MFA Presentation before the
CFTC Technology Advisory Committee
Meeting On
Risk Controls and System Safeguards for
Automated Trading Environments

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Managed Funds Association

- MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices and industry growth for professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Our members serve pensions, university endowments, and other institutions.

- MFA members are active participants in the futures, options and swaps markets; and as fiduciaries to their funds and as investors themselves, MFA members share with the CFTC a strong interest in ensuring that the U.S. regulatory framework for derivatives markets is robust and evolves to serve the needs of our investors.

Introduction

The U.S. derivatives markets, like other industries, have and continue to transition from manual processes to electronic or automated processes.

Technology presents opportunities as well as challenges.

Risk Controls & System Safeguards

ADDRESSING NEW RISKS

- Technology has changed the operational, infrastructure and security risks that market entities and participants face.

- To deter and prevent market disruptions and to protect market participants, it is necessary to address risk controls and system safeguards with respect to **ALL electronic trading**, and *not* just **automated trading or so-called HFT**.

    - For example, SEC staff found from its review of sudden price spikes, or so-called "mini-flash crashes," that these types of events "tend to be triggered by old-fashioned human mistakes." Speech by Gregg E. Berman, Associate Director, SEC, at the SIFMA Tech Conference, June 18, 2013.

Risk Controls & System Safeguards

OVERVIEW

- The CFTC has implemented a robust derivatives market framework that:

  – Requires FCMs, SDs and MSPs that are clearing members to establish risk-based limits based on position size, order size, margin requirements, or similar factors; and requires those entities to use automated means to screen orders for compliance with the risk limits when such orders are subject to automated execution;

  – Requires DCMs to establish and maintain risk control mechanisms to prevent and reduce the potential for price distortions and market disruptions; and

  – Requires SEFs to establish and maintain risk control mechanisms to prevent and reduce the potential for market disruptions.

REGULATORY FRAMEWORK

Recommendation: Address market risks by centralizing risk controls in the following ways:

1) Require that trading platforms have appropriate risk control mechanisms, and policies and procedures to ensure that they operate as intended;

2) Require that clearing firms—effectively, the gateways to the markets—have financial and regulatory controls to reduce the risks associated with market access; and

3) Require that DCOs, trading platforms, and intermediaries provide real-time, post-trade reports that market participants can use to enhance monitoring of all their trading activities.

Marketplace Risks are a shared responsibility. The optimum approach recognizes the different roles of market utilities, intermediaries and market participants/customers.

Pre-Trade Risk Controls

PRE-TRADE RISK CONTROLS

Recommendation: CFTC should require intermediaries and/or trading platforms to implement:

- **Maximum Order Size or "Fat Finger" Limit –** CFTC should require such controls at the intermediary and/or trading platform-level; and apply to all market participants—whether manual traders or those trading through ATSs.

- **Credit Risk Limits –** CFTC should require limits at the intermediary and/or trading platform-level. Such controls would help mitigate a customer ATS software malfunction.

PRICE COLLARS AND TRADING PAUSES

Recommendation: Trading platforms should:

- **Coordinate price collars for linked equity products –** Price collars in the futures markets have been effective in supporting the maintenance of fair and orderly markets. With respect to linked equity products, equity market and derivative market price collars should be coordinated.

- **Adopt trading pauses for derivative products that are related to a security undergoing a trading pause** – After the Flash Crash, the equities markets implemented circuit breakers. When a security is undergoing a trading pause, trading platform rules should address whether a related exchange-traded derivative product should also be paused or halted from trading.

Post-Trade Reports

ORDER REPORTS, TRADE REPORTS, AND POSITION REPORTS

Recommendation: The CFTC should amend and broaden its regulations to require trading platforms, FCMs and/or DCOs to provide real-time Post-Trade Reports to market participants and their clearing firms.

- Trading platforms and/or DCOs should provide, in real-time, post-order receipts or "drop copies," post-trade drop copies, and post-clearing or "position" reports ("Post-Trade Reports") to customers.

- CFTC Rule 1.33, which requires an FCM to provide a customer with a written confirmation of a commodity interest transaction by the next business day is outdated.

  – Even e-commerce customers receive real-time electronic receipts for online purchases. Trading in commodity interests should be no different.

TRADE CANCELLATION AND ADJUSTMENT POLICIES

Recommendation: Trading platforms should adopt clear, objective trade cancellation and adjustment policies that limit administrative discretion and instill accountability; and require that market participants report trade errors as soon as they are identified.

- Trading platforms should have clear, objective trade cancellation and adjustment policies.

  - Clear and objective rules would decrease uncertainty among market participants, especially during times of market distress.

  - Such policies should apply consistently across market participants.

  - In promoting market integrity, policies should instill a reasonable level of accountability on market participants.

- Trading platforms should require market participants to report trade errors as soon as they are identified.

"KILL SWITCH" CAPABILITIES

Recommendation: Market participants operating an ATS and trading platforms should each have the capability to disconnect the ATS from trading platforms in the event a software glitch or other unforeseen reason makes it necessary.

System Safeguards

"KILL SWITCH" CAPABILITIES

- Market participants that operate ATSs should have the capability to disconnect their ATSs from trading platforms in the event a software glitch makes it necessary.
- A trading platform should also have the capability to cancel working orders from an individual market participant or clearing firm in emergency situations and as a last resort.
- While trading platforms should have clear, objective policies and procedures detailing circumstances that warrant use of a kill switch, they should also have some flexibility based upon experience with the trading style or strategies of a market participant; clearing firm; or instruction by the market participant at issue.

DESIGN, TESTING, AND SUPERVISION OF ATSS

Recommendations:

- The industry should engage in more robust and more routine testing of trading software at the trading platform-level.

- In addition to individual testing, trading platforms should offer integrated or holistic testing where a firm's software interacts with others.

- Policies and procedures that may be feasible for market utilities or service providers may not be appropriate or as effective when applied to each customer that has an algorithmic or quantitative component to their trading/investing.

MINIMUM RESTING PERIODS

Recommendation: The CFTC should NOT adopt a minimum resting period or other mechanism to slow down the markets as such mechanisms will likely be more harmful to investors.

- A minimum resting period would allow other market participants to pick off orders on an order book that become stale when the market moves and trade against the relevant positions.

- It would, therefore, reduce market participants' ability to react to changing market conditions and leave them exposed to market movements.

- By creating more risk for market participants to place an order, a minimum resting period would incentivize market participants to place fewer orders and of smaller size which could ultimately lead to a widening of spreads and decreased market liquidity.

HIGH FREQUENCY TRADING

Recommendation: The CFTC should not adopt a definition for HFT, nor should it create such a registration category; instead, it should focus on detecting and prosecuting manipulative or fraudulent market activity.

- Technology is, and has been, a tool for market participants to implement their trading strategies with lower overall transaction costs.

- Technology has ***not*** created a new class of market participants.

- HFT "describes the usage of sophisticated technology that implements traditional trading strategies."*

- As such, Regulators should continue to focus on **market activity** rather than the *means of transaction delivery* or trying to define HFT.

* *See* Peter Gomber et. al., High Frequency Trading, Goethe Universitat, Frankfurt Am Main.

Thank you

- MFA appreciates the opportunity to present its views to the Technology Advisory Committee

- MFA appreciates the assistance of:
    – MFA Trading & Markets Committee
    – Jennifer Han, Associate General Counsel, MFA