# ISDA

Safe,
Efficient
Markets

**March 16, 2016**

Mr. Christopher Kirkpatrick,
Secretary of the Commission,
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St, N.W.
Washington, DC 20581

**Re: Regulation Automated Trading; Proposed Rule: 17 CFR Parts 1, 38, 40 et al.**

Dear Mr. Kirkpatrick:

The International Swaps and Derivatives Association, Inc. ("ISDA")[1] appreciates the opportunity to submit these comments on the Commodity Futures Trading Commission's (the "Commission") Proposed Rule, Regulation Automated Trading ("Proposed Rule").

ISDA fully supports the goal of reducing risk in the financial markets, ensuring reliable and orderly price discovery and preventing market abuses. To that end, we believe that proper risk controls and monitoring requirements are important mechanisms for furthering that goal. Our members have invested substantial human and technological resources to enhance the reliability of financial markets. We support the Commission's efforts to ensure continued implementation of the necessary risk controls to minimize the risk of market disruption. With that in mind, ISDA members believe that the Commission should strike the necessary balance between the regulatory goal of

---

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 67 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.

**ISDA.**

preventing market disruptions and adopting flexible approaches that account for new and evolving technologies.

As we discuss in more detail below, it is important that the Commission requires implementation of risk controls that are appropriately tailored to the role of the market participant and/or the manner in which such participant operates in the market. We caution the Commission against imposing impractical and prescriptive requirements that could deter market participants from improving their risk control systems for fear of being in violation of an ambiguous or unworkable rule.

To avoid unnecessary complexity or duplication, the Commission should consider its existing regulatory authority, including the authority over disruptive trading practices and prohibition against price manipulation and the use of manipulative and deceptive devices.[2] The Commission should also conduct a thorough cost-benefit analysis, taking into account the full impact of the Proposed Rule in conjunction with other regulations, including the upcoming rules that will be phased in over time through 2019. Any new requirements, specifically those relating to new software system development and reporting will incur significant implementation and compliance costs for many market participants, but would be especially burdensome for smaller entities, putting them at a competitive disadvantage.

Lastly, the implementation of the Dodd-Frank Act in the U.S. and MiFID II/MiFIR in Europe has highlighted the importance of consistent regulatory approaches to issues arising from different jurisdictions. Adopting regulations in isolation poses the risk of creating regulatory arbitrage and duplicative compliance obligations. We urge the Commission to consider aligning the overarching concepts inherent in MiFID II when finalizing the Proposed Rule to ensure proper oversight and a more level playing field between the U.S. and EU.

We would like to emphasize the following themes in our letter.

**Definition of Algorithmic Trading**

As currently drafted, the proposed definition applies indistinguishably to "black box trading" (a proprietary trading system that utilizes pre-programmed logic to both generate and route orders to the Designated Contract Market ("DCM") without any human interaction) and to standardized execution algorithms where the order is

---

[2] Antidisruptive Practices Authority, 78 Fed. Reg. 31890 (May 28, 2013); Prohibition against Manipulation, 17 C.F.R. Part 180 (2015).

2

**ISDA.**

initiated by a natural person and the algorithm is utilized to route the order to the DCM. These two models do not pose the same level of risk. The proposed definition only exempts orders whose "every parameter or attribute is manually entered into a front-end system by a natural person" prior to its electronic submission for processing to a DCM. We believe that the definition should be more nuanced and reflect the level of human judgment that is involved in trade execution.

The Commission should make a clear distinction between order routing 'automation' (an electronic system where users set certain parameters, provide manual instruction, and direct the system to execute a trade) and 'algorithmic' trading (a trading system programmed to follow a defined set of instructions to both generate and route orders).[3] This would allow the Commission to establish more effective supervision and risk management standards over the type of trading activity that the proposal is intended to cover.

In response to the Commission's question regarding potentially expanding the proposed definition of Algorithmic Trading to include orders that are generated using algorithmic methods but are then manually entered into a front-end system, ISDA does not believe that such activity should be included within the definition of Algorithmic Trading. As described above, the Commission should make clear that its definition of Algorithmic Trading is intended to cover only those algorithms that both automatically initiate, modify or cancel orders and subsequently route such orders to the DCM for execution without any element of human intervention. This definition would be consistent with ESMA's approach, as well as the approaches of the CME and ICE.

Finally, consistent with the requirements in MiFID II,[4] we recommend that the Commission exclude order routing and/or order processing algorithms from the proposed definition of Algorithmic Trading. Errors in these forms of automation do not put the trading entity at risk of insolvency or otherwise create a material market impact because the initial order has been inputted by a natural person.

**Application of the Proposed Rule to AT Persons**

The Proposed Rule applies to all AT Persons that are either registered or required to be registered with the Commission regardless of whether such Persons use direct or indirect access, whereas Floor Traders with indirect access fall outside the scope of the

---

[3] See e.g., CME's definition of Automated Trading Systems, Operator Identification for Automated Trading Systems, available at https://www.cmegroup.com/rulebook/files/CME_Group_RA0908-5.pdf.
[4] European Commission, "Updated rules for markets in financial instruments: MiFID 2" (June 12, 2014), available at http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm.

**ISDA.**

Proposed Rule. We note that indirect electronic access provides an effective safeguard against market failures arising from a fully automated trade. Futures Commission Merchants ("FCMs") pre-trade limit checks prevent DCM trades from being executed once the applicable limit is reached.

ISDA members firmly believe that the application of this proposal is too broad in terms of persons to which it would apply. There is no regulatory benefit from requiring AT Persons with indirect access to comply with most aspects of the Proposed Rule, especially when it does not apply to Floor Traders with indirect access. For example, certain AT Persons with indirect access exclusively utilize standardized algorithms that are developed and maintained by independent third-party algorithm providers. AT Persons do not have access to the source code for standardized third-party algorithms, which resides on the algorithm providers' servers, and therefore, do not have the ability to modify, control or access the algorithm's programmed risk controls, such as maximum order message frequency.

**Definition of Algorithmic Trading Compliance Issue**

We believe that the broad reach of the proposed definition of Algorithmic Trading Compliance Issue ("ATCI") extends far beyond the intended regulatory objectives and overall public policy goals of the Proposed Rule. It encompasses any violation of the Commodity Exchange Act or the Commission's rules. We recommend that the Commission revise the definition to limit its application to non-compliance with the Proposed Rule and DCM or FCM rules specific to Algorithmic Trading.

In addition, the proposed definition of ATCI covers violations of AT Persons' own internal policies. The goal of internal control and reporting policies should be to identify compliance risks and potential problems and respond by investigating and resolving these problems. However, it is our view that making non-compliance with internal policies a regulatory violation may create a disincentive for firms to detect violations and evaluate possible internal corrective actions for fear of the Commission's enforcement actions, thus creating a less effective system of internal compliance policies.

**Policies and Procedures for the Development and Testing of Automated Trading Systems**

It is important that the Commission maintains a principles-based approach to oversight and testing of Automated Trading Systems and allows market participants to determine and allocate responsibility for, among other things, conducting testing of their trading algorithms.

4

**ISDA**

While we support the implementation of additional safeguards for those participants that develop algorithmic trading strategies, we caution the Commission against adopting duplicative and overly prescriptive rules that would place certain participants in the position of having to comply with a requirement that is not within their direct control.

To that end, the Commission should distinguish between firms that develop (and potentially use) algorithms and entities that license algorithms from third-party algorithm providers. Specifically, the Commission should consider exempting from certain requirements of the Proposed Rule participants that only utilize algorithms that are developed by third-party algorithm providers, especially where such algorithm providers are also registered with the Commission (i.e., FCMs, Introducing Brokers, Floor Traders, Swap Dealers, etc.). The application of certain of the proposed requirements, including testing of algorithms and source code retention, to both the algorithm providers (who create the algorithms) and the market participants who license the same algorithms from the algorithm providers (i.e., Commodity Trading Advisors or Commodity Pool Operators) is duplicative, impractical, and would result in additional costs to market participants without commensurate regulatory benefits.

AT Persons that do not develop Automated Trading Systems but simply access algorithms of third-party providers do not have access to the proprietary source code, and therefore, rely on the algorithm providers that develop their algorithms to test the algorithms, meet the audit requirements, make the code available to regulators, and facilitate compliance with certain pre-trade risk controls. Third-party providers that develop their own automated trading tools should have the responsibility for testing their systems against DCM trading systems. For operating models and trading software to stand up to scrutiny from market participants and regulators, these systems should be tested and supervised by persons who design these systems.

Thus, the Commission should allow a participant that is in the best position to perform the necessary testing to fulfill this requirement on behalf of the other participant. As discussed further below, market participants that develop their own algorithms have significant interest in protecting their valuable intellectual property and typically do not make the source code available to third-party users. The Proposed Rule would put such third-party users in the untenable position of having to maintain audit records and make available source code that they do not possess or have any right to access. If the Commission determines to use the current proposed definition, which would require third-party users to comply with the same requirements as those entities that develop algorithms, we urge the Commission to create an exception that would allow third-party

users who do not have direct electronic access to rely on the algorithm developer, to the extent such developer is also an FCM, to satisfy the testing and source code requirements under the rule.

We note that the Commission has previously allowed for one party to perform specific regulatory requirements where the performance of such obligations by another party would be duplicative or impractical.[5] We recommend that the Commission allow this practice for testing of licensed algorithms as well.

**Source Code Audit Trail and Inspection**

The requirement to maintain a source code repository in accordance with the Commission's recordkeeping requirements raises a number of serious concerns surrounding protections of intellectual property and privacy. AT Persons invest significant resources into developing the software and maintaining its confidentiality; it is the firm's lifeblood and the most important intellectual property. It is completely different from traditional "books and records."

We share the concern that the proposed requirement to retain a source code repository and make it available for inspection by the Commission or the Justice Department without a subpoena would allow the government unprecedented access to a future business strategy of a commercial enterprise.[6]

In addition, as we discussed above, market participants who license algorithms from third-party algorithm providers do not have access to the source code. These entities should not be required to obtain such source code as it would require such entities to maintain third-party proprietary information, which imposes significant liability and risk and makes this software more vulnerable to the risk of inadvertent disclosure or hacking.[7]

Thus, we recommend firms safeguard source code information according to their internal standards and produce it to the government upon the issuance of a subpoena.

---

[5] *See e.g.*, 17 C.F.R. § 45.8 (Swap Data Recordkeeping and Reporting Requirements, Determination of which counterparty must report).
[6] Statement of Commissioner J. Christopher Giancarlo Regarding Notice of Proposed Rulemaking on Regulation Automated Trading, November 24, 2015 ("Commissioner Giancarlo Statement"), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement112415.
[7] *Id.*

**ISDA**

**Compliance Reports**

We believe the requirement that each registrant provide annual compliance reports to each DCM is overly burdensome and costly both for registrants and DCMs that will be responsible for maintaining these records. This requirement should be treated like any other rule with respect to compliance and auditing, where registrants keep their own records and produce them in response to exams and audits.[8] A more effective way of verifying compliance with the proposed regulation is to require certification of compliance signed by senior management and making such certification available for inspection by DCMs or the Commission upon request.

**NFA's New Responsibilities**

We are concerned that the Proposed Rule requires NFA to create an additional layer of the regulatory compliance regime, without identifying any policy or regulatory benefit. We especially question the benefit of NFA's involvement given DCMs' leading role in monitoring algorithmic trading.

DCMs have long been leaders in the innovation, design, and implementation of various risk management functionalities. They employ significant human and technological resources to ensure resiliency of trading systems and adherence by their members to the established and well tested risk management standards.[9]

Any new measures should add regulatory value and not duplicate, and certainly not conflict with what has been successfully adopted by DCMs. Where standards already exist, any additional layer can cause confusion, unnecessary complexity and costs. If a regulatory gap is identified, regulation can establish guidance as to best practices. In our view, the Commission has not identified such a regulatory gap.

In any event, if NFA is required to impose additional regulatory obligations, it is important that the Commission provide all market participants with adequate time to put any new systems and standards in place. If market participants are not given sufficient time to develop and implement new compliance programs and system

---

[8] *See e.g.*, 17 C.F.R. § 38.254, Availability to Obtain Information (each DCM "must have rules that require traders . . . to keep records of their trading . . . and make such records available, upon request," to the DCM).
[9] Commissioner Giancarlo Statement, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement112415.

**ISDA.**

functionality, the Commission will increase the very risks of system failures the Proposed Rule is intended to prevent.

∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎∎

We appreciate the opportunity to comment on the Proposed Rule. Please contact me at 202-756-1972 or via email at brozenberg@isda.org with any questions the Commission might have with respect to the comments contained in this letter.

Sincerely,

*Bella Rozenberg*

Bella Rozenberg
*Senior Counsel*
*Head of Regulatory and Legal Practice Group*