

CFTC ATS Concept Release Alert

October 7, 2013

SECURITIES

Addressing the Need for Speed: CFTC Seeks Comment on Risk Controls for Automated Trading Environments

On September 12, 2013, the Commodity Futures Trading Commission (“CFTC” or “Commission”) published a Concept Release on Risk Controls and System Safeguards for Automated Trading Environments (“Concept Release” or “Release”).¹ In light of the fundamental shift from human-centered derivatives markets to highly automated and interconnected trading environments, and against the backdrop of several recent highly publicized market disruptions,² the Release seeks to catalogue and obtain comment on the efficacy of existing risk controls in US derivatives markets. It also seeks comment on a variety of other risk-mitigating measures.

I. INTRODUCTION

The Release highlights the current prominence of automated trading systems (“ATs”)—including high-frequency trading (“HFT”) systems—that generate and route orders to markets that are themselves automated systems for the matching and execution of orders. The Release notes that while these systems have conferred many benefits upon market participants, they present challenges unique to their speed, interconnectedness, and reliance on algorithmic systems. While the Commission and market participants have taken a number of steps to address and manage the risks posed by highly automated trading systems, the Release evidences the Commission’s commitment to assess the adequacy of the existing regulatory framework and adapt it, as appropriate, to meet the challenges presented by automated systems.

In total, the Release seeks comment on 124 questions. The vast majority of those questions relate to specific categories of pre-trade risk controls, post-trade reports and measures, system safeguards, and additional risk-mitigating measures described in the Release. The Release also poses a series of overarching questions about whether the controls described are already in use, the costs and benefits associated with each, and the value of and extent to which redundant controls should be imposed upon different types of market participants. Finally, the Release poses a series of questions about HFT, latency differences in order handling or trade reporting that provide opportunities for informational advantage, and communications between exchanges’ informational technology systems.

¹ Concept Release, 78 Fed. Reg. 56,542, 56,551 (Sept. 12, 2013), available at <http://www.cftc.gov/ucm/groups/public/@Irfederalregister/documents/file/2013-22185a.pdf>.

² The Commission highlighted the May 2010 Flash Crash, the Knight Capital Group software malfunction, and the technical issues associated with Nasdaq’s commencement of trading after the Facebook IPO. In the Commission’s view, these events illustrate the technological and operational vulnerabilities inherent to automated trading environments. With regard to automated trading systems (“ATs”), the Commission identified the existence of vulnerabilities with respect to “algorithm design flaws, market conditions outside of normal operating parameters, the failure of built-in risk controls, operational failures in the communication networks on which ATs depend for market data and connectivity with trading platforms, and inadequate human supervision.” *Id.* at 56,548-550.

Section II of this alert provides an overview of automated trading environments, their associated risks, and the current regulatory landscape for derivatives (both futures and swaps), as discussed in the Concept Release. Section III provides a summary of the risk controls and other measures discussed in the Release, and highlights key questions posed by the Release.

Of course, increased automation and its attendant risks are not unique to the derivatives markets. The Securities and Exchange Commission (“SEC”), as we have discussed in prior alerts³ and note briefly here, also is addressing many of the same issues discussed in the Concept Release. Although the CFTC and the SEC oversee different markets, those markets are, in fact, highly interconnected.

II. THE CURRENT LANDSCAPE

A. Automated Trading Environment Characteristics and Risks

While the CFTC notes that there is no regulatory definition of ATs,⁴ it observes that the term generally is understood to mean computer-driven systems that automate the generation and routing of orders to one or more markets. In CFTC-regulated markets, orders generated by an ATS are, in turn, routed through high speed communication networks to designated contract markets (“DCMs”) that match or otherwise execute those orders in an automated fashion.⁵ As identified in the Release, the increased automation and exponentially faster communication networks have reduced the order and execution lifecycle to a few milliseconds. In view of this evolution, the Commission emphasized the need for equally sophisticated risk management systems with speeds commensurate to that of the ATS generally, as well as the re-evaluation of traditional risk controls and safeguards that relied on human judgment and speeds more appropriate to manual or floor-based trading environments.

In discussing the characteristics of automated trading environments, the Commission highlights and seeks comment on several risk areas and key considerations in assessing and designing the appropriate regulatory framework.

1. HFT-Related Risks

HFT systems are a subset of ATs. Although the CFTC has not specifically defined HFT, a working group of the CFTC’s Technology Advisory Committee (“TAC”) has identified the following attributes of HFT:

(a) algorithms for decision making, order initiation, generation, routing, or execution for each individual transaction without human direction; (b) low-latency technology that is designed to minimize response times, including proximity and co-location services; (c) high speed connections to markets for order entry; and (d) recurring high message rates (orders, quotes or cancellations) determined using one or more

³ Andre Owens et al., *SEC Gets SCI-entific About Trading Systems with Proposed Regulation SCI*, WilmerHale (Mar. 27, 2013), available at <http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=10737420831>; Andre Owens et al., *SEC Adopts the Consolidated Audit Trail Rule*, WilmerHale (Oct. 1, 2012), available at <http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=112818>; Elizabeth Derbes & Andre Owens, *SEC Adopts Rule Requiring Large Trader Reporting*, WilmerHale (Aug. 1, 2011), available at <http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=92931>; Andre Owens et al., *SEC Proposes Broad Changes for Broker-Dealers with Direct Access to ATs and Exchanges*, WilmerHale (Feb. 3, 2010), available at <http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=93576>; Andre Owens et al., *SEC’s Equity Market Structure Concept Release Highlights Potential New Regulatory Initiatives*, WilmerHale (Jan. 20, 2010), available at <http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=87416>.

⁴ In the SEC context, “ATS” refers to an “alternative trading system.” Regulation ATS defines an alternative trading system to be any organization, association, person, group of persons, or system: “(1) That constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of § 240.3b-16 of this chapter; and (2) That does not: (i) Set rules governing the conduct of subscribers other than the conduct of such subscribers’ trading on such organization, association, person, group of persons, or system; or (ii) Discipline subscribers other than by exclusion from trading.” 17 C.F.R. § 242.300 (2013).

⁵ Although this has been the case historically, ATs (including HFT systems) may be employed with respect to swaps traded on a swap execution facility (“SEF”).

objective forms of measurement, including (i) cancel-to-fill ratios; (ii) participant-to-market message ratios; or (iii) participant-to-market trade volume ratios.⁶

In the Release, the Commission seeks comment on the benefit of defining HFT, as well as the strengths, weaknesses and overall adequacy of the TAC working group's definition. Perhaps more importantly, the Release seeks input on whether HFT should receive different regulatory attention than ATs in general, *i.e.*, whether different risk controls should be required for HFT firms and systems.

2. Latency-Related Risks⁷

The Commission also discusses the premium that some market participants, such as HFT firms, place on speed relative to competitors. The Commission notes that while firms may reduce latencies appropriately through investments in high-speed communications networks and other technologies, there also are incentives for market participants to reduce latency by minimizing pre-trade risk controls—potentially creating a “race to the bottom.” A similar but separate concern is that market participants may be able to trade at speeds that outpace their risk management systems. The Commission asks commenters to identify examples of latency differences due to exchange processes for message transmission that provide informational advantages and asks whether exchanges and other firms should regularly audit their systems to identify and resolve such latencies.

3. Risks Associated with the Rise of Interconnected Markets

The Commission explains that increased interconnectedness of markets may help with pricing efficiencies, but notes that it also increases the speed with which a disruption on one trading platform can impact related markets. To illustrate this point, the Release discusses the steps that the SEC and two derivatives market participants took to address market volatility following the May 2010 Flash Crash, when the major indices in both the futures and securities markets fell by more than 5% in a few minutes, including the adoption or modification of trading halts and pauses. The Commission asks for comment on the benefits of standardizing various risk controls and safeguards across markets and, importantly, the need for joint regulatory and industry response with respect to the controls contemplated in the Release.

4. Continuing Importance of Manual Controls and Safeguards

While the Commission believes that automated risk management systems with sophistication and speed commensurate with the automated trading activity are necessary, it notes that such controls are not sufficient in isolation. Rather, as emphasized in the Release, “manual risk controls, and particularly systems safeguards, remain crucial to orderly markets.”⁸ The Commission notes that, in many cases, manual risk controls have shifted “upstream” to system design and “downstream” to system management.

⁶ Concept Release, *supra* note 1 at 56,545. The SEC similarly has refrained from providing a definition of HFT. Rather, like the TAC, the SEC has identified attributes of HFT, including:

(1) the use of extraordinarily high-speed and sophisticated computer programs for generating, routing and executing orders; (2) use of co-location services and individual data feeds offered by exchanges and others to minimize network and other types of latencies; (3) very short timeframes for establishing and liquidating positions; (4) the submission of numerous orders that are cancelled shortly after submission; and (5) ending the trading day in as close to a flat position as possible (that is, not carrying significant, unhedged positions overnight).

Concept Release on Equity Market Structure, Exchange Act Release No. 61, 358, 75 Fed. Reg. 3,594, 3,606 (Jan. 21, 2010).

⁷ In this context, latency is the measure of the time delay between the actual occurrence of an event (for example, an execution) and receipt of notice of that event.

⁸ Concept Release, *supra* note 1 at 56,547.

B. Market and Agency Responses to Date

In response to recent market events, the CFTC, the SEC, and derivatives and securities market participants have implemented various rules, policies, and procedures designed to address the vulnerabilities highlighted by the market events and mitigate the risk of future disruptions. Below is a brief summary of some recent rulemakings and existing controls. One of the objectives of the Release is to determine the extent to which recommendations by industry and advisory groups, “best practices,” and other voluntary controls have been implemented in a consistent manner across the markets, and the extent to which these recommendations and practices should be established as regulatory requirements.

1. CFTC Markets

The Release discusses a number of provisions in Commission rulemakings to implement the Dodd-Frank Act relating to risk controls, trade reporting, and system safeguards. For example, in April 2012, in its rulemaking to establish core principles for the operation of derivatives clearing organizations (“DCOs”), the CFTC adopted Regulations 1.73 and 23.609, which require each future commission merchant (“FCM”) that is a member of a DCO, and swap dealers (“SDs”) and major swap participants (“MSPs”) that are members of a DCO, to establish risk-based limits for all proprietary accounts and customer accounts and to use automated measures to screen orders subject to automated execution for compliance with risk-based limits on a pre-trade basis.

With respect to DCMs, the Commission adopted Regulations 38.255 and 38.607 in June 2012. Under Regulation 38.255, DCMs must “establish and maintain risk control mechanisms to prevent and reduce the potential risk of price distortions and market disruptions”⁹ Moreover, because “it is impossible for an FCM to protect itself without the aid of the DCM,”¹⁰ Regulation 38.607 requires DCMs that permit direct market access to have effective systems and controls reasonably designed to facilitate an FCM’s management of financial risk and to implement and enforce rules requiring member FCMs to utilize the systems and controls of DCMs.

The Commission has adopted regulations and provided guidance to address manipulative and deceptive devices as well as disruptive trading activity. In July 2011, the Commission adopted Regulations 180.1 and 180.2 implementing the statutory prohibition of Section 6(c) of the Commodity Exchange Act (“CEA”) against manipulation and fraud in the markets. Additionally, in July 2013, the CFTC provided guidance on the scope and application of provisions of Section 4c(a)(5) of the CEA, which prohibits specified disruptive trading practices.

The Release also discusses a variety of recommendations to address automated trading-related risks from industry and international organizations. These include recommendations and concepts developed by the Futures Industry Association’s (“FIA”) Principal Traders Working Group and Market Access Working Group, the International Organization of Securities Commissions (“IOSCO”), the European Securities and Markets Authority (“ESMA”), and the Commission’s TAC. For example, the Release cites the FIA’s Principal Traders Working Group recommendation that firms train personnel in ATSS and develop systems to monitor and control automated trading. The Release also references efforts by the FIA’s Market Access Working Group and ESMA to support the design and testing of ATSS prior to their use.

The Release describes a number of actions that market participants have undertaken voluntarily. Exchanges have imposed circuit breakers against price spikes, kill switches to enable trading firms to halt trading, price limits on market orders, message throttle limits, “orders removed upon logout” functionality, and protections against self-trading. At the firm level, a survey conducted by the Federal Reserve Bank of Chicago reported that all nine of the proprietary firms surveyed have limits on order sizes, intraday position limits, and kill switches. Another survey by the Federal Reserve Bank of Chicago of FCMs

⁹ 17 C.F.R. § 38.255 (2013).

¹⁰ Concept Release, *supra* note 1 at 56,548 (citing Core Principles and Other Requirements for Designated Contract Markets, RIN 3038–AD09, 77 Fed. Reg. 36,612, 36,648 (June 19, 2012)).

indicated that some firms have adopted pre-trade and post-trade checks to mitigate potential trading losses and credit risks at clearing firms.

The Concept Release is intended to provide the Commission with perspectives on the extent voluntary controls and procedures are being implemented and have been effective against the risks posed by ATSS. The Release asks whether existing measures—both regulatory and voluntary—are sufficient to address these risks and whether any other measures should be incorporated into Commission rules. The Release describes the risk controls in general “principles-based” terms, and seeks comment on whether the Commission should adopt a principles-based approach or a more granular approach.

2. SEC Actions with Respect to the Mitigation of Risk in an Automated Trading Environment

The SEC has adopted and proposed regulations designed to address risks associated with the increasing interconnectedness of automated markets. In November 2010, the SEC adopted Rule 15c3-5, which requires broker-dealers with market access to an exchange or alternative trading system to implement pre-trade controls reasonably designed to manage the financial, regulatory, and other risks of such access.¹¹

More recently, the SEC proposed Regulation Systems Compliance and Integrity (“Regulation SCI”) in March of this year,¹² which would require exchanges, certain alternative trading systems, clearing agencies, and plan processors to maintain policies and procedures reasonably designed to meet certain technology standards, and take appropriate corrective action if problems occur. The SEC also recently approved a National Market System Plan to implement a “limit up-limit down” mechanism to create “trading collars” to help limit abrupt market movements in individual securities.¹³ The SEC also adopted amendments to the market-wide circuit breakers to provide for brief, coordinated, cross-market trading halts during a sharp decline in the securities market.¹⁴

III. POTENTIAL RISK CONTROLS DISCUSSED IN THE CONCEPT RELEASE

The Commission solicits comment on the utility, costs and benefits associated with various risk controls that might be applied in the derivatives markets. In considering the scope and application of the potential risk controls, the Commission reiterates the need to determine the appropriate stage at which risk controls should be applied, noting that such controls might be applied by: (1) ATSS at the time of order generation; (2) clearing firms during the order transmission process; (3) trading platforms prior to exposing orders to the market; (4) DCOs; and (5) other risk control focal points (e.g., third-party “hubs”).

¹¹ 17 C.F.R. § 240.15c3-5 (2013); see also Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 63,241, 75 Fed. Reg. 69,792 (Nov. 15, 2010).

¹² See Regulation Systems Compliance and Integrity, Exchange Act Release No. 69,077, 78 Fed. Reg. 18,084 (Mar. 25, 2013) [hereinafter “Proposed Reg. SCI”].

¹³ See Order Approving, on a Pilot Basis, the National Market System Plan to Address Extraordinary Market Volatility by BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Incorporated, Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, The Nasdaq Stock Market LLC, National Stock Exchange, Inc., New York Stock Exchange LLC, NYSE MKT LLC, and NYSE Arca, Inc., Exchange Act Release No. 67,091, 77 Fed. Reg. 33,498 (May 31, 2012); Notice of Filing and Immediate Effectiveness of the Second Amendment to the Limit Up-Limit Down Plan, Exchange Act Release No. 68,953, 78 Fed. Reg. 13,113 (Feb. 26, 2013); Order Approving the Third Amendment to the Limit Up-Limit Down Plan, Exchange Act Release No. 69,287, 78 Fed. Reg. 21,483 (Apr. 10, 2013).

¹⁴ See Notice of Filing of Amendments No. 1 and Order Granting Accelerated Approval of Proposed Rule Changes as Modified by Amendments No. 1, Relating to Trading Halts Due to Extraordinary Market Volatility, Exchange Act Release No. 67,090, 77 Fed. Reg. 33,531 (June 6, 2012). The operative date of the revised circuit breakers was delayed from February 4, 2013 to April 8, 2013; see, e.g., Notice of Filing and Immediate Effectiveness of Proposed Rule Change Delaying the Operative Date of a Rule Change to NYSE Rule 80B, Which Provides for Methodology for Determining When to Halt Trading in All Stocks Due to Extraordinary Market Volatility, From the Date of February 4, 2013, Until April 8, 2013, Exchange Act Release No. 68,784, 78 Fed. Reg. 8,662 (Feb. 6, 2013).

The Commission asks about the effectiveness of various potential risk controls, the degree to which industry participants already utilize the control, and whether there is a need for regulatory action to provide more uniform risk mitigation across CFTC-regulated markets. The Commission groups the potential controls into four broad categories: (1) pre-trade controls; (2) post-trade reports and other post-trade measures; (3) system safeguards; and (4) other potential protections.

A. Potential Pre-Trade Controls

The Commission identifies seven pre-trade controls in the Concept Release that are intended to reduce market disruptions related to automated trading due to errors, system malfunctions or other events with similar effects. The Release states that to best address disruptions, the controls should apply at one or more of three points in the execution chain: (1) individual firms or traders; (2) intermediaries, including SDs, MSPs, FCMs, Floor Traders, Commodity Pool Operators (“CPOs”), and DCOs; and (3) exchanges. The Commission believes that redundancy in controls may permit individual entities to calibrate the relevant control in accordance with their own objectives and risk tolerances, and help respond to competitive and “race to the bottom” concerns. The Commission posed questions with respect to the following seven pre-trade controls:

1. Message and Execution Throttles

Message rate and execution rate throttles (“execution throttles”) “prevent an algorithm from exceeding its expected message rate or rate of execution, and when tripped, can alert monitors at both an exchange and a trading firm.”¹⁵ These controls can be used to rapidly detect malfunctioning algorithms and thus reduce the damages associated with disruptive algorithms. Execution throttles can also be used to mitigate the risk of manipulative or disruptive messaging strategies (e.g., “order stuffing”).

The Commission solicits comment on the manner in which the message rate should be determined for execution throttles and the process of aligning message rates with risk management capabilities. The Commission also seeks to understand the appropriate location for execution throttles and whether they should apply to all ATs or just those using HFT strategies. Additionally, the Release seeks comment on who should be charged with setting message rates for products when they begin trading.

2. Volatility Awareness Alerts

Volatility awareness alerts are triggered when prices in a given product move beyond a certain threshold within a specified time period, prompting human intervention. Different from trading pauses, the alerts would be used by market participants operating ATs to identify and inform personnel of market conditions that may exceed an algorithm’s parameters, or may highlight unintended effects of an algorithm’s orders. The Commission asked how to minimize the risk of false alarms that might interrupt trading or cause human monitors to ignore them over time.

3. Self-Trade Controls

Controls that identify and limit self-trading are intended to provide more accurate indications of the level of market interest on both sides of the market and help ensure arm’s-length transactions that promote effective price discovery. The Commission asks whether all market participants should implement self-trading controls, how such controls should operate, whether there is a need for regulatory standards for such controls, and how granular the self-trading controls should be (e.g., set at the executing firm level or the trader level?).

4. Price Collars

The Commission described two types of price collars that can be implemented at the market participant and trading platform levels: (1) price collars on orders and (2) price collars on executions. The former prevent orders outside of acceptable price ranges from entering the order book. The latter prevent an order that is already in the book from being executed by the matching engine if it is outside of the

¹⁵ Concept Release, *supra* note 1 at 56,553.

acceptable range. The Commission is interested in comment on whether exchanges should adopt price collars for all listed contracts, and whether such collars would help mitigate credit risk to DCOs.

5. Maximum Order Sizes

Maximum order sizes are intended to protect against the execution of an order for a quantity larger than a predetermined limit (*i.e.*, so-called “fat finger” controls). The Commission noted that exchanges currently have this capability, but such controls may vary considerably, depending on product, product class, or clearing member. The Commission seeks comment on whether this technology should be standardized across exchanges, whether there should be regulatory standards for such technology, and whether other market participants, such as clearing firms and trading firms, should also be required to implement these systems.

6. Trading Pauses

Trading pauses are intended to mitigate price movements during instances of market volatility. The Commission identifies three potential triggers of trading pauses: (1) when the execution of resting orders would cause excessive price movements; (2) when prices move in excess of a dynamic threshold over a given time period; or (3) when prices have moved more than a given amount during the trading day. The Commission is interested in the effectiveness of the trading pauses currently in use, and whether any other types of pauses should be implemented.

7. Credit Risk Limits

Pre-trade credit risk limits can serve to limit the activity of malfunctioning ATSS. They may be applied by trading platforms, clearing firms, and/or market participants operating ATSS. The Release seeks comment on the appropriate scope, location and timing in the order lifecycle for credit checks. The Commission is especially interested in the strengths and weaknesses of using a “hub”¹⁶ model for different types of pre-trade risk controls.

B. Potential Post-Trade Controls

The Release notes that a comprehensive pre-trade control framework cannot guarantee against unexpected events. The Commission described certain post-trade controls to further mitigate the impact of unanticipated market events, such as: (1) order, trade and position reports from exchanges and DCOs; and (2) uniform trade cancellation and adjustment policies. The Commission seeks comment on the extent to which order and trade reports are currently offered, their value in implementing risk safeguards, and whether these reports should be standardized.

C. Potential System Safeguards

The Release also discusses a range of system safeguards for trading platforms, clearing firms, and market participants (including ATSS). Such safeguards include: (1) controls related to order placement; (2) policies and procedures for the design, testing and supervision of ATSS; (3) self-certifications and notifications; (4) ATS or algorithm identification; and (5) data reasonability checks.

1. Controls Related to Order Placement: Order Cancellation Capabilities and Repeated Automated Execution Throttles

Controls related to order placement, cancellation or throttling include: (1) auto-cancel on disconnect controls that cancel outstanding orders when the source of the orders lose connectivity; (2) selective working order cancellation controls that facilitate the cancellation of outstanding orders from a given algorithm, account, or desk; (3) kill switches that prevent orders from progressing downstream without human intervention; and (4) system heartbeats that facilitate the auto-cancel on disconnect requirement by indicating proper connectivity with the trading platform. For example, automated execution throttles

¹⁶ The “hub model” entails the use of third-party “hubs” through which orders or order information could flow to uniformly mitigate risks across one or more trading platforms. See *id.* at 56,544.

would limit the number of orders an ATS can submit by automatically disabling the ATS and requiring human intervention once the pre-set maximum number of orders is reached. The required human intervention would independently verify the operation of an ATS to ensure that an algorithm's strategy is operating as anticipated and that the algorithm is responding appropriately to current market conditions. The Commission is particularly interested in comments regarding the benefits of kill switches, and how they should be implemented by exchanges, trading, and clearing firms.

2. Policies and Procedures for the Design, Testing and Supervision of ATSS

The Commission also discusses whether more standardized procedures related to system development, change management, testing, monitoring, supervision, training, and crisis management would benefit the markets and the public.

a. ATS and Exchange System Development, Change Management, and Testing

The Commission discusses requiring market participants operating ATSS to test such systems both internally and on each trading platform on which an ATS will operate. Each algorithm would be required to be tested prior to initial deployment and re-deployment. Additionally, trading platforms would be required to provide test environments that simulate the production trading environment. The Commission requests comment on the necessary elements of an effective ATS testing regime and the challenges or benefits provided by standardized development, change management and testing procedures for exchange systems.

b. Monitoring, Supervision, and Training

The Commission also discusses monitoring, supervision and testing procedures related to ATSS. For example, the Commission discusses providing real-time monitoring and supervision by trained and qualified staff at all times when the ATS is engaged in trading. Specifically, the Commission is interested in better understanding whether regulatory measures or new training standards would promote more effective monitoring and supervision of ATSS.

c. Crisis Management

The Concept Release highlights the need for well-designed crisis management procedures. Specifically, the Commission asks whether crisis management procedures should be standardized across market participants, and whether there are core requirements that should be included in such procedures.

3. Self-Certifications and Notifications

a. Self-Certification and Clearing Firm Certification

The Commission also asks about the possibility of requiring periodic self-certifications from all market participants operating ATSS and clearing firms providing services to those market participants. A certification program might require market participants operating ATSS to attest, on an annual basis, to the extent of implementation of the applicable risk controls. Additionally, clearing firms might be required to institute reasonable measures to validate that their clients employ the required risk controls. The Commission questions whether a market participant's chief executive officer, chief compliance officer, or other similarly ranked representative should be required to provide the attestation and by whom the certifications should be audited—DCMs, SEFs or clearing firms.¹⁷

b. Risk Event Notification

The Commission discusses whether market participants operating ATSS and trading platforms should be required to inform other entities, including the Commission, of certain risk events. Reportable risk events

¹⁷ Securities Exchange Act of 1934 Rule 15c3-5 requires the chief executive officer of a broker-dealer providing market access to annually certify that the risk management controls and supervisory procedures comply with Rule 15c3-5, and that a regular review of the procedures has been conducted.

might include the operation of an ATS in violation of design parameters and any risk control process or technology malfunction.¹⁸

Proposed Regulation SCI would require “SCI entities” to provide notice to the SEC with regard to “SCI events,” take corrective action regarding such events, and disseminate information related to the event to members or participants. The proposal defines an “SCI event” as “an event at an SCI entity that constitutes: (1) a systems disruption; (2) a systems compliance issue; or (3) a systems intrusion.”

4. ATS or Algorithm Identification

The Concept Release also discusses and seeks comment on measures to identify, in ATS generated messages, the originating ATS or underlying algorithms in order to more quickly identify malfunctioning systems that could disrupt markets. For example, all orders submitted by an ATS algorithm could be tagged with a unique identifier.

5. Data Reasonability Checks

Citing the recent adverse market impact of “false information through the unauthorized use of a social media outlet used by the Associated Press,”¹⁹ the Commission expresses interest in the potential for data reasonability checks on incoming data, including, without limitation, market data. The Commission specifically asks whether there are potentially market-moving non-governmental economic reports for which early disclosure should not be permitted.²⁰

D. Other Potential Protections

In addition to the aforementioned controls, reports, and system safeguards, the Commission highlighted and solicited comment on the registration of firms operating ATSS, provision of market quality data, provision of market quality incentives, establishment of policies and procedures to identify “related contracts,” and standardization and simplification of order types.

1. Registration of Firms Operating ATSS

The Commission seeks comment on whether firms using ATSS in CFTC-regulated markets that are not otherwise registered with the CFTC should be required to register as “floor traders” under CEA section 1a(23). The Commission also solicits comment on whether software firms providing algorithms should be required to register and the potential authority for such a requirement.

2. Market Quality Data

The Commission discusses requiring each trading platform to provide daily market quality indicators for each product traded on its platform in order to enable market participants to better understand market stability and efficiency, liquidity, and order flow. Among other metrics, such indicators might include information with respect to effective spreads, order to fill ratios, execution speeds for different types and sizes of orders, and order rejection ratios. Such information could help market participants to make more informed decisions with respect to their trading strategies and mitigate potential adverse effects of their actions on other market participants.

¹⁸ Proposed Regulation SCI would address risk event notifications with respect to the securities activities of “SCI entities.” An SCI entity would be defined as a securities self-regulatory organization, SCI alternative trading system, plan processor, or exempt clearing agency subject to the SEC’s automated review policy. See Proposed Reg. SCI, *supra* note 12 at 18,092.

¹⁹ Concept Release, *supra* note 1 at 56,560.

²⁰ See Concept Release, *supra* note 1 at 56,560 (“While government reports are released pursuant to a lock-up process that is intended to ensure that no entity receives them ahead of others, it has been reported that early access to some non-government economic reports is available for a fee. For example, according to recent reports, the University of Michigan’s consumer report was available to certain investors two seconds ahead of the rest of the market.”).

3. Market Quality Incentives

The Commission also expresses interest in ways to incentivize enhanced market quality and price discovery. For example, such measures might include rewarding market makers for leaving resting orders in the order book for a longer period of time, and ensuring that automated traders place orders based on their knowledge of the economic value of the asset being traded, rather than their knowledge of order book dynamic or other market participants' trading patterns. The Commission also asked whether there should be a minimum time period for orders to remain on a limit order book.

4. Policies and Procedures to Identify “Related Contracts”

To protect against market disruptions on one platform causing market disruptions on other platforms, the Commission discussed the obligation of DCMs to identify “related” contracts under CFTC Regulation 38.255 (trading risk controls). Specifically, Appendix B of Regulation 38.255 provides guidance requiring all DCMs to coordinate their risk controls with respect to “related” contracts. The Commission requests DCMs to describe whether they have fully implemented this guidance, and seeks comment on whether it would be beneficial for each exchange to review the contracts traded on other exchanges to identify linked or substitute contracts.

5. Standardize and Simplify Order Types

The Commission discusses the possibility of reviewing current and proposed order types to consolidate, standardize, and simplify order types that have complex logic embedded within them. The Commission asks whether the standardization of order types across platforms would simplify system testing and thereby reduce the potential for instability due to the unanticipated interaction of multiple ATSS utilizing various means of execution within an order book.

IV. CONCLUSION

The Concept Release discusses a wide range of issues associated with the use, control, and potential further regulation of automated trading systems. Considering the Commission's expressed interest in alleviating the risk and frequency of market disruptions that undermine the efficiency of the markets, future regulatory action in this arena is likely. It is in the interests of market participants to provide the Commission with responses to the most relevant questions throughout the Release to assist in guiding any potential regulatory action. In addition, with the CFTC and SEC each having responsibility for the oversight of two separate, but interrelated markets, it seems particularly important that market participants identify those areas in which the regulators should closely consider the practical effects of proposed regulatory action in one market on the other.

FOR MORE INFORMATION ON THIS OR OTHER CFTC ATS CONCEPT RELEASE MATTERS, CONTACT:

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