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CFTC Withdraws Reg AT Proposal; Proposes Principles-Based Electronic Trading Risk Framework for DCMs

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The CFTC last week formally **withdrew** its controversial Proposed Regulation Automated Trading (Proposed Reg AT) and—consistent with Chairman Tarbert's **principles-based approach** to regulation—**proposed** in its place new electronic trading risk principles (the Risk Principles) for designated contract markets (DCMs). The CFTC's new approach is likely to be welcomed by market participants who had significant concerns with Proposed Reg AT's expansive and prescriptive requirements.

Proposed Reg AT, as originally proposed in 2015 and revised in 2016, would have required market participants involved at several stages of a derivatives transaction to implement pre-trade risk controls at different points in a trade's lifecycle, intended to limit the risks of disruptive events that could arise from automated trading activities on DCMs. Controversially, Proposed Reg AT would have also (1) required CFTC registration and NFA membership of persons trading commodity interests on a DCM via direct electronic access using algorithmic trading strategies (called AT Persons), and (2) compelled swap dealers, FCMs, CPOs, CTAs, and other CFTC registrants that engage in algorithmic trading to retain repositories of their algorithmic trading strategy source code, which would have been available to the CFTC staff for inspection, without a subpoena. In light of significant opposition, the CFTC has abandoned the Proposed Reg AT framework, and indicated that it will not impose a new registration requirement or demand source code without a subpoena.

The Risk Principles would adopt a more workable and flexible principles-based framework. Unlike Proposed Reg AT, the proposed Risk Principles would apply only to DCMs, not other market participants. The Risk Principles would still require that DCMs manage the risk of disruptions due to electronic trading. Specifically, DCMs would be required to:

1. Adopt and implement rules that are reasonably designed to “prevent, detect, and mitigate market disruptions or system anomalies” that could result from electronic trading;
2. Subject electronic orders to pre-trade risk controls that are reasonably designed to “prevent, detect, and mitigate market disruptions or system anomalies; and
3. Notify the CFTC of significant disruptions it its electronic trading platform and provide “timely” information on the causes and remediation.

The CFTC believes that DCMs currently address most, if not all, of the electronic trading risks posed to their trading platforms, and the Risk Principles may not necessitate the adoption of additional measures by DCMs. Further, some aspects of the Risk Principles may already be covered under existing CFTC rules, such as (1) Regulation 38.157, which requires a DCM to conduct real-time market monitoring of all trading activity on its electronic trading platforms to identify disorderly trading and any market or system anomalies, (2) Regulation 38.251(c), which requires a DCM to demonstrate an effective program for conducting real-time monitoring of market conditions, price movements, and volumes, in order to detect abnormalities and, when necessary, to make a good-faith effort to resolve conditions that are, or threaten to be, disruptive to the market, and (3) Regulation 38.255, which requires a DCM to 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.

The proposed Risk Principles have similarities to aspects of the SEC’s Market Access Rule and Regulation SCI, which impose risk management and control requirements for certain securities market participants. The Market Access Rule similarly requires a system of risk management controls and supervisory procedures “reasonably designed” to manage the financial, regulatory, and other risks of this business activity, including pre-trade risk controls—although the SEC’s rule applies at the broker-dealer intermediary-level, rather than exchange-level. Regulation SCI, in addition to requirements that apply to exchanges’ systems, capacity, and resiliency, similarly prescribes that exchanges notify the SEC and keep it informed regarding disruption events and remediation steps.

Comments on the proposed Risk Principles are due by the latter of (i) August 24, 2020, or (ii) 30 days after publication in the Federal Register, which has not yet occurred. We expect the proposal to draw support from market participants as it addresses some of the industry's key concerns with Proposed Reg AT and has a far more limited scope.