

**United States House of Representatives**  
**Committee on Agriculture**  
**Examining the CFTC's Proposed Rule: Regulation Automated Trading**  
**July 13, 2016**  
**Statement of Greg Wood**  
**on behalf of the**  
**Futures Industry Association**

Chairman Conaway and Ranking Member Peterson thank you for holding this very timely hearing on the Commodity Futures Trading Commission's (CFTC) Proposed Regulation Automated Trading (Reg AT). My name is Greg Wood and I am here today representing the Futures Industry Association (FIA). FIA's members have been extremely engaged in providing input to the CFTC as it seeks to finalize Reg AT. I currently serve as the Co-Chair of the FIA Market Technology Division Automated Trading Committee, the Chair of the FIA Market Access Committee, and I previously served as President of the FIA Market Technology Division.

FIA has been working with the industry since well before the 2010 Flash Crash to establish safeguards for electronic trading. We have published five documents that include best practice recommendations for risk controls, developing, testing and monitoring software, and other protections.

FIA employed 10 working groups devoted to analyzing the feasibility of the CFTC's proposed Reg AT and providing recommendations for improving the regulation prior to finalization. Our efforts have involved the trading community, the exchanges, market participants and the futures commission merchants (FCM), who act as facilitators for clients seeking to access the cleared derivatives markets. In March of 2016, FIA filed a comprehensive comment letter to address the various components of the proposal. Subsequently, and in response to a recent CFTC Staff Roundtable, FIA has also worked with the Managed Funds Association, SIFMA Asset Management Group, and the International Swaps & Derivatives Association (together "the Group") to present a view that has broad agreement across the industry. Further details can be seen within the Group's comment letter submitted on June 24<sup>th</sup>.

Today, I will focus my comments on FCMs and their views, particularly with regards to pre-trade risk controls.

During the course of a recent CFTC Staff Roundtable, Staff sought to elicit suggestions on how to better define Direct Electronic Access (DEA) as well as proposals for quantitative measures to reduce the current population of AT Persons to which Reg AT would apply. In addition, the

Staff questioned whether requiring and monitoring compliance by AT Persons could be imposed upon FCMs or designated contract markets (DCMs). Roundtable participants soundly rejected these proposals, as they did not address the real issues and concerns on which the Commission and Reg AT should be focused.

Broadly, across all components of proposed Reg AT, the Group believes that:

1. **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 those of AT Persons.
2. 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.
3. 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.
4. 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.
5. **Rules should not be prescriptive.**

I would like to highlight the following **THREE** key points that FIA feels should be considered in formulating a regulation that is both scalable and effective:

Firstly, **RISK CONTROLS**. US Futures markets have evolved into highly sophisticated, electronic markets, and all market participants have a responsibility appropriate to their participation in the life of an order to help minimize the likelihood of a market disruption, and, accordingly, all electronic trading should be subject to appropriate pre-trade risk controls<sup>1</sup>.

Rather than defining what constitutes an AT Person, and using an artificially constructed trigger to require registration of those participants, we believe that the most important tool for achieving the goal of protecting market integrity is requiring the application of pre-trade risk controls to all electronic orders, regardless of the participant's registration status. To be clear, we are not opposed to a regulation category subject to appropriate requirements for that

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<sup>1</sup> Such pre-trade risk controls can be implemented directly by the market participant or may be administered by the FCM facilitating electronic access to the market - including those implemented within third-party vendor systems or exchange provided graphical user interfaces that the FCM has administrative control over.

group of registrants; however, we believe defining a particular group of people and applying risk controls only to registrants does not safeguard markets to the full extent the industry believes is needed. To that effect, the Group believes:

- **Each market participant’s orders should be subject to pre-trade risk controls, depending on how the market participant accesses a DCM.** Access can be via self-developed software, a third party provided system or FCM-administered<sup>2</sup> software and/or services. Orders from market participants leveraging FCM-administered systems, including those provided by third parties, may utilize pre-trade controls administered by the FCM.

**It is important to note that the Group believes that market participants not using software that includes FCM-administered risk controls should be responsible for applying risk controls to their own orders.**

- **FCMs facilitating electronic access to a DCM should be responsible for implementing appropriate pre-trade risk controls for all electronic trading that passes through those controls that it administers.** This can be accomplished by pre-trade risk controls provided by the FCM itself, or those provided by software that the FCM has administrative control over.<sup>3</sup> Where a market participant is responsible for the administration of risk controls pursuant to Reg AT, the FCM may satisfy this responsibility by administering DCM hosted risk controls.
- **The risk controls proposed in the proposal are too prescriptive.** The specific implementation and location of particular risk controls should not be mandated by the CFTC. Instead, the types of controls required should be principles-based to provide for flexibility as well as to permit innovation and technological advances that could improve future controls.
- **Identical pre-trade risk controls need not be applied at all points in the order flow.** Pre-trade risk controls should not be duplicated in precisely the same manner across the order flow between market participants and DCMs. Pre-trade risk control requirements should permit flexibility such that the controls will be appropriate for

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<sup>2</sup> It is important to note that a customer may use the same FCM to provide both execution and clearing services (“full-service FCM”) or may use one FCM for execution (“executing FCM”) and choose to clear their trades through another FCM (“clearing FCM”) by arranging for the trades to be given up to the clearing FCM by the executing FCM. In this instance, the executing FCM acts as the “gatekeeper” to the DCM matching engine, and, as such, is the only FCM that can administer risk controls at a pre-trade level. Any other FCM(s) that may subsequently clear trades for the customer can only provide risk controls on a post-trade basis once the trades have been given in from the executing FCM.

<sup>3</sup> Note that administration of such controls may be delegated by the FCM to another party, such as an introducing broker.

their location and the type of electronic access being provided, with varying degrees of sophistication and granularity depending on who is setting the controls.

- **The standard used to measure compliance should be that pre-trade risk controls *mitigate* the risks associated with electronic trading – rather than attempt to completely *prevent* them.**

Based on these points, the Group proposes a requirement that all electronic trading must pass through the pre-trade risk controls of a **CFTC registrant** – either the market participant itself, or the FCM that facilitates electronic access to the DCM. These controls are typically in addition to the risk controls provided at the DCM level. The details of this proposal are as follows:

- **SCOPE OF PROPOSAL:** All electronic trading must be subject to pre-trade and other risk controls administered by a CFTC registrant that are appropriate to the nature of the activity. The responsibility for implementing the appropriate pre-trade risk controls lies either:
  - a) with the FCM registrant that is facilitating electronic access to the DCM, or
  - b) in the case of a market participant that is not trading through the risk controls of an FCM, with that participant, who is also a registrant.

In both cases, these pre-trade risk controls must be supplemented by DCM-provided risk controls configured by the member of the DCO that grants access to the DCM.

- **REQUIRED PRE-TRADE RISK CONTROLS:** Required controls must meet the core principles of being designed to reasonably mitigate the potential for:
  1. Sending orders for too large a size to the DCM;
  2. Sending orders for a clearly erroneous price to the DCM; and
  3. Sending too many messages to the DCM.
- **IDENTIFICATION OF COVERED TRADES/PARTICIPANTS:** Market participants trading electronically, without passing through FCM-administered risk controls, either self-identify to applicable DCMs prior to trading, or may be identified via tags on order messages.

- **DUE DILIGENCE REQUIREMENT:** An FCM must perform due diligence on any customer to which it grants electronic access to the DCM without going through risk controls administered by the FCM. Such due diligence may include – for example – a self-certification by the market participant that their orders are subject to appropriate pre-trade and post-trade risk controls. For the avoidance of doubt, such due diligence requirements do not make the FCM responsible for ensuring their customers’ compliance with their own regulatory obligations.

Secondly, **ANNUAL REPORTS**. Reg AT’s proposed requirement of annual reports to be prepared by market participants and clearing member FCMs is ineffective, unnecessary, and redundant with other requirements to which registrants are subject. Additionally, the proposed reports will inundate DCMs with voluminous policies and procedures related to the development and compliance of algorithmic trading systems, as well as mountainous snapshots of stale quantitative risk parameter settings particularized to a given market participant that will be virtually impossible for a DCM to meaningfully assess.<sup>Error! Bookmark not defined.</sup> Accordingly, the Group believes that the objectives of the proposed rule can be met less onerously and more practically by requiring affected parties solely to **certify that they materially comply** with relevant aspects of the rule and to make such certifications available to a DCM or the CFTC upon request.

Thirdly, **SOURCE CODE**. The Source Code requirement for unfettered access to any firm’s intellectual property as proposed is **unprecedented** among regulators and threatens commercially valuable intellectual property and proprietary trading strategies. The Source Code requirement in the proposed rule puts highly proprietary information at risk **without measurable benefits**. Required production of Source Code should only be **available through a legal process** where an owner of Source Code has the right to petition a court for appropriate protection. There is no sufficient set of access conditions (*e.g.*, onsite review, tracking who reviews Source Code, etc.) that would adequately offset the dire potential commercial consequences of requiring production of Source Code absent the protection of legal process.

Again, I would like to thank you for holding this important hearing. Oversight of the CFTC is such an important function of this Committee and we commend you for the time devoted to these matters. I will be happy to answer any questions following my fellow panelists’ testimony.

## Appendix

### How Customers of FCMs Access Markets

A market participant may choose to access a DCM via several channels (please refer to Diagram 1 for examples). Many market participants may use a combination of channels to facilitate different types of trading, using tools that are appropriate to the type of activity that they engage in. With very few exceptions, an executing FCM facilitates electronic access for the customer, and administers pre-trade risk controls appropriate to the type of access.

1. In the context of electronic trading, an **Application Programming Interface (API)** is an interface for electronic access provided by one party for another party to connect directly without using a manual means of placing orders and receiving executions (see Graphical User Interface).

Examples of APIs include the following –

**An API provided by a DCM for market participants to connect directly to the matching engine.** Such APIs are usually proprietary to the DCM, and will offer functionality such as types of messages, order types, etc., that is specific to the DCM. Connection to the API is overseen by the DCM through a certification process. Subsequent to CFTC 1.73, the DCM provides pre-trade risk controls to the FCM that facilitates electronic access (see ❶ on attached diagram).

The FCM administers pre-trade risk controls provided to them by the DCM, but greater responsibility lies with the market participant to implement their own pre-trade risk controls to mitigate the possibility of inadvertent market disruption.

- a) **An API provided by an FCM for market participants to connect via the FCM infrastructure,** with orders subsequently routed via the FCM's Automated Order Routing System (AORS) through to the DCM's API. Such APIs are usually based on the FIX Protocol, a global standard for the exchange of financial information across asset classes. An FCM's API may be used for routing orders directly from a customer's trading system or from a third-party trading system without using a manual means of placing orders and receiving executions (see Graphical User Interface).

Pre-trade risk management for orders routed through an FCM's API is provided by the FCM before the order is subsequently routed to the DCM (see ❷ ❸ on attached diagram).

- b) **An API provided by a third-party software provider for market participants to connect via their infrastructure**, with orders subsequently routed via the software provider's Automated Order Routing System (AORS) through to the DCM's API. Such APIs are usually based on the FIX Protocol, a global standard for the exchange of financial information across asset classes. A software provider API is used for routing orders directly from a customer's trading system or from a third-party trading system without using a manual means of placing orders and receiving executions (see Graphical User Interface).

Pre-trade risk management for orders routed through a software provider's API is provided in their system before the order is subsequently routed to the DCM (see ③ on attached diagram). Such risk controls are typically administered by the FCM facilitating access to the DCM via the software provider.<sup>4</sup>

2. In the context of electronic trading, a **Graphical User Interface (GUI)** is an interface for access provided by one party for another party to manually place orders and visually receive executions.

Examples of GUIs include the following –

- a) **A GUI provided by a DCM for market participants to place orders directly on the DCM.** Such GUIs are usually provided for functionality that is unique to the DCM and/or may not be readily available via the DCM API. In this situation, the DCM is acting as a software provider, and pre-trade risk management for orders entered through such a GUI is administered by the FCM facilitating access.
- b) **A GUI provided by an FCM for market participants to place orders directly with the FCM**, with orders subsequently routed via the FCM's Automated Order Routing System (AORS) through to the DCM's API. Pre-trade risk management for orders routed through such a GUI is provided and administered by the FCM before the order is subsequently routed to the DCM (see ② ④ on attached diagram).
- c) **A GUI provided by a software provider for market participants to place orders directly via their infrastructure**, with orders subsequently routed via the vendor's Automated Order Routing System (AORS) through to the DCM's API. Pre-trade risk management for orders routed through such a GUI is provided by the software

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<sup>4</sup> Note that where a non-FCM clearing member of a DCM uses a software provider to access the market, via either API or GUI, there is no second line of pre-trade risk control administered by an FCM. In such a situation where the non-FCM clearing member sets their own pre-trade risk controls, additional responsibility may be required on the market participant to ensure that all appropriate steps are taken to mitigate the possibility of inadvertent market disruption.

provider before the order is subsequently routed to the DCM (see ③ on attached diagram). Such risk controls are typically administered by the FCM facilitating access to the DCM.

3. An **Automated Order Routing System (AORS)** is software designed to electronically route orders to a DCM, without any subsequent discretion in how to work the order. Any discretion regarding how to work an order based on parameters provided by a trader or customer - for example using algorithmic execution functionality - should be considered “algorithmic trading” and considered differently from an AORS.

AORSs are utilized by many types of market participants, and typically offer pre-trade risk management functionality. It is important to understand *who* administers the pre-trade risk controls.

Types of AORS include the following:

- a) **An AORS provided by an FCM where orders may be entered via an API or GUI and subsequently routed to the DCM’s API** (see ② ④ on attached diagram) using the FCM’s membership on the DCM. Such a system may be developed in-house at the FCM or licensed from a third-party provider, but in either situation, the AORS is considered part of the FCM’s infrastructure. Pre-trade risk controls are provided and administered by the FCM on a customer-by-customer basis. The FCM in this scenario is always the executing FCM, though they may also be the clearing FCM based on their customer relationship.
- b) **An AORS provided by a software provider where orders may be entered via an API or GUI and subsequently routed to the DCM’s API** (see ③ on attached diagram) using an FCM’s membership on the DCM. The software provider gives FCMs the ability to permission the customer to trade and set the appropriate risk limits. Although such a system is not fully under the control of an FCM, especially where the AORS provides access to multiple FCMs, it can still be considered an extension of the FCM’s infrastructure because a customer may not trade until the FCM sets appropriate pre-trade risk controls. As such, pre-trade risk controls are administered by the FCM on a customer-by-customer basis. The FCM in this scenario is always the executing FCM, though they may also be the clearing FCM based on their customer relationship.

**An AORS utilized by a market participant where orders may be entered via an API or GUI and subsequently routed to the DCM’s API** (see ① on attached diagram). Such a system may be developed in-house by the market participant or licensed from a software provider, but in either case is considered part of the participant’s infrastructure. Pre-trade risk controls are administered directly by the participant, and not by an FCM. The AORS is certified by the DCM to connect directly to its API, and access is facilitated by an FCM via its membership on the

DCM. The FCM in this scenario is always the executing FCM, though they may also be the clearing FCM based on their customer relationship.

## Sample Pre-Trade Risk Control Locations

Market Participants (MP) can use 5 ways to access a Designated Contract Market (DCM), and may also use multiple Futures Commission Merchants (FCM) to facilitate that access. Automated Trading Systems (ATS) can be implemented at various points in the order flow. FCM facilitating electronic access implement risk controls appropriate to the type of access.

