

December 16, 2020

CFTC Electronic Trading Rules

CFTC Adopts Final Rule on Electronic Trading Risk Principles

SUMMARY

On December 8, 2020, the U.S. Commodity Futures Trading Commission (“CFTC” or the “Commission”) held an open meeting at which it voted 4-1 (with Commissioner Rostin Behnam dissenting) to adopt a final rule, applicable to designated contract markets (“DCMs”), addressing electronic trading risk principles (the “Final Rule”). The Final Rule, which substantially tracks the proposed rule promulgated on July 15, 2020 (the “Proposed Rule”),¹ takes a principles-based approach to monitoring risks inherent in electronic trading, and is designed to provide DCMs with the flexibility to tailor the rules and pre-trade risk controls for market participants subject to each DCM’s respective jurisdiction. The CFTC believes that this approach provides DCMs with the requisite flexibility to implement rules and procedures appropriate for their markets and to adapt and evolve with changing technologies and markets.² The Final Rule consists of three principles applicable to DCMs:

- Risk Principle 1: The implementation of exchange rules applicable to market participants to prevent, detect and mitigate market disruptions and system anomalies associated with electronic trading;
- Risk Principle 2: The implementation of exchange-based pre-trade risk controls for all electronic orders; and
- Risk Principle 3: The prompt notification of the Commission by DCMs of any significant market disruptions to their electronic trading platforms.

The Commission’s adoption of the Final Rule marks a shift toward a principles-based approach to regulating automated trading as compared with the Commission’s previous regulatory efforts. In June 2020, the CFTC announced its decision to withdraw its prior proposals on regulation of automated trading, moving away from its 2015-2016 attempt to impose registration and related conditions and requirements directly onto market participations that utilize automated trading tools.

The Final Rule will become effective on the date of the publication in the Federal Register.³ DCMs must be in full compliance with the requirements of the rule within 180 days after the effective date.⁴

BACKGROUND

A. WITHDRAWAL OF THE REGULATION AT PROPOSALS

On December 17, 2015, the CFTC promulgated a notice of proposed rulemaking proposing a series of risk controls, transparency measures and other safeguards to enhance the safety and soundness of automated trading on DCMs (the “2015 Proposal”).⁵ The 2015 Proposal was the Commission’s first major effort to regulate directly algorithmic order origination and electronic trade execution on U.S. futures exchanges.⁶ The 2015 Proposal would potentially have required registration of a variety of entities, based on their use of electronic trading tools, even on a proprietary basis.

On November 4, 2016, the CFTC released a supplemental notice of proposed rulemaking with respect to regulation of automated trading⁷ (the “2016 Proposal” and, together with the 2015 Proposal, “Regulation AT”). The 2016 Proposal modified certain aspects of the 2015 Proposal, including by proposing to simplify the risk control framework and narrowing the scope of the registration requirement so that the rule would not capture smaller market participants.⁸

On June 25, 2020, the CFTC voted 3-2 to withdraw Regulation AT, with Commissioners Rostin Behnam and Dan M. Berkovitz dissenting.⁹

B. THE PROPOSED RULE

On June 25, 2020, the CFTC voted 4-1, with Commissioner Rostin Behnam dissenting,¹⁰ to release the Proposed Rule for public comment. The Proposed Rule introduced three flexible principles—consistent with Chairman Heath P. Tarbert’s principles-based approach to regulation¹¹—to be implemented by DCMs. The principles were designed to address the need for prevention, detection and mitigation of market disruptions and system anomalies associated with the entry of electronic orders and messages in DCMs’ electronic trading platforms. During the June open meeting, Commission staff (the “Staff”) indicated that they did not expect the proposed principles to materially alter DCMs’ existing oversight obligations.¹² Moreover, the CFTC staff expected that the proposed principles would not require DCMs to take substantial additional actions, as the principles in the Proposed Rule were already either incorporated into best practices or codified in DCMs’ rulebooks.¹³ Importantly, the Staff emphasized that these principles did not create strict liability for DCMs in the event of a violation, nor did the principles require any specifically defined set of rules or risk controls. The Staff noted during the June open meeting that DCMs should be able to satisfy their requirements under the principles if they have established and implemented rules and pre-

trade risk controls that are “reasonably designed” to prevent, detect and mitigate market disruptions or system anomalies associated with electronic trading.

FINAL RULE

On December 8, 2020, the CFTC voted 4-1 to adopt the Final Rule. Commissioner Rostin Behnam dissented.¹⁴ At the Commission’s open meeting, Chairman Heath P. Tarbert stated that the Final Rule’s principles-based approach would provide both market participants and the CFTC with the flexibility to adapt to new technologies and trading strategies.¹⁵ As the Staff emphasized during the meeting, and as the Final Rule explains, the risk principles are to be applied through an objective reasonableness standard.¹⁶

A. THE THREE RISK PRINCIPLES

1. Risk Principle 1: Each DCM must adopt and implement rules to prevent, detect and mitigate market disruptions or system anomalies associated with electronic trading (Commission Regulation § 38.251(e))

Under Risk Principle 1, DCMs must adopt and implement rules for their market participants to prevent, detect and mitigate market disruptions or system anomalies associated with electronic trading.¹⁷ Any rules adopted pursuant to Section 38.251(e) must be submitted to the Commission in accordance with either the CFTC review and approval procedures of Section 40.5 or the self-certification rules under Section 40.6.¹⁸

In the preamble to the Final Rule, the Commission acknowledged that various DCM practices currently in place today may already be consistent with Risk Principle 1, such as rules requiring market participants to use exchange-provided risk controls that address potential price distortions and related market anomalies.¹⁹ Accordingly, the Commission observed that it is possible that some DCMs would not be required to file new or amended rules to satisfy Risk Principle 1 once the Final Rule becomes effective.²⁰

The Commission adopted Risk Principle 1 as proposed in June, but clarified that a DCM may have rules that only apply to a subset of market participants.²¹

2. Risk Principle 2: Each DCM must subject all electronic orders to exchange-based pre-trade risk controls to prevent, detect and mitigate market disruptions or system anomalies associated with electronic trading (Commission Regulation § 38.251(f))

The Commission adopted Risk Principle 2 as proposed in June and expressly decided against adding specific pre-trade or post-trade risk controls, as those would be inconsistent with the principles-based approach of the Final Rule.²² Risk Principle 2 requires that all electronic orders be subject to a DCM’s exchange-based pre-trade risk controls, but the codified principle does not address post-trade risk controls and the Commission expressly stated that its Final Rule does not impose additional post-trade risk control requirements.²³ The Commission anticipates that full compliance with the Final Rule would require periodic evaluation of a DCM’s trading marketplace and updates to the exchange-based pre-trade risk controls.²⁴

3. Risk Principle 3: Each DCM must promptly notify Commission Staff of a significant market disruption on its electronic trading platform(s) and provide timely information on the causes and remediation (Commission Regulation § 38.251(g))

This third component of the Final Rule requires a DCM to promptly notify the Staff of, and provide timely information on, the cause and remediation of any significant market disruption on its electronic trading platform.²⁵ The notification must contain sufficient information to convey the nature of the disruption, and if known, its causes, as well as the DCM's plan for remediation of the disruption.²⁶ The Commission recognized that the specific cause of the market disruption and the attendant remediation may not be known at the time of the disruption and may have to be addressed in a follow-up e-mail or report.²⁷

The only substantive change between the Proposed Rule and the Final Rule is in Risk Principle 3. Under the Proposed Rule, a DCM would have had to promptly notify Commission staff of "significant disruptions" to its electronic trading platform and provide timely information on the causes and remediation.²⁸ Under the Final Rule, the Commission altered the text to read "significant *market* disruptions." In doing so, the CFTC has aligned Risk Principle 3 language with Risk Principles 1 and 2 language: all now refer to "market disruptions." The CFTC deemed this change critical because it seeks to have the Risk Principle 3 notification requirements apply to only a "subset of the market disruptions under Risk Principles 1 and 2, *i.e.*, to those market disruptions that are 'significant.'"²⁹

This change to the Risk Principle 3 language appears to have been central to Commissioner Dan M. Berkovitz's affirmative vote: "I am also able to support the Final Rule because . . . it clarifies that Risk Principles 1 and 2 are intended to address any type of market disruption arising from market participants or electronic orders that materially affects electronic trading."³⁰ Specifically, Commissioner Berkovitz observed that this change "makes clear that while Risk Principle 3 addresses 'significant' market disruptions, Risk Principles 1 and 2 include the broader set of 'material' disruptions."³¹ As stated in the Final Rule, "the standard for a significant market disruption under Risk Principle 3 is higher than the standard for a market disruption under Risk Principles 1 and 2."

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ENDNOTES

- 1 Electronic Trading Risk Principles, 85 Fed. Reg. 42,761 (July 15, 2020). For additional information about the Proposed Rule, please see our memorandum to clients: Sullivan & Cromwell LLP, CFTC Electronic Trading Rules (June 26, 2020), *available at* <https://www.sullcrom.com/files/upload/SC-Publication-CFTC-Proposal-Electronic-Trading-Risk-Principles.pdf>.
- 2 See Final Rule: Electronic Trading Risk Principles (hereinafter, the “Final Rule”), at 7 (Dec. 8, 2020), *available at* <https://www.cftc.gov/media/5416/votingdraft120820ETRP/download>; Statement of Chairman Heath P. Tarbert in Support of the Final Rule on Electronic Trading Risk Principles (Dec. 8, 2020) [hereinafter, “Tarbert Statement in Support of the Final Rule”], *available at* <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement120820> (“Electronic trading presents a prime example of where principles-based regulation—as opposed to prescriptive rule sets—is more likely to result in sound regulation over time.”).
- 3 Final Rule at 1.
- 4 *Id.*
- 5 Regulation Automated Trading, 80 Fed. Reg. 78,824 (Dec. 17, 2015). For additional information about the Regulation Automated Trading, please see our memorandum to clients: Sullivan & Cromwell LLP, CFTC Proposes Rulemaking Regarding Automated Trading (Dec. 2, 2015), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_CFTC_Proposes_Rulemaking_Regarding_Automated_Trading.pdf.
- 6 Regulation AT was intended to modernize the Commission’s regulatory regime, promote the safety and soundness of trading on all contract markets, and seek to keep pace with evolving technologies. See Regulation Automated Trading, 81 Fed. Reg. 85,334, 85,335 (Nov. 25, 2016). Following the Commission’s notice of proposed rulemaking for Regulation AT, the Commission identified deficiencies with the proposed rule as drafted, including compliance burdens to the disproportionate impact on small market participants. Statement of Dissent by Commissioner J. Christopher Giancarlo Regarding Supplemental Notice of Proposed Rulemaking on Regulation Automated Trading (Nov. 4, 2016), *available at* <https://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement110416>.
- 7 Regulation Automated Trading, 81 Fed. Reg. 85,334 (Nov. 25, 2016) (Supplemental notice of proposed rulemaking).
- 8 *Id.* Despite the announcement of the 2016 Proposal, certain Commissioners, including Commissioner J. Christopher Giancarlo, indicated that the 2016 Proposal “does not go far enough.” *Id.* For example, Commissioner Giancarlo expressed concern that the 2016 Proposal “subjects the source code retention and inspection requirements to the special call process and provides an unworkable compliance process for AT Persons that use software from third-party providers.” *Id.*
- 9 See Dissenting Statement of Commissioner Rostin Behnam Regarding Electronic Trading Risk Principles (June 25, 2020) [hereinafter, “Dissenting Statement of Commissioner Behnam on Proposed Rule”], *available at* <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement062520>; Statement of Commissioner Dan M. Berkovitz on Proposed Rules for Electronic Trading Risk Principles and Withdrawal of Regulation AT (June 25, 2020) [hereinafter, Statement of Commissioner Berkovitz], *available at* <https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement062520>.
- 10 See Dissenting Statement of Commissioner Behnam on Proposed Rule.
- 11 Heath P. Tarbert, Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation, HARVARD BUS. LAW REV. (June 15, 2020).
- 12 CFTC Open Commission Meeting (June 25, 2020).
- 13 *Id.*

ENDNOTES (CONTINUED)

- 14 Dissenting Statement of Commissioner Rostin Behnam Regarding Electronic Trading Risk Principles (Dec. 8, 2020) [hereinafter, “Dissenting Statement of Commissioner Behnam on Final Rule”], available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement120820>.
- 15 Tarbert Statement in Support of the Final Rule.
- 16 Final Rule at 36 (“[I]n assessing a DCM’s rules and risk controls, the Commission as part of its oversight responsibility will consider the objective reasonableness of those measures in light of the DCM’s products, volume, market participants and other factors, and how similarly positioned DCMs address similar risks.”).
- 17 *Id.* at 52.
- 18 *Id.* at 52.
- 19 *Id.* at 52.
- 20 *Id.* at 52.
- 21 *Id.* at 41.
- 22 *Id.* at 43.
- 23 *Id.* at 44 (“The Commission declines to impose additional pre-trade or post-trade risk control requirements on DCMs. The Commission does not consider such requirements to be necessary or consistent with the Commission’s principles-based approach to the Risk Principles.”).
- 24 *Id.* at 72.
- 25 *Id.* at 54.
- 26 *Id.* at 54.
- 27 *Id.* at 54.
- 28 *Id.* at 44, 49.
- 29 *Id.* at 49; Statement of Commissioner Dan M. Berkovitz Regarding Risk Principles for Electronic Trading (Dec. 8, 2020) [hereinafter, “Statement of Commissioner Berkovitz on Final Rule”], available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement120820>. (“Markets and market participants will benefit from the Commission’s decision to resolve this potential ambiguity in the proposed rule and to implement a rigorous standard for Risk Principles 1 and 2.”).
- 30 Statement of Commissioner Berkovitz on Final Rule.
- 31 *Id.*

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