

May 1, 2017

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St, N.W.
Washington, DC 20581

**Re: Regulation Automated Trading; Proposed Rule: 17 CFR Parts 1, 38, 40 et al
Supplemental Notice of Proposed Rulemaking, RIN 3038-AD52**

Dear Mr. Kirkpatrick:

The International Swaps and Derivatives Association, Inc. (“ISDA”)¹ appreciates the opportunity to submit these comments on the Supplemental Notice of Proposed Rulemaking for Regulation AT (“Supplemental Notice”)² published by the U.S. Commodity Futures Trading Commission (“CFTC” or “Commission”).

We reiterate our full support of the Commission’s goal to reduce risk in the financial markets, ensure reliable and orderly price discovery and prevent market abuses. As we noted in our prior submission, we believe that proper risk controls and monitoring

¹ Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association’s website: www.isda.org.

² CFTC Supplemental Notice of Proposed Rulemaking, *Regulation Automated Trading*, 81 Fed. Reg. 85334 (Nov. 25, 2016).

requirements are important mechanisms for furthering that goal. To that end, any final regulation should fully account for the effectiveness of the existing industry mechanisms and best practices, as well as the continuing self-regulatory efforts to minimize the risk of market disruption, and seek to minimize the impact of the final regulations on market participants to the extent necessary to achieve the Commission's stated goals.

In this regard, we ask that the Commission review both the Regulation Automated Trading Proposal³ and the Supplemental Notice to ensure that it is in line with the objectives of Acting-Chairman Giancarlo's project KISS—an initiative to apply the Commission's rules in ways that are more straightforward and cost-effective. In light of the Acting-Chairman's goals, we urge the Commission to reconsider its current approach under both the Regulation Automated Trading Proposal and the Supplemental Notice and take a principles-based approach toward automated trading, rather than implementing a set of impracticable and prescriptive rules. We believe that a principles-based approach will enable the Commission to achieve its goals of reducing risk and/or preventing market disruptions while, at the same time, minimizing excessive burdens and costs to market participants.

We appreciate the Commission's decision to issue this Supplemental Notice to address the feedback it received in response to its initial Proposal.⁴ We support certain aspects of the Supplemental Notice, including allowing market participants greater discretion regarding compliance with the pre-trade risk control requirements and proposing a risk control framework at two, rather than three levels AT Person or Futures Commission Merchant ("FCM") and Designated Contract Market ("DCM").

We are troubled, however, by the Commission's unexpected expansion of the Proposal's scope through the Supplemental Notice. Specifically, the proposed definition of Direct Electronic Access ("DEA") now includes all *electronic* orders originating from clients that are processed in any manner through an FCM's electronic order handling infrastructure—even if an algorithm is not utilized or they are not routed directly by a client to a DCM. This change represents a significant departure from the position taken by the Commission in the NPRM and does not address the risks related to automated trading on DCMs.⁵ Rather, we believe a more appropriate approach would be to amend the AT Person definition to capture those Commission registrants who have DEA and whose trades do not flow through an FCM's risk controls before reaching the DCM.

³ CFTC Notice of Proposed Rulemaking, *Regulation Automated Trading*, 81 Fed. Reg. 78824 (Dec. 17, 2015).

⁴ Proposed Rule, *Regulation Automated Trading*, 80 Fed. Reg. 78837 (Dec. 17, 2015) (to be codified at 17 C.F.R. §§ 1, 38, 40, and 170).

⁵ *Id.* at 78827.

We also are concerned that the Commission’s proposed compliance alternative for AT Persons using third-party Automated Trading Systems (“ATs”) does not relieve AT Persons from the responsibility to test and maintain the source code that they do not possess or have any right to access. Further, consistent with Acting-Chairman Giancarlo’s dissenting statement in the Supplemental Notice⁶, this requirement places AT Persons who use third-party ATs in the untenable position of having to compel compliance by its service providers with the Supplemental Notice’s testing and recordkeeping requirements.

Finally, we remain concerned that the Commission continues to insist on circumventing the due process procedures by proposing to have the ability to access the ATs source code without obtaining a subpoena. In lieu of the due process protections, the Commission proposes to utilize a “special call” procedure, an internal agency process that is authorized by the Commission itself and executed by the Director of the Division of Market Oversight (“DMO”).

The discussion below focuses on the three areas of concern.

1. Unsubstantiated Expansion of the Scope of the Proposal

Absent a significant material change in the markets, the Commission has not explained why it has determined to change course and expand the scope of the Proposal. Under the new proposed definition, DEA includes any arrangement where a market participant electronically transmits an order, modification or cancellation to a DCM. The Commission intends to address concerns regarding market disruptions by simply casting a wide net without explaining why the newly captured market participants now pose the type of risk that could lead to market disruptions.

Further, in an attempt to limit the registration requirements to firms that can cause significant market disruptions, the Commission proposes to set a minimum volumetric trading threshold as a pre-requisite to the registration requirement. While an aggregate volume threshold may exclude smaller firms from the CFTC regulations, these firms would still fall within CFTC jurisdiction due to the re-proposed expanded definition of DEA and the overly expansive reach of the volume threshold test, which applies to the volume of all *electronic* trading. To that end, it is not apparent to ISDA why the Commission has concluded that the proposal will reduce the number of participants affected by the proposed regulation to 120 firms.

⁶ Statement of Dissent by Commissioner J. Christopher Giancarlo Regarding Supplemental Notice of Proposed Rulemaking on Regulation Automated Trading (Nov. 4, 2016), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement110416>.

We believe that, at a time when market participants continue to work tirelessly to comply with other new and forthcoming regulatory requirements, the Commission should fully consider the impact that an unexpected expansion of the Proposal would have on the compliance costs for smaller firms and firms that do not engage in the activity in which the Proposal is focused. These firms will be expected to yet again allocate scarce resources in the form of personnel, time and capital to comply with the costly registration and compliance requirements and to overhaul or modify their existing risk control mechanisms and other operations. Moreover, due to the breadth of the definition, some smaller firms would have no experience with the CFTC regulatory regime, which is likely to exacerbate their compliance costs. All of these changes still would not address the essence of the Commission's fundamental concern—prevention or reduction of risk to the market caused by firms engaged in black box and high frequency trading directly on the DCM.

Separately, requiring firms that execute trades through an FCM to register as AT Persons would be another example of regulatory overreach with significant costs and potentially conflicting compliance requirements with no associated benefit. A better approach would be to limit the definition of DEA to trading activity that does not flow through an FCM's risk controls. We believe that our proposed alternative aligns with the Commission's stated goals and would accurately limit the scope of the rule to capture only those participants that do not have the necessary risk controls in place and that may pose the type of risk that could lead to market disruptions.

As we noted in our March 16, 2016 letter, prior to establishing any automated trading regulatory framework, it is essential to distinguish between two categories of AT Persons: (1) market participants that use a pre-programmed computer algorithm that involves no human involvement and (2) market participants that utilize some form of electronic trading system to execute their orders. Undoubtedly, the latter category does not remotely present a similar level of threat to the market to warrant the imposition of the same regulatory framework. Instead of subjecting more market participants to the burdensome regulatory requirements, the Commission, together with market participants who utilized pre-programmed trading algorithms, should first and foremost focus on establishing properly-tailored risk control mechanisms to be able to quickly and effectively respond to possible disruptive events caused by large algorithmic traders. Alternatively, the Commission should refine the definition of DEA and narrowly tailor the scope of the AT Person definition to focus on market participants that use a pre-programmed algorithm that involves no human involvement and where such orders are transmitted directly to the DCM without passing through the FCM's risk controls.

2. Unworkable Alternative Compliance Regime for Third-Party Systems

The Commission proposes an alternative framework for AT Persons to comply with their obligations related to monitoring and testing of ATSs. Under the Supplemental Notice, AT Persons who, due solely to their use of third-party systems, are unable to comply with a particular development or testing requirements, may comply with the obligations by satisfying two requirements: (i) obtaining a certification that the third party is complying with the obligation and (ii) conducting due diligence regarding the accuracy of the certification. This approach is untenable as it requires an AT Person to cause an independent third-party ATS to comply with the relevant regulations, while the AT Person remains responsible for the third-party's compliance with the relevant recordkeeping obligations, including the third-party's willingness to provide the Commission access to the third-party's proprietary source code.

Although the Proposal theoretically permits an AT Person to rely on certification by the third-party of its compliance with the rules, including testing and recordkeeping, this approach is unworkable in practice because the third-party ATS provider is not legally obligated to provide such a certification and an AT Person does not have the authority to cause an independent third party to turn over their proprietary source code. Rather, the scope of any testing, certification or due diligence undertaken by the third-party is subject to a bilateral negotiation, which will likely entail increased costs for third-party users due to the regulatory and operational complexities attendant to using third-party ATSs under the Proposal.

In addition to an initial certification and an annual certification, the Proposal requires AT Persons to obtain a new certification from the third-party ATS provider in the event of any material changes to the ATS. This requirement is overly burdensome and will result in increased costs and administrative obstacles, particularly in light of the requirement to provide an initial certification and annual certification covering all existing and future changes. These certifications, particularly to the extent the AT Person is separately required to conduct due diligence (discussed below), amounts to regulatory overkill.

With regards to the proposed requirement that AT Persons, despite obtaining the certifications demonstrating that the ATS complies with the CFTC required system development and testing requirements, must still conduct due diligence to verify the accuracy of the certification, it is important to note that the third-party ATS provider may refuse the AT Person's request to provide access to the requisite information since the third-party does not have a legal obligation to honor the request. Finally, the third-party may also refuse to provide the relevant source code upon the AT Person's request, based on a CFTC subpoena or special call request to the AT Person, in which event the AT Person would remain liable for such an omission by a third-party over which the AT Person has no control. The net result of this alternative compliance regime would leave

AT Persons with the same untenable responsibility to monitor and test ATs that was proposed in the NPRM and that was vehemently opposed by the majority of market participants.

Notably, the Commission acknowledges that “obtaining certification and conducting due diligence may still be challenging for some AT Persons,” but nevertheless decides to go forward with the proposal. Setting out an unworkable regulatory framework would only lead to more enforcement reviews and would disincentivize market participants to provide liquidity and price discovery.

We firmly believe that FCMs and third-party providers are in a better position to perform the necessary testing and requisite certification to fulfill the regulatory requirements.

3. Supplemental Notice Continues to Place Firms’ Source Code at Unnecessary Risk

We are concerned that the Commission continues to insist on making the source code available for inspection by the Commission without a subpoena despite fervent objections by market participants. The internal procedural safeguards offered by the Commission do not remedy the problem. We agree with Acting-Chairman Giancarlo that “the special call process provides the CFTC an end-run-around the subpoena process” and that although the Commission states it will “use the special call process to obtain source code in carrying out its market oversight responsibilities, there is no limit in the proposed rule on DMO staff from sharing source code with staff of the Division of Enforcement.”⁷ To reiterate, the fact that the Commission will have unprecedented access to firms’ intellectual property by forgoing the requisite due process protections cannot be justified by any policy objective. We echo Acting-Chairman Giancarlo’s concerns that this requirement would “give[] unchecked power to the CFTC to decide if, when and how property owners must turn over their source code.”⁸

Accordingly, we strongly believe that the Commission should be allowed to obtain the source code only upon issuance of a subpoena.

⁷ Statement of Dissent by Commissioner J. Christopher Giancarlo Regarding Supplemental Notice of Proposed Rulemaking on Regulation Automated Trading (Nov. 4, 2016), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement110416>.

⁸ *Id.*



We appreciate the opportunity to comment on the Supplemental Notice. Please contact me at (212) 901-6031 or via email at kdarras@isda.org with any questions the Commission might have with respect to the comments contained in this letter.

Sincerely,

A handwritten signature in blue ink, appearing to read "KDarras", positioned above a horizontal line.

Katherine T. Darras
General Counsel
International Swaps & Derivatives Association, Inc.