TESTIMONY
OF
ANDREW VRABEL
EXECUTIVE DIRECTOR & GLOBAL HEAD OF INVESTIGATIONS
MARKET REGULATION
CME GROUP INC.
BEFORE THE

House Committee on Agriculture
Hearing Examining CFTC's Proposed Regulation Automated Trading
July 13, 2016

Thank you, Chairman Conaway, Ranking Member Peterson and Members of the Committee.

My name is Andrew Vrabel. I am the Executive Director of Global Investigations at CME Group, which is part of our Market Regulation division. I am pleased to present CME Group's views on the CFTC's proposed rules to enhance regulation of algorithmic trading, known as "Regulation AT."[1]

Algorithmic trading, a type of automated trading, is a source of considerable market liquidity today, facilitating price discovery and efficient risk management. Yet, as with any automated process, there are risks associated with algorithmic trading. To preserve and protect the integrity of our markets from these risks, CME Group has pioneered innovative risk controls and system safeguards, and continually employs substantial human resources and technological capabilities for the development, implementation and enhancement of these controls. In my role, I see first-hand every day the sophisticated tools our exchanges have developed and use to mitigate risks and protect our markets.

Regulation AT aims to mandate additional standards for protections on top of the strong self-regulatory measures that our exchanges already apply. We are concerned that much of Regulation AT's framework is overly broad in scope, unworkable and could be counterproductive. Our comment letters urge the CFTC to re-focus its proposal on the essential area of flexible, not mandated, market risk controls that can be tailored to the different business

[1] *See* Regulation Automated Trading, 80 Fed. Reg. 78824 (December 17, 2015); *see also* Public Staff Roundtable on Elements of Regulation Automated Trading; Reopening of Comment Period, 81 Fed. Reg. 36484 (June 7, 2016).

operations and roles of traders, intermediaries and exchanges to best protect market integrity. [2] Getting Regulation AT right is critically important to all who use our markets.

We identify the following key areas where the proposed rulemaking needs to be substantially refined:

<u>Regulation AT should not require a Designated Contract Market ("DCM" or "Exchange") to prevent Algorithmic Trading Disruptions or Algorithmic Trading Compliance Issues</u>

Our primary concern is that Regulation AT appears to require exchanges to *prevent* Algorithmic Trading Disruptions ("algorithmic trading disruptions").[3] As CFTC Chairman Massad, observed when approving the Proposal, no control—like no rule—can always prevent disruptions and other operational problems that may arise from algorithmic trading.[4] We agree. As a result, we believe the "prevent" standard is unachievable. Instead, we urge the CFTC to adopt a standard that requires exchanges to implement tools to *mitigate* the effects of an algorithmic trading disruption. Any final rule text and accompanying preamble should consistently articulate this achievable objective for exchanges.

Regulation AT also appears to require exchanges to *prevent* Algorithmic Trading Compliance Issues ("algorithmic trading compliance issues").[5] The Proposal would require exchanges to prevent an event that causes a certain trader to operate in a manner that does not comply with the Commodity Exchange Act or its rules and regulations, rules of any exchange to which such algorithmic trader submits orders through algorithmic trading, the National Futures Association rules, the algorithmic traders own internal requirements, or the requirements of the trader's clearing firm. We oppose this requirement for two reasons. First, as discussed below, we believe Regulation AT generally should not attempt to address compliance issues, but should instead focus on deterring algorithmic trading disruptions. Second, imposing this type of universal compliance obligation on DCMs is a major departure from DCMs' traditional self-regulatory role Congress envisioned, as reflected in the Core Principles.[6]

Exchanges have never been asked to guarantee, or provide tools to guarantee, the universal compliance by certain market participants because such a requirement would be unrealistic and unreasonable. People who intend on violating the law, federal regulation, or rule of a self-

---

[2] *See* Letter from CME Group to CFTC re Notice of Proposed Rulemaking on Regulation Automated Trading (RIN 3038-AD52), dated March 16, 2016. *See* Letter from CME to CFTC re Reopening of Comment Period re Regulation Automated Trading (RIN 3038-AD52), dated June 24, 2016.

[3] As used herein, "Algorithmic Trading Disruption" has the meaning contained in the Proposal.

[4] See Chairman Massad's Statement on November 24, 2015 (http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement112415)

[5] As used herein, "Algorithmic Trading Compliance Issues" has the meaning contained in the Proposal.

[6] *See* Section 5(d) of the Commodity Exchange Act

regulatory organization will find a way. Further, requiring an exchange to guarantee compliance and prevent algorithmic trading compliance issues could inadvertently create a safe-harbor in an enforcement action. If a trader or firm subsequently is accused of violating an exchange rule, CFTC regulation, or provision of the Commodity Exchange Act, they could cite to an exchange's prior action (or inaction) in defense of the allegations. This could significantly undermine the effectiveness of an enforcement program and disciplinary action.

What has proven effective is when exchanges operate in the self-regulatory role Congress envisioned, which includes adopting and enforcing rules of conduct related to trading. This serves to not only penalize wrongdoers where warranted but also to deter other would-be violators, whether they deploy algorithmic trading strategies or are manual, point-and-click traders.

<u>Requiring Exchanges to review and evaluate annual compliance reports, policies, and procedures and enforce compliance with Regulation AT is unworkable and beyond the scope of an Exchange's role</u>

CME Group believes the Commission's proposed requirement that certain algorithmic traders prepare and submit extensive annual compliance reports to exchanges creates an unnecessary administrative burden and substantial costs on all parties involved without providing significant benefit to market integrity. There are many reasons that support removing this aspect of the Proposal. First, the information contained in the proposed compliance reports would be stale and not representative of how a firm is currently addressing risks by the time the reviews are submitted to an exchange. This renders the exchange review substantially ineffective at preventing or mitigating a future algorithmic trading event.

Second, exchanges are not practically in a position to assess an algorithmic trader's compliance with Regulation AT or issue remediation instructions. Assessing pre-trade risk controls designed to prevent or even mitigate an algorithmic trading event will be dependent on granular aspects of each algorithmic strategy, including inputs, variables, and calculations that inform the strategy; system architecture; operational infrastructure; and the skills and experience of each trader, programmer, and developer. Not only is this information highly sensitive and proprietary, but assessing these aspects will require highly specialized skills and knowledge possessed only by the traders or firms themselves.

Finally, under the Proposal, a DCM's review of a compliance report and remediation instructions, if any, would seemingly endorse the policies, procedures, and risk control parameters. This imposes significant liability on the exchanges, and again, it potentially creates a safe-harbor if an issue subsequently arises.

As the Commission is well aware, the CME Group exchanges rigorously scrutinize the trading on our markets each day pursuant to our commitment to protecting the integrity of our markets and complying with existing DCM core principle requirements. We routinely monitor the market and conduct exhaustive reviews of market events and other conduct that might be considered disruptive. As a matter of practice, if an algorithm malfunctions and causes a disruption in the market, we conduct an in depth review of the participant's risk controls, development and testing procedures, and compliance policies. We submit that this is the proper role of an exchange and that the Commission should not force exchanges to change these well-functioning mechanisms as a result of Regulation AT.

To the extent verification of an algorithmic trader's compliance is needed, we believe the clearing member that granted the trader access to the exchange would be better positioned to accept a certification of compliance as a condition precedent to granting that trader access to the market.

We believe that a refined focus on the risk of market disruptions, e.g., algorithmic trading disruptions, would enable the Commission to establish a coherent and meaningful framework to address the risks presented by algorithmic trading.

Pre-Trade Market Risk Controls Applied to all Algorithmic Traders

CME Group proposes that two layers of pre-trade risk controls would apply to all algorithmic trading orders. The first layer would be administered by either the algorithmic trader itself or its clearing member that granted access to the exchange. The second layer would be developed and administered by the exchange. Both layers of market risk controls must be reasonably designed to mitigate the effects of algorithmic trading disruptions, and set at a level of granularity appropriately tailored to the underlying nature of the algorithmic trading activity such that the risk mitigation standard is met.

CME Group believes that *all* algorithmic traders should be subject to market risk controls. Proposed Regulation AT leaves a control void for some algorithmic traders by only requiring market risk controls for, the so-called "AT Persons."[7] The reason for this gap is that the CFTC has focused primarily on attempting to capture a set number of new registrants. We believe registration is a secondary concern—the first aim of any rule in this area should be establishing a blanket of market risk controls that applies to all algorithmic trading in a consistent manner.

We also believe the long-term effectiveness of any market risk control framework is dependent upon market participants being afforded flexibility to innovate as trading technology evolves. Accordingly, CME Group's alternative framework would not mandate the use of any specific market risk control measures. Rather, the rules would establish acceptable practices that market participants can follow in order to meet the applicable risk mitigation standard, consistent with

[7] As used herein, the term "AT Person" has the meaning contained in the Proposal.

the Commission’s history of establishing acceptable practices in other areas of DCM core principle compliance.

<u>The Source Code Open Access Requirement raises serious Confidentiality Concerns</u>

Other industry representatives will testify about the source code issue. We agree with those who want to avoid undue, routine disclosure of their intellectual property to government officials. This provision raises serious concerns regarding the confidentiality of proprietary information. Currently, if the Commission has reason to believe that it needs access to a market participant’s source code, it can obtain the code subject to adequate confidentiality protections via the subpoena process. We know of no reason why this approach should not be satisfactory to the CFTC given the sensitivity of the information at issue.

****

CME Group appreciates the opportunity to share our views on this important rule proposal. We remain hopeful that the CFTC will continue to work with all stakeholders to build a stronger and better rule.

I look forward to answering any questions you might have.