BETTER MARKETS

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By Electronic Submission

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Secretary of the Commission
Commodity Futures Trading Commission
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Re: Regulation Automated Trading; Withdrawal (RIN 3038-AD52); Electronic Trading Risk Principles (RIN 3038-AF04).

Ladies and gentlemen,

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") withdrawal of proposed Regulation Automated Trading[2] and new proposed principles and acceptable practices relating to electronic trading risks.[3] The CFTC's new proposed regulations consist merely of three sentences, two of which are essentially duplicative of existing designated contract market ("DCM") regulations and none of which provides safeguards to comprehensively address risks associated with electronic trading. Furthermore, the CFTC's withdrawal of proposed Regulation Automated Trading without a comparable electronic and automated trading framework to replace it dangerously and indefinitely defers action to address one of the highest ongoing risks to market integrity, orderly trading, fair competition, and the price discovery process in the derivatives markets. Thus, although the proposed electronic trading regulations themselves are unlikely to do much harm, they are also unlikely to do much good.

As described in more detail below, we have the following reservations with respect to the CFTC's minimal proposed framework for electronic trading:

- **The Proposal Apparently Requires Few, If Any, DCM Actions to Address Electronic Trading Risks:** The CFTC's proposed regulations would codify three principles repeatedly

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 CFTC, Regulation Automated Trading; Withdrawal, 85 Fed. Reg. 42755 (July 15, 2020), available at https://www.govinfo.gov/content/pkg/FR-2020-07-15/pdf/2020-14383.pdf. The withdrawal of proposed Regulation Automated Trader ("AT") ended an eight-year rulemaking process and essentially discarded an administrative record with hundreds of hours of thoughtful public comment on automated trading issues. Many, if not most, of those issues remain unaddressed in the proposal.

3 CFTC, Electronic Trading Risk Principles, 85 Fed. Reg. 42761 (July 15, 2020), available at https://www.govinfo.gov/content/pkg/FR-2020-07-15/pdf/2020-14381.pdf.

acknowledged in the preamble to require (perhaps) no action on the part of DCMs, much less others, to protect market integrity, orderly trading, fair competition, and the price discovery process from electronic trading risks. These three principles are largely duplicative of existing CFTC regulations, suggesting the proposal is mere pretext for withdrawing proposed Regulation Automated Trading ("AT").

- **<u>The Proposal Inappropriately Defers to the Exchanges to Determine Whether Their Electronic Trading Risk Policies, Procedures, and Controls Are Sufficient and Lawful</u>:** The proposal would not codify or require adoption of best practices already in place at certain derivatives exchanges, and it does not comprehensively survey existing policies, procedures, and controls relating to electronic trading risks. Instead, the proposal would defer to for-profit exchanges that rely upon electronic and automated trading revenues to deliver returns for shareholders. Although exchanges have commercial interests that align, in part, with the Commodity Exchange Act's ("CEA") core statutory objectives,[4] they also have significant conflicts of interest that may influence efforts to responsibly limit disruptive, but profitable, electronic trading practices.

- **<u>The Proposed Principles Are Imprecise and Unenforceable and Would Ensure that Electronic Trading Policies, Procedures, and Controls Diverge Dramatically:</u>** The proposal provides insufficient guidance, sets forth imprecise regulatory text, and lacks key definitions to reasonably ensure that the proposed DCM risk principles are enforceable and that DCMs uniformly adopt and require pre-trade and other controls. For example, the proposal uses imprecise and unenforceable terms to set forth regulatory reporting obligations and to govern the timing and substance of such reporting with respect to "significant market disruptions."

- **<u>The Proposal is Substantially Incomplete</u>:** The proposal would leave numerous market structure frailties and electronic trading practices unaddressed and would not comprehensively address risks associated with electronic order <u>origination</u>, <u>programming</u>, <u>transmission</u>, and <u>execution</u>. In fact, the proposal would address an extremely narrow set of electronic trading risks, for example pre-trade risks associated with electronic point-and-click trading and so-called "fat finger" errors and disruptive order management practices, and it would address those risks only with respect to DCMs. The proposal would not, and does not purport to, address the serious risks posed to the U.S. financial system by automated trading and order management practices more broadly.

- **<u>The Proposal Fails to Ensure Timely Access to Accurate and Comprehensive Books and Records</u>:** The CFTC's most basic accountability mechanism for market participants trading

[4] The CEA is codified at 7 U.S.C. § 1 et seq. For some of the CEA's core statutory objectives, <u>see</u> 7 U.S.C. § 5(a) ("The transactions subject to this chapter . . . are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair, and financially secure trading facilities."). <u>See also</u> 7 U.S.C. § 5(b) ("[I]t is . . . the purpose of this chapter to **<u>deter and prevent price manipulation or any other disruptions to market integrity</u>**; to ensure the financial integrity of all transactions . . . and the avoidance of systemic risk; and **<u>to promote responsible innovation and fair competition among boards of trade, other markets, and market participants</u>**.").

> on exchanges is to ensure timely access to accurate, comprehensive transaction and order management information. For participants with direct market access and a significant and persistent market presence, the CFTC and DCMs should ensure creation and retention of order management, transactional, and other records that facilitate firm and market oversight and enforcement.

In these and other areas, the CFTC should have at least proposed regulations with appropriate context, including a comprehensive description of risk controls already in place at the 15 DCMs, the risk-based limits and order screening controls already required of derivatives intermediaries, and the risk control mechanisms already required for designated contract markets ("DCMs") and swap execution facilities ("SEFs"). That holistic context—which would have been necessary for meaningful public comment—would undoubtedly reveal that the proposal would require very little beyond current law and practice for most, if not all, DCMs.

I. The CFTC's proposal codifies three principles repeatedly acknowledged to require (perhaps) no regulatory actions on the part of DCMs, much less others, to protect market integrity, orderly trading, fair competition, and the price discovery process from electronic trading risks.

Electronic trading risks have increased dramatically with the evolution of the derivatives and securities markets over the past 20 years. These risks have been demonstrated in numerous market disruptions and trading anomalies since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[5] including the Flash Crash,[6] the recent WTI trading anomalies in the oil markets,[7] and the Knight Capital meltdown.[8] These events and others prove all too clearly that electronic trading, while very often beneficial to market quality measures, also presents varied, complex, and potentially extensive risks to market integrity, orderly trading, fair competition, and the price discovery process across the financial markets.

Rather than thoughtfully addressing these electronic trading risks, the CFTC's present regulations propose largely duplicative measures masquerading as meaningful regulatory action. **Indeed, the CFTC itself acknowledges repeatedly that in the most significant areas, the proposal would impose few requirements beyond those already "covered by existing Commission regulations, including regulations related to the prevention of market disruptions and financial risk controls."**[9] The proposal's contributions therefore are minimal, while the risks attendant to the duplicative framework and the CFTC's neglect of critical market structure, order management, and trading issues and practices are substantial. This is concerning, too, because the proposal has been tied to the withdrawal of proposed

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5 Pub. L. 111–203, 124 Stat. 1376 (2010).

6 See. e.g., L. Vaughan, Flash Crash: A Trading Savant, a Global Manhunt, and the Most Mysterious Market Crash in History, Doubleday (May 12, 2020).

7 See, e.g., Section I of the following comment letter: Better Markets Letter to CFTC, Re: Position Limits for Derivatives (RIN 3038-AD99) (May 15, 2020), available at https://bettermarkets.com/sites/default/files/Better_Markets_Comment_Letter_on_Position_Limits_for_Derivatives_Upload.pdf.

8 See, e.g., a brief description of the Knight Capital meltdown in Better Markets, The Volcker Rule: Liquidity Impacts and Other *Myths* Used to Carry Water for the Banks, at 7 (2019), available at https://bettermarkets.com/sites/default/files/The%20Volcker%20Rule%20Liquidity%20Impacts%20and%20Other%20Myths%20Used%20to%20Carry%20Water%20for%20the%20Banks%20%28002%29.pdf.

9 Id (emphasis added).

Regulation AT, which would have taken a number of initial steps to address electronic trading risks and provide the CFTC information with which it could take additional, properly informed regulatory steps in the future.[10]

A. The CFTC's proposal is mostly duplicative of existing DCM regulations, giving the public the false impression that the CFTC is taking meaningful regulatory action to address electronic trading risks.

The CFTC's proposal appears to be largely redundant of existing DCM regulations, though differences in terms used to describe DCMs' regulatory responsibilities introduce ambiguities. For example, under DCM Core Principle 2 and § 38.157, DCMs already are required to perform real-time monitoring of all trading on their electronic platforms "**to identify disorderly trading activity and any market or system anomalies**."[11] That provision applies to monitoring for the purpose of "identifying," as opposed to preventing, market or system anomalies. However, it is focused on the DCMs' authorities to "adjust trade prices or cancel trades when necessary to mitigate market disrupting events caused by malfunctions in . . . electronic trading platform(s) or errors in orders submitted by members or market participants."[12] It is therefore highly relevant to the CFTC's regulatory framework for mitigating market disruptions and system anomalies.

In addition, DCM Core Principle 4 (***Prevention*** of Market Disruption) and §§ 38.251(a) requires DCMs to monitor and evaluate individual traders' market activities on an ongoing basis in order to "**detect and prevent manipulation and price distortions**."[13] Although that regulation emphasizes "collection" and "evaluation" of trading data, as opposed to preventative controls, DCMs also must implement an effective program for conducting real-time monitoring of market conditions, price movements and volumes, in order to "**detect abnormalities"** and make necessary, good-faith efforts to "**resolve conditions that are, *or threaten to be*, disruptive to the market**."[14] DCMs are also required to demonstrate the ability to comprehensively and accurately reconstruct daily trading activity for the purposes of detecting trading abuses.[15]

The CFTC's proposal repeatedly distinguishes the above regulations from the proposal on the basis that the latter is "anticipatory," whereas the former focuses on detection and "after-the-fact accountability."[16] That distinction is not entirely clear and possibly inaccurate, however, given the CFTC's

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[10] See CFTC, Concept Release on Risk Controls and System Safeguards for Automated Trading Environments, 78 Fed. Reg. 56542 (Sept. 12, 2013), available at https://www.govinfo.gov/content/pkg/FR-2013-09-12/pdf/2013-22185.pdf; CFTC, Regulation Automated Trading, 80 Fed. Reg. 78824 (Dec. 17, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-12-17/pdf/2015-30533.pdf; and CFTC, Regulation Automated Trading, 81 Fed. Reg. 85334 (Nov. 25, 2016), available at https://www.govinfo.gov/content/pkg/FR-2016-11-25/pdf/2016-27250.pdf. See also, e.g., Better Markets Letter to CFTC, Re: Regulation Automated Trading, at 1 (March 22, 2016), available at https://bettermarkets.com/sites/default/files/CL%20-%20CFTC%20-%20Regulation%20Automated%20Trading%20-%20Corrected%20Version%20-%203-22-2016_0.pdf ("While the proposed rule does not seek to [fundamentally] alter current market practice, it succeeds in serving as a broad framework for identifying market participants and collecting data, which may inform a more robust regulatory regime as may be needed in the future.").

[11] 17 C.F.R. § 38.157.

[12] Id.

[13] 17 C.F.R. . § 38.251(a)-(b) (emphasis added).

[14] 17 C.F.R. . § 38.251(c) (emphasis added).

[15] 17 C.F.R. . § 38.251(d).

[16] CFTC, Electronic Trading Risk Principles, 85 Fed. Reg. 42761, 42764 (July 15, 2020).

emphasis on market conditions that "threaten to be disruptive to the market" and related guidance that the "***detection and prevention of market manipulation, disruptions, and distortions*** should be incorporated into the design of [DCM] programs for monitoring trading activity."[17] In this regard, consider Appendix B to part 38, which sets forth guidance on, and acceptable practices in, compliance with DCM Core Principle 4 (Prevention of Market Disruption):

> Monitoring of intraday trading should include the capacity to detect developing market anomalies, including abnormal price movements and unusual trading volumes, and position-limit violations. **The DCM should have rules in place that allow it broad powers to intervene to prevent or reduce market disruptions**. **Once a threatened or actual disruption is detected, the DCM should take steps to prevent the disruption or reduce its severity** . . .
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> The Core Principle 4 Acceptable Practices also provide that **an acceptable program for preventing market disruptions must demonstrate appropriate trade risk controls**, in addition to pauses and halts. Such controls must be adapted to the unique characteristics of the markets to which they apply and must be designed to avoid market disruptions without unduly interfering with that market's price discovery function. **The DCM may choose from among controls that include: Pre-trade limits on order size, price collars or bands around the current price, message throttles, and daily price limits, or design other types of controls**. Within the specific array of controls selected, the DCM also must set the parameters for those controls, **as long as the types of controls and their specific parameters are reasonably likely to serve the purpose of preventing market disruptions and distortions** . . . .[18]

In light of the above, part 38 already contemplates (1) DCM rules permitting interventions to prevent or reduce market disruptions; and (2) DCM risk controls "for preventing market disruptions," including appropriate pre-trade controls, provided the selected controls are "reasonably likely to serve the purpose of preventing market disruptions and distortions."[19]

In other words, the CFTC has essentially re-proposed existing DCM responsibilities, with slightly different language, while falsely suggesting that electronic trading risks are being usefully addressed in the present release. If it were concerned about DCMs' compliance with part 38 and guidance, the CFTC could have simply converted existing guidance and accepted practices to part 38 regulations. **Instead, it has used the minimal proposed electronic trading framework to largely reiterate existing requirements and simultaneously eliminate the policies, procedures, and controls that would have been applicable not only to DCMs but to FCMs and/or certain markets participants under the now-withdrawn Regulation AT**.

The clearest indication of this misdirection, however, is evident from even a cursory review of **§ 38.255, which is squarely focused on risk controls for the prevention sand mitigation of market disruptions**. Under that existing provision, DCMs are required to establish and maintain risk control mechanisms to "**prevent and reduce the potential risk of price distortions and market disruptions**,

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17 Id at 42764, fn. 22. See 17 C.F.R. Appendix B to Part 38 - Guidance on, and Acceptable Practices in, Compliance With Core Principles.

18 Id.

19 Id.

including market restrictions that pause or halt trading in market conditions" prescribed by the DCMs.[20] The language and contemplated controls in the proposal and existing § 38.255 and related regulations are so closely drafted and so closely related that it would be unreasonable, if not deceptive, for the CFTC to proceed to finalization under the pretext that it is setting forth a new and improved electronic trading framework.

The CFTC has adopted still other regulations to address electronic trading risks ostensibly targeted by the proposal. For example, the above provisions complement CFTC regulations with risk control requirements for DCMs that provide direct electronic access to market participants. More specifically, under § 38.607, DCMs that offer direct electronic access to market participants must have effective systems and controls reasonably designed to facilitate an FCM's management of financial risk, such as "**automated pre-trade controls**."[21] Furthermore, DCM system safeguards implemented pursuant to DCM Core Principle 20, including § 38.1050 and § 38.1051, already require DCMs to establish and maintain a program of "risk analysis and oversight to identify and minimize sources of operational risk," including "through **the development of appropriate controls and procedures, and the development of automated systems, that are reliable, secure, and have adequate scalable capacity**."[22]

These provisions are the law today, and they are applicable to all 15 DCMs subject to the CFTC's oversight. Given the collective requirements of these regulatory provisions, there is almost nothing new about the proposed framework, except that the CFTC is clear that "each DCM will have the flexibility to tailor the implementation of the proposed rules to best prevent, detect, and mitigate market disruptions or system anomalies in their respective markets."[23] **In this regard, the CFTC's new proposed regulations are not only largely duplicative but also responsive to siren song of industry self-policing**; that is, the proposal would permit DCMs to decide for themselves how to address prevention, detection, and mitigation of undefined market disruptions and system anomalies associated with electronic trading and the entry of electronic orders into DCMs' electronic trading platforms. That industry view, of course, is a critical perspective to consider. But it should not, and cannot, be the last word, given trading revenues and conflicts of interest.

B. The CFTC's proposal cleverly acknowledges that the DCM Risk Principles are largely duplicative of existing DCM regulations.

The CFTC's proposal is unlikely to, and likely is not intended to, meaningfully address the serious market structure concerns associated with the evolution of the derivatives markets towards electronic trading. Excluding non-binding acceptable practices, the regulatory text of the proposal includes three sentences as follows:

New Proposed § 38.251(e)-(g)

- Proposed DCM Risk Principle 1: A [DCM] must . . . (e) Adopt and implement rules governing market participants subject to its jurisdiction to prevent, detect, and mitigate market disruptions or system anomalies associated with electronic trading;

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20 17 C.F.R. § 38.255.

21 17 C.F.R. § 38.607.

22 17 C.F.R. § 38.1050.

23 CFTC, Electronic Trading Risk Principles, 85 Fed. Reg. 42761, 42771 (July 15, 2020).

- Proposed DCM Risk Principle 2: A [DCM] must . . . (f) 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; and

- Proposed DCM Risk Principle 2: A [DCM] must . . . (g) Promptly notify Commission staff of any significant disruptions to its electronic trading platform(s) and provide timely information on the causes and remediation.

The limitations of the proposal are obvious from the language used by the CFTC in describing its proposed actions and likely effects. For example, the CFTC reveals an unsupported view that "**DCMs are addressing most, if not all, of the electronic trading risks currently presented to their trading platforms**"[24] and therefore emphasizes what should be a puzzling expectation that the proposed "**Risk Principles may not necessitate the adoption of additional measures by DCMs**."[25] Of course, if DCMs are already doing what they should be doing and likely would be required to do nothing further, one could reasonably question the value of the proposal. Furthermore, in assessing the proposal's costs and benefits, the CFTC explains as follows:

> **DCMs' current risk management practices**, particularly those implemented to comply with existing regulations 38.157, 38.251(c), 38.255, and 38.607, **already may comply with the requirements of [new] proposed rules 38.251(e) through (g).**[26]

Thus, the CFTC proposes electronic trading regulations that knowingly require perhaps *nothing at all* and therefore are purposely ineffective, if not fraudulent. That is irresponsible and shortsighted, as undoubtedly will be exposed when the next automated trading-related market disruption reveals the proposal's infirmities.

The CFTC also repeatedly clarifies that DCMs would be permitted to decide for themselves which controls, ***if any***, should be implemented to address electronic trading risks. In several places, the CFTC emphasizes that the proposed DCM Risk Principles would not require "any specifically defined set of rules or risk controls."[27] Rather, it emphasizes that DCMs "shall have satisfied their requirements under the Risk 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."[28] Unfortunately, the CFTC says different things in different places with respect to the meaning of "reasonable design" in this context. In some parts of the preamble, it specifies that "reasonable" in this context is an "objective" measure, akin to a reasonable person standard under the law.[29] In other places,

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24 CFTC, Electronic Trading Risk Principles, 85 Fed. Reg. 42761, 42762 (July 15, 2020).

25 Id. Interestingly, there appears to be some conflict with respect to this view in the document, as the release elsewhere estimates that the principles impose non-trivial implementation costs on DCMs. For the reasons discussed above, we doubt those estimates.

26 Id at 42772.

27 CFTC, Electronic Trading Risk Principles, 85 Fed. Reg. 42761, 42763 (July 15, 2020).

28 Id.

29 Id.

the CFTC appears to indicate that what is "reasonable" is subjectively within the discretion of the DCMs to determine.

For example, the CFTC recognizes "many existing DCM pre-trade risk control practices to be consistent with the requirement in proposed regulation 38.251(f)."[30] The term "consistent" as used in the preamble does not necessarily infer that such consistent pre-trade controls are also *sufficient.* However, the CFTC emphasizes that "each DCM has the flexibility to apply the specific controls that ***the DCM deems reasonably designed*** to prevent, detect, and mitigate market disruptions or system anomalies,"[31] which suggests some confusion as to whether the CFTC has set forth an objective or subjective reasonableness standard.

In this regard, we think it likely that the CFTC meant to propose an objective standard. Doing so clearly is critical in this context, however, because the CFTC makes numerous statements along the lines of the following: "**it may be possible f*or a DCM to appropriately conclude that its existing pre-trade risk controls satisfy the proposed Acceptable Practices for proposed regulation 38.251(f),* and that the adoption of this rule does not require it to do something more, or different, at this time**."[32] Should the CFTC or its staff need to second-guess DCM conclusions in this regard, it would be helpful, at a minimum, to rely on balancing statements in the forthcoming final preamble that *the adoption of the proposal **very well may require DCMs to do things differently** if their pre-trade risk controls do not objectively meet the letter of the regulations and their prevention and mitigation purposes.* **The CFTC's near obsession with pointing out that the proposed regulations may do nothing at all and with setting forth a near *presumption of reasonableness* is very telling, inappropriate, and contrary to the Commodity Exchange Act.**

The CFTC's analysis pursuant to the Paperwork Reduction Act similarly acknowledges that "various DCM practices in place today that may be consistent with proposed regulation 38.251(e)" and therefore that "**it is possible that some DCMs would not be required to file new or amended rules to satisfy Risk Principle 1, if adopted**."[33] With respect to Risk Principle 1, the CFTC estimates that the costs associated with implemented that supposedly new "requirement" would be "**expected to be de minimis**[,]"[34] because the filings required to effectuate new policies, procedures, or controls would apparently be non-existent. That term "consistent" similarly appears in the preamble discussion of various trading controls currently in place, including requirements to adopt order size limitations, kill switch systems, and automatic cancellations.[35]

Elsewhere, in the cost-benefit analysis, the CFTC outright concludes that "DCMs currently monitor their markets and have rules to prevent and mitigate market disruptions or system anomalies, ***as required by proposed rule 38.251(e)***."[36] That statement unequivocally demonstrates the CFTC's proposal for DCM Risk Principle 1 does little more than reiterate existing requirements, raising the question of why a new proposed principle is necessary in the first instance. Proposed § 38.251(g) would similarly require minimal

30 Id.

31 Id at 42773.

32 Id at 42768.

33 Id at 42770.

34 Id.

35 Id at 42766.

36 Id at 42772.

notifications for undefined significant disruption events. The CFTC indicates in that context—yet again—that DCMs are doing much, if not all, of what is required under the proposal. Consider the following statement:

> DCMs already report to Commission staff certain interruptions in orderly trading in markets, including electronic trading halts and significant system malfunctions; cyber security incidents or targeted threats that actually or potentially jeopardize automated system operation, reliability, security, or capacity; and activation of business continuity-disaster plan, as required by rule 38.1051(e).
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> **Hence, the direct incremental cost of proposed rules 38.251(e) through (g) on DCMs is expected to be minimal**.[37]

Thus, while the proposal may require reporting of additional types of "significant disruptions," the CFTC itself expects the collective scope of the new reporting and other provisions to be, in its words, "minimal."

Interestingly, the CFTC provides DCMs this overweening deference, even though it apparently recognizes a need for supervisory guidance that extends beyond the principles-based framework for DCMs. It actually encourages the National Futures Association ("NFA") to "reevaluate whether additional supervisory guidance" beyond current Interpretive Notice 9046, relating to the supervision of automated order routing systems, "should be provided to its members."[38] That interpretive guidance requires NFA members to "implement firewalls, conduct testing, and perform capacity reviews, as well as consider implementation of pre-trade controls."[39] The CFTC's encouragement of an NFA review to determine whether additional controls guidance is necessary is puzzling, given the CFTC's determination not to itself engage in a searching review of whether federal controls guidance is necessary and its determination also to withdraw Regulation AT. **The CFTC appears to view such controls improvements as more appropriately for the self-regulatory organizations ("SROs") to decide, though it neither states that preference explicitly nor discusses conflicts of interest that may impede the independence of the exchanges and SROs**.

II. In several respects, the proposal is imprecise and unenforceable. It therefore ensures a lack of uniformity in DCM policies, procedures, and controls and potentially incentivizes a Gresham's dynamic that would competitively punish the most responsible but restrictive exchanges.

In several respects, the proposal is imprecise and unenforceable. For any reporting framework to be effective, two basic conditions must be satisfied: (1) regulated entities must know what they are expected to report (and be able to do it); and (2) the regulator must have high confidence that the regulated entities will report as expected. For example, **if the reporting of "significant market disruptions" is necessary to responsible oversight of the derivatives exchanges, these exchanges must know what to report, where to report it, when to report it, and under what circumstances reporting is required**. The proposed reporting framework fails the basic conditions, because it relies upon ambiguous terms, like "significant" and "disruption," that demand explication and therefore would certainly lead to divergent practices. The CFTC could never be confident under the proposed reporting framework that it is

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37 Id at 42772.

38 Id at 42764.

39 Id.

responsibly overseeing the markets, because it could never be confident that it is receiving timely and complete information on adverse market events.

Proposed § 38.251(g) requires DCMs to "promptly" notify the CFTC staff of any "significant disruption" to its electronic trading platform(s). The CFTC explains that a notification would need to be minimal, for example an "email containing sufficient information to convey the nature of the disruption, and if known, its cause, and the remediation."[40] However, Proposed § 38.251(g) provides (1) no formal definition of market "disruptions" subject to notification requirements, (2) insufficient indication of which such disruptions cross the "significance" threshold, triggering notifications; and (3) no indication of the detail required to "sufficiently" notify the CFTC's staff of the market events. **Yet, the CFTC apparently interprets these terms fairly broadly, estimating that each of the 15 registered DCMs would be required to make notifications approximately 50 times per year**.[41] That means the CFTC estimates something on the order of 750 significant market disruptions annually and yet, imposes almost no specific regulatory requirements to address such expected events.

This estimate can be little more than pure speculation, of course, given the CFTC's recognition that its proposal provides essentially unfettered "**discretion to each DCM in terms of how to precisely define market disruptions and system anomalies as they relate to their particular markets**."[42] The vesting of that sort of discretion in exchanges makes little sense in this context. There is no reason to conceptually distinguish reportable market disruptions from one exchange to another. Permitting differing definitions to proliferate will only undermine comparative analyses of market disruptions across derivatives exchanges.

In addition, given the statutory standard for review of rule filings under part 40, it is doubtful that the CFTC would overturn a submitted approach as legally deficient and inconsistent with the Commodity Exchange Act. Nevertheless, **the CFTC must at least clarify that the word "rules" includes internal policies, procedures, controls, advisories, and trading protocols contemplated in the broad definition in 40.1, and perhaps beyond**. Furthermore, the unspecified process for "emailing" market disruption notifications should be revised to require filings pursuant to part 40. For the CFTC to oversee an objective standard, it needs to at least know the full scope of "rules" and risk controls designed to address electronic trading risks.

III. Exchanges have taken commendable steps to avoid "significant market disruptions" but also answer to shareholders that demand electronic trading revenues from the firms most affected by the controls environment.

DCMs have commercial incentives to maintain market integrity, protect the price discovery process, and ensure orderly trading and markets. Many of the largest DCMs have implemented sophisticated means for protecting their markets, proactively instituting pre-trade and post-trade risk and financial controls, like conformance testing, messaging throttles, interval price limits, maximum order measures, heartbeat monitoring and automatic cancellation controls, and individual position and margin limits. These efforts are not dependent on the altruism of the exchanges. The network effects associated with market integrity improve market quality characteristics and transaction costs, furthering the network effects and shielding significant revenues from competitive pressures. That is why exchanges, like the CME Group's multiple DCMs, have taken some commendable regulatory steps to protect against market

40 Id at 42770.

41 CFTC, Electronic Trading Risk Principles, 85 Fed. Reg. 42761, 42770 (July 15, 2020).

42 Id at 42771.

disruptions and system anomalies caused by poor risk management, order management, and connectivity management.

Undeniably, DCMs have other incentives as well. Exchanges face conflicts of interest between maximizing profit and shareholder value and diminishing trading volumes through meaningful limits on certain electronic trading practices. With competitive pressures and revenues at stake, one exchange is unlikely to be a first mover and absorb the costs and rancor of market participants in implementing risk controls and related measures that its competitors may, for market share reasons, postpone indefinitely. That is why a federal baseline set of controls and regulations—revisited as often as is necessary to ensure *responsible* innovation—must be applied to all DCMs. The CFTC acknowledges this regulatory arbitrage concern but minimizes such concerns due to a belief that "differences in the application of the proposed regulation across DCMs would [not] be substantial enough to induce market participants to switch to trading at a different DCM, even if there were two DCMs trading similar enough contracts."[43] Consider its explanation:

> DCMs are also given the flexibility to decide how to apply the proposed requirements in their respective markets. This flexibility could result in differences across DCMs, potentially contributing to regulatory arbitrage. For example, DCMs' practices could differ in the information collected from market participants; the rules applied to prevent, detect, and mitigate market disruptions or system anomalies; and the intensity of pre-trade controls. The parameters for establishing disruptive behavior could be defined differently by the various DCMs, which might lead to differing levels of exchange-based pre-trade risk controls.
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> The Commission acknowledges that to the extent there is potential for market participants to choose between DCMs, **those DCMs with lower information collection requirements and potentially less stringent pre-trade risk controls could appear more attractive to certain market participants. All or some of these factors could create the potential for market participants to move their trading from DCMs with potentially more stringent risk controls to DCMs with less stringent controls**, which could cost certain DCMs business.[44]

We essentially agree, acknowledging the network effects that limit the migration of trading activities.

Conclusion

With more than "96 percent of all on-exchange futures trading occur[ing] on DCMs' electronic trading platforms"[45] and increasing "automated" trading activities throughout the derivatives and related markets,[46] far more comprehensive oversight of market-wide risk controls to prevent, detect, and mitigate market disruptions and system anomalies associated with the electronic order origination, programming, transmission, and execution is needed. **The CFTC's proposed regulations, oversight tools, and resourcing simply are not reasonably tailored to the types of risks posed by electronic trading, much**

43 Id at 42774.

44 Id.

45 Id at 42762.

46 Id.

<u>less automated trading, systems employed across the markets</u>.[47] The risks of this neglect are substantial. In an initial investigation of the 2010 Flash Crash, the CFTC and SEC joint staff report identified that "[o]ver 20,000 trades across more than 300 securities were executed at prices more than 60% away from their values just moments before."[48]

The CFTC has engaged in almost a decade of deliberation with respect to an electronic and automated trading framework for the derivatives markets. Unfortunately, in withdrawing proposed Regulation AT and replacing it with three sentences that are imprecise, unenforceable, and susceptible to varying DCM interpretations, the present proposal does nothing to meaningfully address market structure, order management and proliferation, and other necessary reforms to detect, prevent, and mitigate electronic trading risks.

Sincerely,

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47 CFTC, Electronic Trading Risk Principles, 85 Fed. Reg. 42761 (July 15, 2020).

48 Securities and Exchange Commission and Commodity Futures Trading Commission, Findings Regarding the Market Events of May 6, 2010: Report to the Staffs of the CFTC and SEC to the Joint advisory Committee on Emerging Regulatory Issues, at 1 (Sept. 30, 2010), available at https://www.sec.gov/news/studies/2010/marketevents-report.pdf.