March 22, 2016

Mr. Christopher Kirkpatrick
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Regulation Automated Trading

Dear Mr. Kirkpatrick,

Better Markets Inc.[1] appreciates the opportunity to file this amended comment on the above-captioned proposed Regulation Automated Trading ("Proposal", "Proposed Rule"), issued by the Commodity Futures Trading Commission ("CFTC," "Commission").[2]

INTRODUCTION

The shift to a world of primarily electronic trading is causing major changes in the way markets operate. The many resulting benefits of this shift, in speed of execution and streamlining of market operations, are tempered by the significantly increased risk of major market disruptions and potential for systematic exploitation of retail and other investors. As they become able to facilitate greater volumes of trades faster than ever before, exchanges and Designated Contract Markets ("DCMs") and their most powerful customers may find their interests aligned against those of the rest of the market, and short-term profit may be prioritized over the long-term stability and fairness of the financial markets.

The Commission's decision to release this proposal is an important step towards modernizing regulation to account for these developments. While the proposed rule does not seek to 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 will be needed in the future.

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability in the financial markets.

2 This letter is the same as the one filed on March 16, 2016 other than a correction to the text and citation on page 6 regarding Citadel's swap market activities.

The requirement for registration of Automated Trading firms is common sense and straightforward, and furthermore we are pleased to see the focus on several important safeguards that we have advocated in the past, such as the message throttles and Commission access to algorithm source code. Similarly, the focus on plain language descriptions and narratives regarding the behavior and activity of algorithms is an important element for comprehensive oversight. Furthermore, we are supportive of the special measures for Direct Electronic Access contemplated in the rule, as well as robust oversight and regulation of rebate and incentive programs.

DISCUSSION

The Pre-Trade Risk Controls are Appropriate Minimum Standards

While the enumerated Pre-Trade Risk Controls are simply a codification of the most broadly-used current industry practices, they represent a strong foundation for ensuring the most obvious safeguards are in place to protect markets from the risks of automated execution. Stronger defenses, such as minimum resting periods or de-minimis transaction fees, may ultimately be required to ensure stability in these markets – but the framework provided by the Proposed Rule serves as an important first step towards bringing overdue regulatory oversight to electronic markets.

It is important to note, however, that the Proposed Rule generally only specifies that firms develop and employ the enumerated controls, and does not dictate the specifics of such controls, such as the levels at which certain limits should be set. This may be appropriate as a starting point, but such self-regulatory regimes require diligent oversight by the Commission to constantly oversee and ensure that these limits or practices are effective, both on an individual firm level and the collective effect of those individual levels on the market as a whole.

Perhaps the most important and effective provision in the proposed rule is the requirement that firms maintain their source code, and make it available to the CFTC upon request. As is clear from the Proposed Rule, the outcry over claimed potential risks to intellectual property are unfounded and alarmist because no firm is required to make any part of their code public or submit it for unsolicited examination or approval. Importantly, hysterical and baseless claims aside, the clear and many benefits arising from the Commission's ability to perform post-mortems after disruptive market events far outweigh any legitimate concerns, which haven't been proffered. One must only consider the multiple years it took market regulators to assess the causes of the Flash Crash – largely unsuccessfully – by piecing together market data post hoc.

There are also regulatory benefits to source code access beyond crash or crisis scenarios. Many types of predatory or manipulative behavior may be simply unidentifiable using most conventional reported market data. Bids, offers, and – crucially – order cancellations can all be required in concert to reconstruct the manipulative

behavior such as the type of front-running conducted by predatory HFT firms.[3] Such behavior cannot be easily monitored and likely would not be found unless the regulator knew what to look for. Hence, it is crucial that regulators have access to HFT algorithm source code, rather than facing the impossible task of reconstructing manipulative algorithms from market data alone. This is likely the real reason why some industry participants are making baseless objections to the Commission's need for this very limited and wholly justified access to source codes.

The ability to access a firm's source code exponentially improves the CFTC's ability to effectively and efficiently oversee their markets. It is a common sense requirement that is essential to any automated trading regime and must be maintained.

Special Provisions for DEA

Strategies that access the markets directly, bypassing many of the initial safeguards generally provided by DCMs and other intermediaries, require special consideration due to the increased risks they can pose to stability. Indeed, key to the registration requirements of this proposed rule are the definitions of direct electronic access (DEA) and algorithmic trading. The Commission's proposed definition of direct electronic access (DEA) does encompass all types of access commonly understood in Commission-regulated markets as "direct market access."[4] The Securities and Exchange Commission's (SEC) uses a definition generally broader than the Commission's definition of DEA, but the proposed definition benefits from the consistency with the definition peppered throughout a number of CFTC regulations.[5] Accordingly, the Commission need not define sub-categories like the Securities and Exchange Commission (SEC).

Additionally, while other regulators use the term "direct market access" (DMA) rather than "DEA", the Commission must use DEA to provide regulatory consistency and to prevent regulatory compliance confusion in Commission-regulated markets. However, the content in footnote 202 of the Proposal must be included in the "DEA" definition. As such, the definition of DEA should read as follows:

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3 See Better Markets "Comment letter on concept release on risk controls and system safeguards for automated trading environments," available at https://www.bettermarkets.com/sites/default/files/documents/CFTC-%20CL-%20ATS-%2012-11-13.pdf.

4 See 17 CFR 38.607 "A designated contract market that permits direct electronic access by customers (i.e., allowing customers of futures commission merchants to enter orders directly into a designated contract market's trade matching system for execution) must have in place effective systems and controls reasonably designed to facilitate the FCM's management of financial risk, such as automated pre-trade controls that enable member futures commission merchants to implement appropriate financial risk limits. A designated contract market must implement and enforce rules requiring the member futures commission merchants to use the provided systems and controls." And 17 CFR 48.2(c) " Direct access means an explicit grant of authority by a foreign board of trade to an identified member or other participant located in the United States to enter trades directly into the trade matching system of the foreign board of trade."

5 *Id.*

"An arrangement where a person electronically transmits an order to a DCM, without the order first being routed through a separate person who is a member of a DCO to which the DCM submits transactions for clearing.

The analysis hinges on the following factors, with the first factor being controlling and the remaining factors not determinative alone to satisfy the definition:

a. submission of an order to a DCM without the order first being routed through a separate person who is a member of a DCO to which the DCM submits transactions for clearing;

b. Co-location; or

c. Use of FCM-provided software"

Moreover, the Commission should explicitly define the term "routed" included in the "DEA" definition to provide regulatory certainty for market participants and prevent regulatory arbitrage when the rule is finalized. The concept of routing is so fundamental to the precise meaning of DEA that it is incumbent on the Commission to the define the term.

Furthermore, we agree with the Commission that the proposed 1.3(yyy) DEA definition is more technical than § 38.607 and § 48.2(c). As such, all existing definitions should be harmonized with the proposed definition.

Control of Incentives/Rebate Structure

We commend the Commission for its efforts in seeking to improve DCM market maker and other incentive programs. While these programs may encourage liquidity provisioning and order flow to their electronic trading platforms, these programs could have the potential to lead market participants in unnecessary and harmful trading strategies solely designed to capture liquidity rebates. Such strategies push up transaction costs for investors in the process and make no contribution to liquidity or price discovery. Moreover, these strategies can lead to conduct that are clearly illegal, regardless of the fact that they are done by computers and not human beings.

For example, once a market participant has discovered an institutional order placed in slices via an algorithm, it can insert itself between slices, offering "liquidity" at a price attractive to one side of the market (taking a small loss that is offset by the liquidity rebate), before immediately turning around and offering "liquidity" to the returning algorithm (again, capturing a rebate), all in the space of milliseconds. When successful, strategies of this sort will cause worse prices for the institutional investor, even though they may appear to reduce observed spreads.

Therefore, we are pleased to see that the Commission has proposed to promulgate rules, that we have previously advocated for, that require DCM's to provide additional public information regarding their market maker and trading incentive programs, place

restrictions on the types of payments by DCM's in connection with such programs, and that require DCM's perform surveillance of such programs to prevent abusive practices.

Threshold Test Required as Part of § 40.25(a)

While we agree with and support the information proposed in § 40.25 that the Commission will collect when DCMs request approval or self-certifying market-maker or trading incentive programs, we do believe there should be an additional requirement for the approval process. As a threshold matter, the Commission should only permit programs where market participants must maintain a two-sided market during distressed periods and must be subject to penalties for abusing their privileges, to receive liquidity provider benefits. If this threshold is satisfied, then the Commission's analysis should continue. On the other hand, if this threshold is not satisfied, then the Commission's analysis must end here, and the Commission should deny the application.

In general, market makers profit by capturing bid-ask spreads, and would risk their own capital to support the market when two-way liquidity waned. In contrast, predatory HFT practices – even those (mis)labeled as so-called beneficial "market making" – make profit beyond spreads, and flee the market during times of major dislocation. This is the precise opposite of conventional market making; rather than providing a service to the market during good times and bad, these modern HFT practices are parasitic upon it during good times and absent or even implicated during bad.

CFTC Must Also Prohibit per Trade Basis Benefits in § 40.27(a)

We agree with the Commission's decision to prohibit DCM's from paying market maker incentive program benefits for trades between accounts under common ownership in § 40.27(a). Indeed, there is no market utility in paying market maker incentive program benefits for trades between accounts under common ownership. Notwithstanding these programs are designed to provide liquidity in markets, as discussed above, markets do not gain increased liquidity by increasing the amounts of trades a trader does with itself. Therefore, the text of proposed § 40.27(a) is a step in the right direction.

However, the Commission should also prohibit per trade basis benefits, to sufficiently identify with particularity the types of trades that are not eligible for payments or benefits pursuant to a DCM market maker or incentive program. Specifically, the Commission should prohibit DCMs from paying these program benefits for trades in which the benefits are, on a per trade basis, greater than the fees charged by the DCM and affiliated derivatives clearing organization. Per trade basis benefits provide nothing more than a subsidy for un-economic trades and thereby potentially risks distorting the overall market.

DCMs Must Post Market Maker and Other Incentive Programs on Their Websites

The most appropriate place or manner for a DCM to disclose the information required by § 40.25(b) is on the website, as proposed, in a clear and conspicuous manner. It should not be buried on the site. For example, it could be one of the introductory tabs on the home page. Additionally, DCMs should be required to post any new programs on the website within

a reasonable time period (one to three months) prior to the launch of the program and should provide notice (electronic or print formats, as necessary) to market participant as well. In that way, DCMs will have placed all market participants on notice of the new programs – not just a select few that the DCM elects to inform or the participants that luckily visit the site at the time. Such transparency of the programs would facilitate impartial access to all market participants by inviting all market participants to partake in the programs, as opposed to just a select few. Additionally, transferring this program from darkness to the light will eliminate anti-competitive effects as peer DCMs can see the programs that other DCM's are implementing. Among other things, this will foster healthy competition in the market place.

DCMs should be required to maintain on their public websites the information required by proposed § 40.25 for an additional six-month period after the end of the market maker or trading incentive program for increased transparency. Indeed, this information is vital for open, fair and impartial access to DCM's and market integrity. Therefore, this information should not be labeled as confidential.

Exclusion of Trades Conducted on Swap Execution Facilities

We are concerned at the exclusion of trades executed on Swap Execution Facilities ("SEFs") from the provisions of the Proposed Rule. While swaps markets are indeed insufficiently automated to raise significant concerns in their current state, the risks posed by algorithmic trading in these markets is enormous and must be taken very seriously.[6] For instance, Citadel

> "has emerged as a top dealer in U.S. interest-rate swaps, becoming one of the first nonbank firms to step into a breach created by postcrisis rules overhauling trading in those derivatives. ... Citadel Securities' emergence as a big market maker in interest-rate swaps may draw other nonbank firms into what is seen as a potentially lucrative but technically challenging business, traders said."[7]

Therefore, we urge the Commission to commit to a schedule for revisiting this exclusion periodically to reassess its appropriateness as the swaps markets evolve.

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6 Commissioner Christopher Giancarlo echoed these concerns in his Swap Execution Facility white paper, stating, "It would be a regulatory failure to restrict human discretion in the $600 trillion swaps market, and herd trading onto automated electronic platforms, where software failures and other technical glitches could someday cause a 'flash crash' unlike anything yet seen in global markets." P.61 Cite Giancarlo's white paper.

7 See Katy Burne, "Citadel makes inroads into swaps arena," Wall Street Journal (June 22, 2015), available at http://www.wsj.com/articles/citadel-makes-inroads-into-swaps-arena-1434997210?cb=logged0.5250350800342858.

CONCLUSION

We hope these comments are helpful.

Sincerely,

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