

June 26, 2020

CFTC Electronic Trading Rules

CFTC Releases New Proposed Rule on Electronic Trading Risk Principles and Withdraws Regulation AT Proposal

SUMMARY

On June 25, 2020, the U.S. Commodity Futures Trading Commission (“CFTC” or the “Commission”) voted to publish for public comment a new proposed rule addressing electronic trading risk principles (the “Proposed Rule”). The Proposed Rule takes a principles-based approach, focusing primarily on regulated futures exchanges, referred to under the Commodity Exchange Act as “designated contract markets,” or “DCMs,” and is designed to balance the need for flexibility in oversight with the need for clear regulatory requirements that exchanges establish rules for electronic trading to prevent and mitigate market disruptions and trading anomalies. The proposed regulations consist of three principles applicable to exchanges concerning: (i) the implementation of exchange rules applicable to market participants to prevent, detect, and mitigate market disruptions and system anomalies associated with electronic trading; (ii) the implementation of exchange-based pre-trade risk controls for all electronic orders; and (iii) the prompt notification of the Commission by DCMs of any significant disruptions to their electronic trading platforms.

Notably, the CFTC also announced its decision to formally withdraw its prior proposals on regulation of automated trading, moving away from the 2015-2016 attempt to impose registration and related conditions and requirements directly onto market participations that utilize automated trading tools.

THE PROPOSAL

On June 25, 2020, the CFTC voted four-to-one, with Commissioner Behnam dissenting,¹ to publish the Proposed Rule for public comment. The Proposed Rule introduces three flexible principles—in line with Commissioner Heath P. Tarbert’s principles-based approach to regulation²—to be implemented by designated contract markets (“DCMs”) that are designed to address the need for prevention, detection and

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mitigation of market disruptions and system anomalies associated with entry of electronic orders and messages in DCMs' electronic trading platforms. During the opening meeting, Commission staff indicated that they do not expect the proposed principles to materially alter DCMs' existing oversight obligations. Moreover, the staff expects that the proposed principles will not require DCMs to take substantial new action, as the principles in the Proposed Rule are already either incorporated into best practices or codified in DCMs' rulebooks. Importantly, the staff emphasized that these principles do not create strict liability for DCMs in the event of a violation, nor do the principles require any specifically defined set of rules or risk controls. The staff noted during the open meeting that DCMs shall have satisfied 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. The Commission indicated that it will interpret "reasonably designed" to mean that a DCM's rules and risk controls are objectively reasonable.

The three proposed principles would be codified as new in CFTC Rules 38.251(e) through (g):

- Proposed Rule 38.251(e) would require DCMs to adopt and implement rules governing market participants subject to its jurisdiction designed to prevent, detect and mitigate market disruption and system anomalies associated with electronic trading, such as excessive messaging caused by malfunctioning systems, "fat finger" orders or erroneous messages manually entered that result in unintentionally large or off-price orders and loss of connection between an order management system and the trading platform. In explaining the proposed rules, the CFTC indicated that a number of existing risk controls and current industry practices already cover this principle (e.g., exchange-provided risk controls primarily addressing financial risk or market risk that also address preventing or mitigating market disruptions caused by electronic trading). Importantly, the CFTC noted that DCMs may not be able to detect all market disruption or system anomalies. Thus, the Commission highlighted that DCMs will not be in violation of the Proposed Rule if a market disruption or system anomaly occurs when a DCM has "reasonably designed" rules in place, where "reasonably designed" means that the DCM's rules are objectively reasonable. The CFTC emphasized its view that this principle provides DCMs with reasonable discretion to impose rules to address electronic trading risks and notes that DCMs should take into both account industry best practices and the technological feasibility of implementing certain practices and controls when adopting and implementing these rules.
- Proposed Rule 38.251(f) would require DCMs to subject all electronic trades to exchange-based pre-trade risk controls. The staff noted during the open meeting that this principle incorporates existing controls from DCM Core Principle 4 and that existing best practices under CFTC Rule 38.255 would not be affected.³ The purpose of this principle is to require DCMs to consider market participants' trading activities when designing and implementing exchange-based risk controls. The CFTC indicated that such controls should be adapted to the unique characteristics of the markets in which the DCM operates, without unduly interfering with that market's price discovery function. The CFTC also noted that it is entirely possible that existing risk controls already satisfy best practices for this principle, including pre-trade limits on order size, message throttles, "heartbeat" messages confirming connectivity and daily trade limits.
- Proposed Rule 38.251(g) would require DCMs to promptly notify the Commission of any significant disruption on its platform, as well as provide information about any mediation efforts or resolution related to that significant disruption.

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Importantly, the CFTC noted that a disruption is not “significant” unless the ability of market participants to manage risk or engage in price discovery is materially impacted by a malfunction of a participant’s trading system.⁴

In his dissenting statement,⁵ Commissioner Behnam criticized the Proposed Rule as too broad to meaningfully address regulation of the use of automated systems in derivatives markets. Commissioner Behnam highlighted a number of market disruption events since the 2010 flash crash and discussed how the Proposed Rule, in which the CFTC discusses how DCMs are largely already engaged in best practices to satisfy its requirements, does little to alter the status quo under which those disruptions occurred. He also criticized the Proposed Rule for “providing flexibility at the cost of market certainty.”⁶ Commissioner Behnam noted that while current market practices may be considered “reasonably designed” at present, a future Commission may require additional actions of DCMs down the line in order to comply with the Proposed Rule, depriving market participants of the certainty required to make business decisions and potentially giving the Commission broad powers for overreach, including enforcement action.⁷

WITHDRAWAL OF THE REGULATION AT PROPOSALS

On December 17, 2015, the CFTC published in the Federal Register 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 all DCMs (the “2015 Proposal”).⁸ The 2015 Proposal was the Commission’s initial effort to reduce risk and increase transparency in algorithmic order origination and electronic trade execution on U.S. futures exchanges.⁹

On November 4, 2016, the CFTC released a supplemental notice of proposed rulemaking for Regulation AT (the “2016 Proposal,” and together with the 2015 Proposal, “Regulation AT”). The 2016 Proposal modified certain aspects of the 2015 Proposal, including by attempting to simplify the risk control framework and narrowing the scope of registration so that the rule would not capture smaller market participants.¹⁰

On June 25, 2020, the CFTC voted three-to-two to withdraw Regulation AT and replace it with the proposed Electronic Trading Risk Principles. Commissioners Behnam and Berkovitz dissented,¹¹ finding that Regulation AT was stale, and noting that (1) significant time has elapsed since the Regulation AT proposal and (2) the inconsistency of comments to Regulation AT (which were mostly negative) made moving forward with the proposal as drafted was not practical.

COMMENTS REQUESTED

The CFTC has requested public comments on the proposal, which will be due on or before the later of 60 days from the date of the Commission vote (August 24, 2020), or 30 days following publication in the Federal Register. The Commission has requested comment on the following areas of interest:

- Whether the Commission’s description of “electronic trading” is sufficiently clear.

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- Whether the term “trading disruption” or another alternative would be more preferable than “market disruption.”
- What type of unscheduled halts in trading would constitute “market disruptions” that impact the ability of other market participants to trade or manage their risk?
- What amount of latency to other market participants (measured in milliseconds) should be considered a market disruption? How can DCMs evaluate changes over time in the amount of latency that should be considered a market disruption?
- Are there other types of risk that may lead to market disruptions that the Commission should address or be aware of?
- Is there guidance that the Commission can give DCMs for how best to monitor for emerging risks that are not mitigated or contemplated by existing risk controls or procedures?
- Whether an alternative to what is proposed would result in a more effective approach and whether such alternative offers a superior cost-benefit profile.
- Whether it be preferable to codify the three risk principles within existing regulation 38.255 rather than within regulation 38.251, which covers general requirements relating to the prevention of market disruption.
- DCMs may differ in the rules they establish to prevent, detect, and mitigate market disruption and system anomalies. Would such disparity have a harmful effect on market liquidity or integrity?
- What rules have DCMs found to be effective in preventing, detecting, or mitigating the types of market disruptions and system anomalies associated with electronic trading? Should the Commission include any particular types of rules as acceptable practices for compliance with proposed regulation 38.251(e)?
- Current acceptable practices include pre-trade limits on order size, price collars or bands around the current price, message throttles, and daily price limits. Do DCMs consider these controls to be effective in preventing market disruptions in today’s markets? What other risk controls do DCMs consider to be most effective in preventing market disruptions and addressing risk as described in this proposal?
- As noted above, proposed regulation 38.251(g) requires a DCM to notify Commission staff of a significant disruption to its electronic trading platform(s), while Commission regulation 38.1051(e) requires DCMs to notify the Commission in the event of significant systems malfunctions. Is the distinction between these two notification requirements sufficiently clear?
- Request to describe any disruptive events that would potentially fall within the notification requirements of both proposed regulation 38.251(g) and Commission regulation 38.1051(e).
- Is the Commission’s description of whether a given disruption to a DCM’s electronic trading platform(s) is “significant” for purposes of proposed regulation 38.251(g) sufficiently clear? Please describe circumstances in which it would be appropriate for a DCM to notify other DCMs about a significant market disruption on its trading platform(s). Should proposed regulation 38.251(g) include such a requirement?

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ENDNOTES

- 1 Dissenting Statement of Commissioner Rostin Behnam Regarding Electronic Trading Risk Principles (June 25, 2020) [hereinafter “Dissenting Statement of Commissioner Behnam”], available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement062520b>.
- 2 Heath P. Tarbert, Rules for Principles and Principles for Rules: Tools for Crafting Sound Financial Regulation, HARVARD BUS. LAW REV. (June 15, 2020).
- 3 CFTC Rule 38.255 requires that DCMs “establish and maintain risk control mechanisms to prevent and reduce the potential risk of price distortions and market disruptions, including, but not limited to, market restrictions that pause or halt trading in market conditions prescribed” by the DCM.
- 4 The Commission indicated that this requirement is distinct from CFTC Rule 38.1051(e), which requires DCMs to promptly notify the Commission of all electronic trading halts, cybersecurity incidents and activation of the DCM’s business continuity-disaster recovery plan, but that such notifications by DCMs would take a similar form to those required by CFTC Rule 38.1051(e). See 17 C.F.R. 38.1051(e).
- 5 See Dissenting Statement of Commissioner Behnam.
- 6 *Id.*
- 7 *Id.*
- 8 Regulation Automated Trading, 80 Fed. Reg. 78824 (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 this [link](#).
- 9 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. 85334, 85335 (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>.
- 10 *Id.* Despite the announcement of the Supplemental NPRM, certain Commissioners, including Commissioner J. Christopher Giancarlo, indicated that the Supplemental NPRM “does not go far enough.” *Id.* For example, Commission Giancarlo expressed concern that the Supplemental NPRM “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.*
- 11 See Dissenting Statement of Commissioner Behnam; 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>.

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