is a summary of the key aspects of the Reg AT Supplemental Proposal based upon the discussion at the CFTC's open meeting along with the fact sheet and Q&A document posted to the CFTC website.<sup>2</sup>

### **I. Quantitative Test for Registration as AT Person**

Under Proposed Reg AT, commission registrants that engage in algorithmic trading are subject to commission rules related to the registrant's algorithmic trading (AT persons). Proposed Reg AT also would expand the scope of floor traders required to register with the commission to include algorithmic traders that trade on a designated contract market (DCM) via direct electronic access.

The Reg AT Supplemental Proposal generally retains this framework. However, it proposes a new quantitative threshold to determine whether a person must register under the new category of floor trader, and whether a commission registrant is an AT person. The proposed volume threshold is 20,000 contracts on average, per day, over a six-month period. Thus, if a market participant trades on a DCM via direct electronic access, the participant must register as a floor trader if the participant exceeds the volume threshold. Furthermore, if an existing commission registrant engages in algorithmic trading, the registrant is an AT person if the registrant exceeds the volume threshold. With the proposed volume threshold, the CFTC estimates that 120 persons will fall into the definition of an AT person, of which, 50 would be newly registered floor traders and 70 would be current registrants.

### **II. Confidentiality Structure for Source Code**

Proposed Reg AT required that AT persons maintain records of their source code and make the source code available to commission staff upon request. As initially proposed, CFTC Staff did not need to seek commission approval to request and obtain the source code. However, under the Reg AT Supplemental Proposal, the staff only would be able to obtain the source code through issuance of a subpoena or special call, either of which must be approved by a commission vote.

The open meeting revealed significant differences of opinion on the commission about the effectiveness of the new provisions related to obtaining source code information. Commissioner Giancarlo, who dissented, compared the process for obtaining source code through the special call procedure under the Reg AT Supplemental Proposal as an unconstitutional taking without due process of law. In contrast, Chairman Massad viewed the special call procedure as providing the CFTC with the same tools it already has with respect to nonalgorithmic traders. Notwithstanding these differences, the chairman and Commissioner Giancarlo appeared to agree that the Reg AT Supplemental Proposal could be improved by narrowly tailoring the way

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CFTC Staff access source code, for example, by building in safeguards that limit the location of the review and the duration of the CFTC's access to the information.

### III. Elimination of Annual Reports

The Reg AT Supplemental Proposal removes the requirement for futures commission merchants (FCMs) and AT persons to file annual reports with a DCM regarding their risk control framework. In lieu of the annual report, the Reg AT Supplemental Proposal would establish an annual certification process for AT persons to certify compliance with Regulation AT to a DCM. The Reg AT Supplemental Pro-

posal also obligates DCMs to establish a program for periodic review of AT persons' compliance with Regulation AT.

### IV. Risk Controls: Two-Tier Framework in lieu of Three-Tier Framework

Proposed Reg AT includes various pretrade risk controls that DCMs, FCMs, and AT persons must design and implement. The Reg AT Supplemental Proposal shifts the three-tier structure for pretrade risk controls in Proposed Reg AT to a two-tier structure. Specifically, both the applicable DCM, as well as either the AT person or its FCM, must adopt pretrade risk controls. The Reg AT Supplemental Proposal also shifts the FCM pretrade risk controls from

the clearing FCM to the executing FCM. In deciding who should implement the pretrade controls, an AT Person may delegate pretrade risk controls to its executing FCM, but that FCM is not obligated to accept the delegation.

Finally, the Reg AT Supplemental Proposal would expand the scope of pretrade risk controls to require controls for all electronic trading, as opposed to Proposed Reg AT, which would have limited the pre-trade risk controls to the algorithmic trading of AT persons. Under this proposed regulatory framework, FCMs would need to develop pretrade risk controls for electronic trading of nonAT persons.

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# review

By Arthur Jones

## The Industries of the Future

The Kenyan farmer joked, "iCow tells me when to give my cow maternity leave." He was referring, in Alec Ross's *The Industries of the Future* (Simon and Schuster, \$28), to "a text message and voice-based app" being used by more than 11,000 small-scale dairy farmers who tend an average of three cows. The iCow app was created by an African woman, Su Kahumbu.

Ross is a fine writer. He deals with the biggest future industries and trends crisply in chapters that range from robots to the weaponization of code. In this space, I cannot do justice to how deeply Ross is exploring these topics.

Ross posits Africa's possibility of leap-frogging into the technological future using "frugal innovation," but not stopping there." Already American Jeremy Johnson, through his Andela program, is connecting Nigeria's brightest and best "technology geniuses to top technology employers." Johnson is running Andela "boot camps" to identify thousands more.

Robots? Japan's aging popula-

tion will require 4 million eldercare nurses. It has 1.4 million. Enter the nursing home robots, and it staggers the imagination with which robots are already doing what. The "future of the human machine," that's us, he sums up with "everything we know about life sciences is going to change." The critically insightful chapter, "Code-ification of Money, Markets and Trust," as cash rapidly gives way to coded money, speaks to the disappearance of the wallet from everyday use. All you'll need is your phone.

We've already glimpsed the new face of war Ross writes about in "Weaponization of Code." We see the need to develop cyber-defense strategies in everything from recent political revelations, apparently Putin-prompted, to the hacking of major US corporations and key governmental agencies.

West Virginian Ross writes with deepest feeling when he describes the plight of his fellow West Virginians, their past economic lives tied to coal, chemicals and heavy industry, and their current woes and empty future. The US natural resource

treasure trove of raw materials – coal, iron, copper – is now depleted or no longer wanted. "Data," he says, is "the Raw Material of the Information Age."

Takeways for everyone's tomorrows: locations and skills. My suggestion is to plunk down \$28. Ponder with Ross the "geography of future markets," and the principles of what it will take to be competitive. Then look on your money spent as an investment in your children's and grandchildren's future as you read Ross's concluding, "The Most Important Job You Will Ever Have."

First-class material from a young man who spent time in 41 countries as Secretary of State Clinton's senior adviser for innovation and now pulls it all together as a Johns Hopkins visiting fellow and corporate and government innovation adviser.

*Arthur Jones is a former Forbes European bureau chief and Financial Times correspondent.*