Via Electronic Filing

May 1, 2017

Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

> **Re:** **Regulation Automated Trading: Supplemental Notice of Proposed Rulemaking - CFTC RIN 3038-AD52**

Dear Mr. Kirkpatrick:

The Investment Adviser Association ("**IAA**")[1] appreciates the opportunity to comment on the CFTC's supplemental proposal to further amend proposed Regulation Automated Trading ("**Reg AT**").[2] If adopted, Reg AT would require a series of risk controls and other measures to govern the regulatory regime for automated trading and algorithmic trading on U.S. designated contract markets ("**DCMs**").

As buy-side participants, IAA members trade on DCMs on behalf of clients and have a strong interest in markets that are fair and orderly for all participants. We support the CFTC's goals of ensuring the safety and integrity of U.S. markets—in particular, DCM and market participants' trading systems—as they experience continued rapid technological changes. As described more fully below, however, we recommend changes to several aspects of the Supplemental Proposal, including the proposed requirements placed on AT Persons with respect to the use of third-party algorithmic trading systems. We are also concerned that the CFTC chose not to amend the proposed definitions of AT Person and Algorithmic Trading in the Supplemental Proposal as we recommended, and we reiterate our comments on the original proposal.

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[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms that are registered with the U.S. Securities and Exchange Commission ("**SEC**"). The IAA's membership consists of more than 600 firms that collectively manage approximately $20 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. Many IAA members are also registered as commodity pool operators ("**CPOs**") or commodity trading advisors ("**CTAs**"). In that capacity, they manage assets for their clients as fiduciaries under the Investment Advisers Act of 1940 (the "**Advisers Act**"). The terms "investment adviser" and "adviser" throughout our comments refer to SEC-registered investment advisers that are also registered under the Commodity Exchange Act ("**CEA**"). For more information about the IAA, visit www.investmentadviser.org.

[2] Regulation Automated Trading, Supplemental Notice of Proposed Rulemaking, 81 Fed. Reg. 227 (Nov. 25, 2016) ("**Supplemental Proposal**"), available at http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-27250c.pdf.

Background

Reg AT was originally proposed in December 2015.[3] The IAA submitted a comment letter expressing our belief that the scope of the proposal was too broad in that it would apply to all market participants, irrespective of the different ways in which they access DCMs and the differing levels of risk that their trading activity may pose. We offered a number of specific ways to amend the proposal to accomplish the CFTC's goals through other, more targeted approaches.[4]

After sponsoring a public roundtable in June 2016 and considering comments on proposed Reg AT, the CFTC proposed additional amendments in the Supplemental Proposal that would, among other things: broaden the pre-trade risk controls for AT Persons to apply to all "electronic trading"[5] in proposed Regulation 1.80(g), in addition to algorithmic trading; add a volume threshold test to the definition of "AT Person"; add requirements for recordkeeping and production of source code to the CFTC under new proposed Regulation 1.84; and add new certification, due diligence and recordkeeping obligations in new proposed Regulation 1.85 for AT Persons that use third-party algorithmic trading systems or components.

Summary of Comments

The Supplemental Proposal raises an important and significant new concern with regard to an AT Person's use of third-party algorithmic trading systems or components ("**ATSs**"). In particular, Proposed Regulation 1.85 would require an AT Person to obtain certifications from third parties, conduct due diligence, remain responsible for compliance with source code recordkeeping obligations under new Regulation 1.84, cause third parties to maintain source code records, and cause third-party source code records to be produced. We recognize that the CFTC eliminated the requirement that AT Persons using third-party systems be required to comply with the development, monitoring, and testing requirements in proposed Regulation 1.81.[6] However, we have serious concerns that compliance with the

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[3] Regulation Automated Trading, 80 Fed. Reg. 78823 (Dec. 17, 2015) ("**Original Proposal**"), available at http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-30533a.pdf.

[4] *See* Letter from Robert Grohowski, General Counsel, IAA to CFTC, re: Regulation Automated Trading – CFTC RIN 3038-AD52 (Mar. 16, 2016) ("**Original Letter**"), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/160316cmnt.pdf.

[5] *See* proposed Regulation 1.3(dddd) (defined as, "trading in any commodity interest . . . on an electronic trading facility as such term is defined by section 1a(16) of the Act, where the order, order modification or order cancellation is electronically submitted for processing on or subject to the rules of a designated contract market.")

[6] Proposed Regulation 1.81(a)(1)(vi). Under the Original Proposal, which has not been amended in the Supplemental Proposal, each AT Person would be required to implement written policies and procedures that would include, among other things maintaining a source code repository to manage source code access,

recordkeeping obligations in newly proposed Regulation 1.85 is not feasible or necessary for CPOs and CTAs that may be AT Persons using third-party algorithms in their discretionary management of their client's portfolios. Therefore, we urge the CFTC to reconsider this provision.[7]

In addition, the Supplemental Proposal did not change the elements of Reg AT that initially concerned us. Our core concern remains that the scope of the proposal continues to be too broad. We continue to recommend that the CFTC: (a) amend the definition of "AT Person" to exclude entities without direct electronic access ("**DEA**"); (b) amend the definition of "algorithmic trading" to focus on algorithms that both generate and place an order with a DCM (i.e., exclude investment algorithms used by buy-side investment advisory firms), and to exclude order routing or execution systems from the definition; and (c) eliminate duplicative requirements for pre-trade risk controls where the AT Person is relying on an FCM's pre-trade risk controls. We discuss our recommendations below.

I. The CFTC Should Reconsider Proposed Regulation 1.85 for the Use of Third-Party Algorithmic Trading Systems

The IAA and many other commenters expressed significant concerns regarding the original recordkeeping requirements pertaining to source code proposed in Reg AT.[8] In response, the CFTC proposed new recordkeeping rule 1.84 to provide that the CFTC would have access to Algorithmic Trading Source Code[9] and related records only via a subpoena or a special call approved by the CFTC itself, not by staff, and that any such access would be subject to policies and procedures to protect confidentiality.[10] In connection with new 1.84,

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persistence, copies of all code used in the production environment, and changes to such code. Such source code repository must include an audit trail of material changes to source code that would allow the AT Person to determine, for each such material change: who made it; when they made it; and the coding purpose of the change.

[7] Indeed, we agree with Acting Chairman J. Christopher Giancarlo's statement that the proposal "provides an unworkable compliance process for AT Persons that use software from third-party providers." *See Statement of Dissent by Commissioner J. Christopher Giancarlo Regarding Supplemental Notice of Proposed Rulemaking on Regulation Automated Trading* (Nov. 4, 2016), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/giancarlostatement110416.

[8] *See* Supplemental Proposal at 85337.

[9] Newly defined term "Algorithmic Trading Source Code" would mean "computer commands written in computer programming language that is readable by natural persons. For purposes of Sections 1.81 and 1.84, Algorithmic Trading Source Code shall include at minimum computer code, logic embedded in electronic circuits, scripts, parameters input into an Algorithmic Trading system, formulas, and configuration files." *See* Proposed Regulation 1.3(ccccc). The CFTC recently proposed amendments to Regulation 1.31.

[10] Proposed Regulation 1.84, instead of Regulation 1.31, would require AT Persons to maintain three categories of records in their native format for five years: (1) Algorithmic Trading Source Code; (2) records that track

the CFTC proposed in new Regulation 1.85 to require that an AT Person that uses third-party algorithmic trading systems to: (i) obtain a certification from the third party that the relevant system or component meets the applicable legal requirements under Reg AT; (ii) obtain a new certification from the third party each time there is a "material change" to the system or components; (iii) conduct due diligence to reasonably determine the accuracy and sufficiency of a certification provided by a third party; and (iv) remain responsible for compliance with 1.84, retain records in compliance with 1.84 or cause the third-party service provider's records to be maintained under 1.84, as well as produced upon the CFTC's special call or subpoena.

While we appreciate the goals of proposed Regulation 1.85, we request that the CFTC reconsider the requirement that AT Persons using third-party algorithmic trading systems or components (such as an independent software vendor or "**ISV**") "remain responsible" for compliance under new proposed Regulation 1.84, "retain records" or "cause such records to be maintained" under 1.84, and "produce records" or "cause such records to be produced" when requested by the CFTC."[11] This approach is not workable because AT Persons do not have access and cannot control access to records and source code owned by the third-party ATS provider. We remain concerned that the Supplemental Proposal subjects AT Persons that license third-party software to implement investment strategies to the recordkeeping obligations under proposed Regulation 1.84, despite *not* being in possession of the required records or having legal access to the required records owned by third-party software providers.[12] While an adviser may select the use of a third-party algorithm for a given order, an adviser that does not own or have access to the third-party algorithm's source code is unable to cause a third party to maintain certain records or cause a third party to make these records available.[13]

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changes to the Algorithmic Trading Source Code; and (3) log files that record activity of the AT Person's ATS. These records would need to be kept in a form and manner that ensures the authenticity and reliability of the information contained in the records. *See* Supplemental Proposal at 85382.

[11] Supplemental Proposal, Proposed Regulation 1.85(d).

[12] The CFTC expects that, in order to use third-party software, an AT Person will "re-write its contracts with third parties, so that the AT Person can comply with the recordkeeping and production provisions of Supplemental proposed 1.84." Supplemental Proposal at 85284. This language highlights the limits of proposed 1.85 – in fact, an AT Person still must comply with all aspects of 1.84 recordkeeping and production, even if the AT Person has no access or authority to access the third party's source code.

[13] Investment advisers that are also registered CPOs or CTAs make use of various sub-advisers, consultants, or other third parties in developing trading strategies on behalf of clients, and therefore it will often be the case that an adviser does not itself develop and own source code for any particular algorithm. For example, such an adviser would generally access a DCM through a third-party trading system as a result of licensing that system from an ISV whose services, for example, are listed through a DCM's website. The source code is extremely valuable intellectual property that is carefully protected by the developers and owners for commercial and security reasons. Given the limited benefit to the CFTC of routine access to source code, the IAA continues to oppose the source code repository concept in general as overly prescriptive and urges the CFTC to eliminate this aspect of the regulation in any final rule on algorithmic trading.

We also believe these provisions are unnecessary because the CFTC has access to AT Persons' records in the ordinary course. That is, CPOs and CTAs that are AT Persons are already subject to recordkeeping requirements under CFTC Regulations 4.23 and 4.33, respectively. Under these rules, CPOs must maintain, for example, itemized daily records of each commodity interest transaction of the pool, copies of confirmations or acknowledgements of a commodity interest transaction of the pool, and all other records, data and memoranda prepared or received in connection with the operation of the pool.[14] Additionally, CTAs must maintain, for example, specific records such as confirmations of commodity interest transactions and records of all transactions in all business dealings in which the CTA engages.[15] These records are required to be maintained and produced to the CFTC irrespective of whether the trades and positions are put in place as a result of an investment strategy using a third-party software provider.

Accordingly, the IAA urges the CFTC to recognize that obligations under Regulation 1.85(d) for recordkeeping production for source code should **not** apply to any firm that does not own or have unrestricted access to the source code of the third-party algorithmic trading system being used. In reality, such a requirement would force an adviser to forego the use of algorithms that it may deem useful to its clients, thus disadvantaging the adviser's clients without providing any benefit to the CFTC, because the adviser will be unable to "remain responsible for compliance with the obligations" with the new proposed Regulation 1.85.

If the CFTC disagrees and nevertheless proceeds with these unworkable provisions, we believe any certification requirement under proposed Regulation 1.85(b) should not apply to a third-party software provider that is registered with the CFTC because the CFTC has jurisdiction over such parties. If, however, certifications are to be required from such providers, we do not believe that an AT Person should be required to obtain a separate certification *each time* there has been a material change to third-party provided systems or components.[16] Instead, we suggest that such certifications could attest to an *ongoing obligation* to comply in the event of potential material changes to the system or components. A separate certification upon every material change serves no meaningful regulatory purpose and would only result in a more burdensome and costly regulation. We also do not believe the CFTC should *mandate* the specific elements of appropriate "due diligence" when a certification is obtained nor should it require that the due diligence be required to specifically include review of technical design information, testing protocols and test results, documented

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[14] *See* CFTC Regulation 4.23.

[15] *See* CFTC Regulation 4.33. Further, a CPO or CTA AT Person that is acting in a discretionary capacity for its clients, as an SEC-registered investment adviser, would also have recordkeeping obligations under the Advisers Act to maintain records of trading activity on behalf of clients.

[16] Supplemental Proposal at 85352.

dialogue between staff of the AT Person and the third party, or other measures.[17] AT Persons do not have access to highly confidential and proprietary aspects of the third-party's software, nor would a third-party software provider be willing to provide such information.

II.   The CFTC Should Reconsider the Proposed Definitions of AT Person and Algorithmic Trading and the Scope of the Proposal

We remain concerned with proposed definitions in the Original Proposal that were not addressed in the Supplemental Proposal. As we explained in our Original Letter, we recommend that the CFTC amend the definitions of "AT Person" and "Algorithmic Trading" to appropriately target the regulation. We also recommend that the CFTC *not* broadened the scope of the regulation by including "electronic trading" in proposed Regulation 1.80(g). Finally, the CFTC should permit AT Persons to rely on FCMs' pre-trade risk controls, as FCMs would be already required to comply with these provisions. We discuss our comments below.

a.   *The CFTC Should Amend the Definition of AT Person*

The CFTC did not amend the definition of "AT Person" in the Supplemental Proposal so that it would include only persons using DEA, as the IAA requested. Instead, the CFTC determined that "the volume-based approach proposed . . . is a better option as it is based on verifiable and easily observed data regarding the trading volumes of all market participants on DCMs."[18]

We submit that a volume-based threshold will not serve as a meaningful test for an AT Person. As noted in our Original Letter, we continue to believe that AT Person should be limited to persons using DEA, and that the CFTC should focus on how entities access the market where those persons' algorithmic trading activities represent increased risk. We believe the scope of the Proposal should be based on the nature of the market participant's algorithmic trading and the risks posed thereby, which are significantly different for DEA market participants as compared to non-DEA market participants. Most investment advisers who are also registered as CPOs and CTAs do not have DEA, but rather access DCMs through their clearing member FCMs, and all of their algorithmic trading orders flow through the risk parameters established and monitored by the FCMs. Such advisers do not have the ability to directly place a trade on a DCM. We continue to believe that limiting the definition of "AT Person" to persons with DEA would help focus regulatory resources on the most important locations for risk controls—at the point of entry to a DCM. Excluding CPOs and CTAs that do not access the markets through DEA from the definition of AT Person also would be consistent with the Commission's stated goal of achieving a two-level risk control regime because such controls already would be required of clearing member FCMs and the

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[17] See the CFTC's request for comment, Supplemental Proposal at 85352.

[18] Supplemental Proposal at 85340, n. 24.

DCM. Accordingly, we recommend excluding from the definition of "AT Person" entities such as registered CPOs and CTAs that do not have DEA.[19]

We also recommend again that the CFTC specifically exempt from the definition of "AT Person" registered CTAs that have hired other advisers to manage a client's assets (*i.e.,* contractually delegated the responsibility to manage the underlying portfolio in a managers of managers arrangement). Only the firm that actually executes the orders and the trading function, not those that delegate the trading function out under an investment management agreement, should be subject to any rules under the proposal.

> b.   *The CFTC Should Amend the Definition of "Algorithmic Trading"*

In our Original Letter, we urged the CFTC–if it determined not to exclude entities that do not have DEA from the scope of the Proposal–to amend and clarify the overly broad definition of "algorithmic trading" in proposed Regulation 1.3(zzzz). Unfortunately, the CFTC chose not do so in the Supplemental Proposal. We continue to urge the CFTC to reconsider its approach and to recognize that "algorithmic trading" should exclude investment algorithms used by buy-side investment advisory firms.

> i.   *Focus on Algorithms that Both Generate and Place an Order with a DCM*

While the algorithmic trading definition attempts to exclude trading that is manually executed, we believe it would inadvertently capture trading by many market participants, including those that use manual processes to determine their investment or hedging strategies.[20] Investment decision-making algorithms that simply process market and other data to recommend trade ideas for an adviser to submit simply do not pose risks to the orderly functioning of DCMs.

In fact, these trading recommendations do not affect the market until a trade is *actually* placed on a DCM. In situations where orders are manually entered, a trader

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[19] In any event, registered CPOs and CTAs should be excluded from the definition of "AT Person" because they are already subject to registration and comprehensive regulation by the CFTC and the National Futures Association ("**NFA**"), including through quarterly systemic risk reporting on Forms CTA-PR and CPO-PQR, and periodic NFA reporting and examinations.

[20] We reiterate our recommendation to amend the second prong of the definition to read as follows: (2) Such order, modification or order cancellation is electronically submitted for processing on or subject to the rules of a designated contract market; provided, however, that Algorithmic Trading does not include an order, modification, or order cancellation whose every parameter or attribute is manually entered into a front-end system by a natural person, with no further review, interaction or discretion by any imposed by a natural person or another computer system or algorithm or system prior to its electronic submission for processing on or subject delivery to the rules of a designated contract market.

exercises his or her investment discretion to initiate the trade. In these instances, the natural person trader may determine to revise or change the trade recommendation, including the order's key parameters (*e.g.*, contract, exchange, direction, maximum size, and limit price), further distancing the nexus between the investment algorithm that generated the recommendation and the market. These investment algorithms themselves do not submit trades and, therefore, do not result in trading activity unless the algorithm were to both generate orders <u>and</u> transmit such orders directly to the DCM. Accordingly, the more appropriate focus of the definition should be on algorithms that both generate <u>and</u> place an order with a DCM, such as "black box trading" algorithms that have broad discretion in both <u>generating</u> orders (including determining key parameters such as contract, exchange, quantity, and limit price) <u>and</u> whether to submit such orders for execution on a DCM.

We also reiterate, as the CFTC has recognized, that the proposed definition of algorithmic trading is at odds with the standards adopted by the European Securities and Markets Authority ("**ESMA**"). Under ESMA rules, definition of algorithmic trading would *not* include orders that are generated using algorithmic methods, even if such orders are manually entered into a front-end system by a natural person, who determines all aspects of the routing of the orders. We believe there is no compelling reason for the CFTC to diverge in its view on the definition of algorithmic trading from other global regulators. Many firms, including IAA members, are either themselves (or as part of a related group of companies) subject to ESMA requirements on algorithmic trading. Such enterprises often attempt, where feasible, to implement compliance policies and procedures on a global basis, so any deviation by the CFTC from what the industry and regulators have heretofore understood to constitute algorithmic trading can only make a difficult regulatory burden even more complicated and costly.

For all of these reasons, we continue to recommend that the CFTC should not expand the definition of algorithmic trading to include orders that are input by a natural person, in whole or in part. Algorithms that do not both generate <u>and</u> place an order directly with a DCM should be excluded from the definition of algorithmic trading.

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ii. *Exclude Order Routing or Execution Systems from the Definition of "Algorithmic Trading"*

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As noted in our Original Letter, we continue to urge the CFTC to exclude order routing systems in the definition of "Algorithmic Trading." Specifically, the IAA recommends that the CFTC *exclude* from the definition of "algorithmic trading" those "systems that only make decisions as to the routing of orders to one or more trading venues."[21] Order routing systems used by asset managers do not take the place of an individual trader making investment decisions, and they do not operate in isolation without an investment decision first made by an asset manager to execute an order as part of an

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[21] Original Proposal at 78840.

investment strategy on behalf of one or more of the manager's clients. Additionally, order routing systems cannot modify any of the key parameters of an order determined by the individual trader exercising the investment decision.

As discussed above, most registered CPOs and CTAs do not create their own proprietary algorithms, but license algorithms from third-party algorithm providers (typically, FCMs). Importantly, these third-party algorithms are "execution" algorithms and do not generate orders or have the ability to change the parameters of orders that are established by the adviser and communicated to the algorithm by the adviser's trader. These key parameters include, for example, the contract, direction, time, limit price threshold, maximum quantity, and aggressiveness. In particular, once the key parameters of the trade are entered into the front-end system, they are messaged to the third-party algorithm provider's server, on which the algorithm resides. The algorithm partitions the order based on the proprietary source code, which is designed and solely controlled by the algorithm provider, and transmits the order to the DCM. Functionally, this transmission is no different than if the trader were to pick up the phone and place the order with the FCM or broker, and request that the order be executed using the same parameters, including the same execution algorithm offered by the FCM.

Further, including order routing systems would present another way in which the CFTC's definition would differ from other regulators. For example, the European CFTC's new Directive on markets in financial instruments ("**MiFID II**"), published on June 12, 2014,[22] does *not* include in its definition of algorithmic trading systems those that only make decisions as to the routing of orders to one or more trading venues.[23] In addition, the definition of "algorithmic trading strategy" adopted by the Financial Industry Regulatory Authority ("**FINRA**") does *not* include such systems either.[24] FINRA's proposal would not capture standard order routers that are not designed to implement a particular strategy.[25] We urge the CFTC to consider these alternative regulatory approaches.

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[22] *See* 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.

[23] Proposed Rulemaking at 78840.

[24] *See* FINRA, Regulation Notice 15–06, "Registration of Associated Persons Who Develop Algorithmic Trading Strategies" (Mar. 2015), available at http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-06.pdf. In the Notice, FINRA defines an "algorithmic trading strategy" as "any program that generates and routes (or sends for routing) orders (and order-related messages, such as cancellations) in securities on an automated basis." *Id*. at 3. FINRA generally considers an "algorithmic trading strategy" to be any program that generates and routes (or sends for routing) orders or order-related messages in securities into the marketplace on an automated basis without material intervention by any person. The FINRA proposal would not capture standard order routers that are not designed to implement a particular strategy. *Id*. at 7.

[25] As we noted in our Original Letter, FINRA determined, even after the Knight Capital and Goldman Sachs cases, to **not** include order routing systems that are not designed to implement a particular strategy within its algorithmic trading definition. The CFTC should take a similar approach.

     c.   *The CFTC Should Narrow the Scope of Proposal Related to Pre-Trade Risk Controls*

The CFTC expanded proposed Reg AT in the Supplemental Proposal by including "electronic trading" within the scope of the required pre-trade risk controls in proposed Regulation 1.80(g). We are concerned that the scope is too broadly focused on covering all "electronic trading" and that the pre-trade risk controls are more appropriate for algorithmic trading, as we define above, and high-frequency trading, particularly because they address "AT Order Messages" and "Algorithmic Trading Events." The CFTC should instead try to identify the risks that proposed Reg AT is trying to address by focusing on DEA access.

The Supplemental Proposal also adds a new option for AT Persons to delegate to FCMs the obligation under proposed Regulation 1.80(a) to implement pre-trade risk controls. While we appreciate the revised approach to implement risk controls at two levels, rather than at three levels, we reiterate out comment in our Original Letter that registered CPO and CTA trades are already subject to FCMs' risk controls. It is unnecessary and inefficient for the CFTC to require multiple levels of market participants to implement identical risk controls on the same third-party algorithm. The market disruption risks that the Commission is concerned about are not present if an AT Person is going through an FCM that itself has pre-trade risk controls. Accordingly, there is no need to impose the pre-trade risk controls on the AT Person where the AT Person is accessing the market through an FCM.

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We appreciate your consideration of our comments on the Supplemental Proposal and would be pleased to discuss our comments with you or provide additional information. Please contact me at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

/s/

Monique S. Botkin
Acting General Counsel

cc: The Honorable J. Christopher Giancarlo, Acting Chairman
       The Honorable Sharon Y. Bowen, Commissioner

       Amir Zaidi, Director, Division of Market Oversight
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