FIA Special Report: CFTC Issues Concept Release on Automated Trading
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The Commodity Futures Trading Commission today issued a concept release on “risk controls and system safeguards for automated trading” in the U.S. derivatives markets. The CFTC said the concept release, which covers more than 100 pages, will serve as a “platform” for cataloguing existing industry practices, determining their efficiency and implementation to date, and evaluating the need for additional measures. Comments are due 90 days from publication in the *Federal Register.*

“We have witnessed a fundamental shift in markets from human-based trading to highly automated electronic trading,” CFTC Chairman Gary Gensler said in a statement. “This concept release is intended to stir public discussion and debate on how best to protect the functioning of markets…particularly in light of the reality that the majority of the market is using automated trading systems.”

A major focus of the concept release is the prevention of market disruptions such as the Flash Crash in April 2010 that were linked to the malfunction of an automated trading system or a trading platform. The release discusses several types of risk controls that could limit the extent of such disruptions, such as a “kill switch” that could be used to immediately cancel all working orders generated by an automated trading system and prevent further order entry. “Such a kill switch could be operated by the market participant generating orders, the clearing firm guaranteeing its trades, or the trading platform on which its orders would be executed,” the release notes.

Regarding high-frequency trading, the concept release describes HFT as a form of automated trading and asks for comment on a definition of HFT developed by a working group of industry experts sponsored by the CFTC’s Technology Advisory Committee. The release asks whether HFT should receive “different regulatory attention” than automated trading in general, including whether a different set of risk controls is needed for systems and firms that engage in HFT.

The concept release adds that many of the risk control measures under consideration are consistent with recommendations made by industry groups such as the Futures Industry Association and the FIA Principal Traders Group. For example, the release says that its descriptions of system safeguards pertaining to the cancellation of orders or disconnecting a market participant in emergency situations are similar to an FIA PTG proposal.

The concept release is organized into two parts: a description of the operational characteristics of automated trading environments, including potential risks and preventative measures, and an extensive description of a wide range of risk controls, system safeguards and other protections.

The release reviews existing risk management practices at exchanges, clearing firms, and trading firms and asks for comment on whether these existing practices would benefit from "additional granularity or regulatory standardization."

The release also poses specific questions on seven types of pre-trade risk controls, two types of post-trade controls, five types of system safeguards, and five "other protections" such as a registration requirement for firms that use automated trading systems, simplification of order types and the creation of market quality incentives.

The topics covered by these specific questions include the following:

- The use of credit risk limits for limiting the activity of malfunctioning automated trading systems, including whether the "hub" model proposed for swaps could be applied to futures markets and whether these hubs should have "kill switches" to cancel all working orders from an individual trading or clearing firm.
- The use of "drop copy" reports provided by exchanges as a risk management took, including whether these reports should be standardized and whether an additional fee should be charged for this service.
- The use of exchange-provided functionality to block wash trades and other forms of "self-matching" trades, including whether the functionality should cancel the resting orders or the taking orders, and whether the functionality should be mandatory for some or all participants.
- The effectiveness of message throttling and whether the throttling should be controlled by the exchange, the clearing firm or the trading firm.
- Whether the CFTC should establish additional standards for the supervision, maintenance, testing and monitoring of automated trading systems, including whether the CFTC should develop an "algorithm identification system" to help identify malfunctions more quickly and improve market oversight.
- Whether certain types of trading behavior should be discouraged through the use of "market quality incentives" such as minimum resting periods for orders, batched order processing, and limits on the amount of order book data available in real-time.

CFTC Commissioners Bart Chilton and Scott O'Malia issued concurring statements that expressed their concerns with particular aspects of the release.

Chilton complained that it took too long for the CFTC to draft the release and called on the CFTC to take action quickly to address technology glitches, wash trades and market manipulation. He also called on Congress to increase the size of the fines that the CFTC can impose for violations of its rules.

O'Malia asked for feedback on whether regulatory action is needed to "federalize" current industry practices. He also asked for feedback on the HFT definition proposed by the Technology Advisory Committee, which he chairs, and on the idea put forward in the release that firms operating automated trading systems should be required to register with the CFTC.

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