UNITED STATES OF AMERICA

COMMODITY FUTURES TRADING COMMISSION

OPEN MEETING OF THE COMMISSION

Washington, D.C.

Tuesday, November 24, 2015

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 5    COMMISSIONER J. CHRISTOPHER GIANCARLO

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1   P R O C E E D I N G S

2   (9:00 a.m.)

3   CHAIRMAN MASSAD: Good morning. The

4   meeting will come to order. This is a public

5   meeting of the Commodity Futures Trading

6   Commission. I'd like to welcome members of the

7   public, market participants, and members of the

8   media, as well as those taking part on the phone

9   or via webcast.

10   Today we are considering a proposal that

11   addresses the increased use of automated trading

12   in our markets. In the futures markets, today

13   almost all trading is electronic in some form.

14   And over the last few years, more than 70 percent

15   of all trading has become automated.

16   Automated trading has brought many

17   benefits to market participants. These include

18   more efficient execution, lower spreads, and

19   greater transparency. But its extensive use also

20   raises important policy and supervisory questions

21   and concerns. The Commission has already taken a

22   number of steps to respond to the development of

1   automated trading in our markets.

2   Following the 2010 flash crash, the CFTC

3   worked with the SEC to establish certain controls

4   to minimize the risk of market disruptions. The

5   Commission has also required clearing members to

6   implement policies and procedures governing the

7   use of automated trading programs. And we've

8   required automatic screening of orders for

9   compliance with risk limits if they are

10   automatically executed. But as markets continue

11   to evolve it is important to continue looking at

12   this issue.

13   And, therefore, in September 2013, the

14   Commission issued a Concept Release that requested

15   public comment on the necessity and operation of a

16   variety of risk controls and measures. The

17   Commission received many written comments and also

18   held a meeting of its Technology Advisory

19   Committee to discuss the issues raised. The

20   Concept Release served as a very useful way to

21   understand existing industry practices and discuss

22   what further actions might make sense.

1   The proposal we are considering today

2   addresses several areas discussed in the Concept

3   Release and incorporates much of the public input.

4   It focuses on minimizing the potential for

5   disruptions and other operational problems that

6   may arise from the automation of order

7   origination, transmission, or execution. This may

8   come about due to malfunctioning algorithms,

9   inadequate testing of algorithms, errors, and

10   similar problems.

11   Now, no set of rules can prevent all

12   such problems, but that doesn't discharge us from

13   our duty to take reasonable measures to minimize

14   these risks. It is our responsibility as

15   regulators to create a framework that promotes the

16   integrity of these markets and I believe the

17   proposal we are considering today helps do just

18   that.

19   In a moment, we will hear presentations

20   from the staff to outline the proposal. And I

21   want to note that this proposal is the product of

22   a lot of hard work by the CFTC staff over a

1   significant period of time. And I want to thank

2   all of them for that effort. The work to draft

3   the Concept Release began in early 2013 and, in

4   particular, I'd like to thank our staff members

5   from the Division of Market Oversight who led this

6   effort; the staff from the Office of the Chief

7   Economist and the Office of the General Counsel,

8   who made major contributions; and staff from other

9   divisions who have helped, as well.

10   With that, I would like to recognize my

11   fellow Commissioners for their opening statements

12   and I will turn first to Commissioner Bowen.

13   COMMISSIONER BOWEN: Thank you. It's a

14   pleasure to be here this morning to vote on the

15   proposed rule on automated trading. I want to

16   thank the Commission staff for the time they

17   devoted on this proposal.

18   As I have previously said, our markets

19   have seen immense technological change in the last

20   15 years. In particular, algorithmic trading has

21   substantially increased. Sadly, we still do not

22   have comprehensive, precise data on the percentage

1   of trades created or entered by algorithms in many

2   of our product classes. Clearly, further research

3   and work remains for all stakeholders, from

4   regulators to industry participants, to academics

5   and advocates of financial reform.

6   Yet I do not believe that this lack of

7   information requires that regulators passively

8   wait for information to emerge. As I said earlier

9   this fall, even though the amount of algorithmic

10   trading and definitions of various terms are not

11   crystal clear, what is clear is that trades

12   involving algorithms make up a substantial portion

13   of our markets and algorithms can and do

14   malfunction at times with negative effects on the

15   markets. As a result, I believe we are obligated

16   to consider if it is prudent to establish some

17   regulations on algorithmic trading in our markets.

18   Today, we begin this process of

19   potentially establishing those regulations. I

20   believe the proposed regulation meets the

21   standards of establishing a reasonable regulation

22   on this technology, and it does so in a way that

1   allows for innovation and continued development of

2   this nascent technology.

3   Having said what I think lies at the

4   core of this regulation, let me also be clear

5   about what this regulation is not. The rule

6   before us today should not substantially change

7   how many firms use algorithms. In effect, this

8   rulemaking largely formalizes and mandates firms

9   involved in algorithmic trading to engage in a

10   variety of practices that they should already be

11   doing for their own protection.

12   I expect that some observers will have

13   issues with this regulation for not doing more to

14   constrain growth and use of algo-trading. And I

15   expect that there will be further debate. I do

16   not regard this regulation as the final word on

17   the regulation of algo-trading. If there is clear

18   evidence that more precise regulations are needed

19   on this technology to protect investors or to ward

20   off systemic risk, I would support further

21   regulatory action. And I'm sure that given the

22   ferocious rate of change of this technology we

1   will need to update this regulation regularly to

2   account for those changes.

3   In many ways this regulation is merely

4   the first step in a process. It's a starter home

5   rather than a two-story. But we have to start

6   somewhere and starting with something that

7   formalizes best practices and increases disclosure

8   is an excellent place to start. I've said

9   numerous times that I support smart regulation,

10 regulation that works.

11   That goal is especially critical when it

12 comes to regulation to such a new, significant,

13 and widespread technology as algo-trading. I,

14 therefore, hope we'll get comments on this

15 proposal from a wide swath of stakeholders, from

16 industry participants to end users being affected

17 by this technology, to even ordinary citizens and

18 investors about the potential effects of

19 algo-trading on commodity prices.

20   I do not expect that everyone will have

21 the same views on the subject. Even though I've

22 only been in Washington about a year and a half,

1   I've experienced enough to know that people have

2   different opinions on high-visibility issues such

3   as this one. However, I do encourage people to

4   comment so that we can get a full and fair read on

5   popular opinion. And if people have concrete

6   evidence that algo-trading is distorting markets

7   and needs to be curtailed, please submit it with

8   your comments.

9   In closing, let me stress again that I

10   want this rule to be both effective and workable.

11   No one benefits from rules that work in the

12   abstract, but are confusing, impossible to

13   implement as written, or are full of gaps that

14   prompt widespread regulatory arbitrage. I believe

15   this proposal is a commonsense effort to

16   establishing reasonable regulation of this

17   automated trading. But if there are flaws with

18   it, if it goes too far or not far enough, I want

19   to know about that now before it is finalized.

20   Thank you and I want to wish you all a

21   safe and happy Thanksgiving holiday.

22   CHAIRMAN MASSAD: Thank you,

1   Commissioner Bowen. Commissioner Giancarlo.

2   COMMISSIONER GIANCARLO: Thank you. The

3   electronification of trading over the past 30 to

4   40 years and the advent of exponential digital

5   technologies have transformed financial

6   businesses, markets and entire economies. In U.S.

7   Futures markets we see this change most presently

8   in the area of automated trading that can lower

9   transaction costs while increasing trader

10   productivity through greater transaction speed,

11   precision and sophistication. For many markets,

12   automated trading brings trading liquidity,

13   broader market access, enhanced transparency and

14   greater competition.

15   At the same time, automated trading

16   presents new challenges. They include increased

17   risk of sudden spikes in market volatility and

18   phantom liquidity arising from the sheer speed of

19   execution. They also include the risk of data

20   misinterpretation by computerized analysis and

21   mathematical models that increasingly replace

22   human thought and deliberation.

1   Legal scholars raise important questions

2   about the viability of traditional regulatory

3   methods and concepts in automated trading markets.

4   How markets and regulators adjust to this change

5   from human to automated trading will be extremely

6   important. It requires delicate balancing. To

7   ensure vibrant, accessible and durable markets, we

8   must embrace effective safeguards without harming

9   innovation and promising market development.

10   In turning to Reg AT, my staff and I

11   brought dozens of issues and concerns to the

12   Division of Market Oversight. While they were

13   responsive to a few topics, many other issues

14   require much further attention and consideration

15   that I have summarized at length in my written

16   statement released this morning.

17   Still, after reading through the almost

18   500 pages of the proposal I'm left with one major

19   question: Does this proposal sufficiently benefit

20   the safety and soundness of America's futures

21   markets to outweigh its additional cost and

22   burdens? I wish the answer was more clear.

1   I have three main concerns with

2   Regulation AT. First, some of the requirements of

3   the rule appear to be window dressing. That is

4   especially the case in its requirement for

5   development and implementation of risk controls

6   and related testing standards that the industry

7   has already widely adopted.

8   Second, I'm concerned about the high

9   cost and burdens of the proposal, especially on

10   smaller market participants. And I'm especially

11   concerned about its requirement that registrants

12   hold their proprietary source code in data

13   repositories available for inspection at any time,

14   for any reason, to any representative of the CFTC

15   or the U.S. Department of Justice.

16   Third, I question the regulatory

17   inconsistencies regarding the market participants

18   who must comply with this rulemaking.

19   A year ago, I set forth six principles

20   that I would follow as I evaluate financial market

21   regulations at the CFTC. Those principles were

22   compiled into a mnemonic that I call SMART REG,

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1   and it stands for: Solve real problems, not

2   anecdotes of bad behavior; measure success through

3   sound cost-benefit analysis; advance innovation

4   and competition through flexible rules; represent

5   the best approach amongst alternatives; take into

6   account evidence, not assumptions; realistically

7   set compliance deadlines; encourage employment of

8   U.S. workers; and be grounded in law. These are

9   the measuring rods that I will apply to Reg AT.

10   I look forward to hearing

11   well-considered views of market participants on

12   whether this proposal passes muster. I will

13   release a longer statement that will be included

14   in the proposal and I encourage the public to

15   weigh in on the numerous questions I pose that

16   should be considered during the comment period.

17   Thank you.

18   CHAIRMAN MASSAD: Thank you. The staff

19   will now make a presentation to the Commission on

20   the proposed rule. After each presentation, the

21   floor will be open for questions and comments from

22   each of the Commissioners. Following the close of

1   discussion, the Commission expects to vote on the

2   staff recommendation as presented. The final vote

3   conducted in this public meeting shall be

4   recorded. The results of a vote approving the

5   issuance of a rulemaking document will be included

6   with that document in the Federal Register.

7   At this point I ask unanimous consent to

8   allow staff to make technical corrections to the

9   document voted on today prior to sending it to the

10   Federal Register.

11   COMMISSIONER GIANCARLO: No objection.

12   CHAIRMAN MASSAD: Without objection, it

13   is so ordered. And at this time, I would like to

14   welcome Vince McGonagle, Sebastian Pujol, Marilee

15   Dahlman, Joseph Otchin, all from the Division of

16   Market Oversight, and John Dunfee, from the Office

17   of General Counsel, for their presentations on the

18   proposal. Thank you.

19   MR. PUJOL: Good morning, Mr. Chairman

20   and Commissioners, and thank you. I'd like to

21   begin today by thanking my fellow team members for

22   their hard work in preparing the proposals that we

1   are about to present. Dedicated staff from across

2   the offices and divisions of the Commission were

3   essential to completing the materials before you

4   this morning.

5   I would particularly like to acknowledge

6   Mike Penick, Richard Haynes, Meghan Tente, Adam

7   Kezsbom, John Dunfee, Andrew Ridenour, Joe Otchin,

8   and especially Marilee Dahlman and Mark Schlegel

9   as members of the rulemaking team.

10   Today, staff is recommending that the

11   Commission approve a Notice of Proposed Rulemaking

12   regarding automated trading on U.S. designated

13   contract markets. The proposed rules, known as

14   "Regulation Automated Trading," or Reg AT, reflect

15   a comprehensive approach to reducing risk and

16   increasing transparency in both algorithmic order

17   origination and electronic trade execution.

18   The proposed rules would enhance the

19   Commission's regulatory regime to keep pace with

20   evolving markets and technologies, and would

21   promote the continued safety and soundness of

22   trading on U.S. derivatives markets. As a

1   threshold matter, Reg AT takes a multilayered

2   approach to pre-trade and other risk controls with

3   key entities in the life of an order each

4   implementing controls that are similar in nature,

5   but calibrated to their individual needs.

6   Relevant entities and risk control

7   layers for purposes of Reg AT include trading

8   firms generating algorithmic orders; clearing

9   FCMs, who are responsible for risk-filtering such

10   orders; and DCMs. In each case, the proposed

11   rules provide for flexibility in the

12   implementation of required risk controls while

13   simultaneously helping to ensure a uniform

14   regulatory baseline for all relevant market

15   participants.

16   The basic structure of Reg AT includes

17   four elements. First, it proposes to require the

18   registration of persons engaged in proprietary

19   algorithmic trading on a DCM via direct electronic

20   access, or DEA. Such persons would be required to

21   register under an amended definition of "floor

22   trader," and would be subject to all relevant

1   requirements of the proposed rules. Through

2   registration, Reg AT would help address a

3   population of entities with a significant impact

4   on Commission-regulated markets, but who are not

5   currently subject to direct oversight by the CFTC.

6   Second, Reg AT proposes to codify "AT

7   Person" as a defined term in the Commission's

8   rules. AT Persons would include the new floor

9   traders described previously, as well as FCMs,

10   floor brokers, swap dealers, major swap

11   participants, commodity pool operators, commodity

12   trading advisors, and introducing brokers engaged

13   in algorithmic trading. In this regard, staff

14   notes that "AT Person" is an important

15   organizational concept in the proposed rules as it

16   identifies those entities that would be subject to

17   key requirements in Reg AT.

18   With respect to AT Persons, the proposed

19   rules include a range of pre-trade risk controls

20   and related measures designed to reduce potential

21   risks in algorithmic trading. Such measures

22   include, for example, controls for maximum order

1   frequency and maximum order size. Other elements

2   of the proposed rules applicable to AT Persons

3   include order cancellation capabilities; standards

4   for the development, testing, and supervision of

5   algorithmic trading systems, or ATSs; and

6   requirements that AT Persons provide DCMs with

7   certain compliance reports regarding their pre-

8   trade risk controls.

9   A third element of Reg AT includes

10   pre-trade risk control requirements for both DCMs

11   and clearing member FCMs with respect to their

12   customers engaged in algorithmic trading. Such

13   pre-trade risk controls would be similar to those

14   required for AT Persons, including, for example,

15   maximum order frequencies and maximum order sizes.

16   Reg AT would also require basic

17   compliance reports from clearing FCMs and would

18   require that DCMs review compliance reports

19   submitted to them.

20   Finally, in addition to pre-trade risk

21   controls, Reg AT is intended to accomplish a

22   number of goals focused more closely on DCMs.

1   These include greater transparency around DCMs'

2   electronic trade matching platforms, promoting the

3   use of self-trade prevention tools, and greater

4   transparency in DCM market maker and trading

5   incentive programs. Each of these provisions will

6   be described in greater detail over the course of

7   this presentation.

8   The proposals in Reg AT build on

9   numerous efforts by entities in recent years to

10   promote best practices and regulatory standards

11   for automated trading, including standards for

12   ATSs and for electronic trade matching. In

13   preparing Reg AT, staff considered comments

14   received in response to the Commission's 2013

15   Concept Release. Staff also evaluated initiatives

16   by fellow regulators, industry participants, and

17   others to develop regulatory standards and best

18   practices. Particularly in the area of pre-trade

19   risk controls, the proposed rules leverage

20   existing industry practices and seek to create an

21   agreed-upon baseline for the mitigation of risks

22   in automated trading.

1   Mr. Chairman and members of the

2   Commission, with that overview in place, I'll turn

3   to my colleague, Marilee Dahlman, for more

4   detailed information on the pre-trade risk

5   controls and related measures applicable to AT

6   Persons, DCMs, and clearing FCMs under the

7   proposed rules.

8   MS. DAHLMAN: A fundamental element of

9   Reg AT is a new Regulation 1.80, which requires

10   that AT Persons implement certain risk controls.

11   Regulation 1.80 would require AT Persons to

12   implement pre-trade risk controls, order

13   cancellation systems, and other measures

14   reasonably designed to prevent a market disruption

15   caused by an algorithmic trading malfunction.

16   The required pre-trade risk controls

17   are: Maximum order message frequency and maximum

18   execution frequency per unit time, order price

19   parameters, and maximum order size limits. The

20   regulation would also require order cancellation

21   systems with an ability to immediately disengage

22   algorithmic trading and prevent the submission of

1   new orders.

2   Consistent with comments received in

3   response to the Concept Release, proposed 1.80

4   provides market participants latitude in the

5   design of required controls and, in fact, requires

6   only a small number of specific controls that the

7   Commission understands are already widely

8   implemented by likely AT Persons. The proposed

9   regulation does not mandate specific limits,

10   calibrations, or even vendor technologies that AT

11   Persons must use in implementing the required

12   controls.

13   With respect to clearing member FCMs,

14   Reg AT proposes a new Regulation 1.82 to require

15   clearing FCMs to implement pre-trade risk and

16   other controls with respect to their AT Person

17   customers. Proposed 1.82 requires that clearing

18   FCMs implement the same types of pre-trade and

19   other risk controls described above with respect

20   to AT Persons.

21   The location of the pre-trade and other

22   risk controls that would be required of clearing

1   FCMs varies according to whether orders from an AT

2   Person customer are placed through DEA or

3   intermediated by the clearing FCM. In the case of

4   algorithmic trading orders submitted through DEA,

5   the pre-trade and other risk controls would be

6   established by and located at the DCM, but be

7   controlled or calibrated by the clearing FCM. For

8   non-DEA algorithmic trading orders, the controls

9   would not reside at the DCM. Instead, the

10   clearing FCM itself would establish the pre-trade

11   risk and other controls with respect to such

12   orders.

13   Finally, as to risk control requirements

14   on DCMs, Reg AT includes a new Regulation 40.20

15   that would require DCMs to establish pre-trade and

16   other risk controls designed to address the risks

17   that may arise from algorithmic trading on the

18   DCM. The controls required of DCMs in Regulation

19   40.20 are similar to those required of AT Persons

20   in proposed 1.80 and of clearing member FCMs in

21   1.82. Regulation 40.20 also would require

22   pre-trade risk controls and order cancellation

1   capabilities for orders that do not originate from

2   algorithmic trading.

3   Reg AT would also address the

4   development, monitoring, and compliance of ATSs.

5   Proposed Regulation 1.81 requires AT Persons to

6   adopt written policies for developing, testing,

7   and monitoring their ATSs. Taken together, the

8   goal of these requirements is to standardize a set

9   of principles in order to reduce the operational

10   risk of ATSs.

11   To provide two examples of these

12   procedures, Regulation 1.81 would require AT

13   Persons to implement written policies and

14   procedures for the development and testing of

15   ATSs, so as to better identify coding errors and

16   other problems that could arise in live trading.

17   Regulation 1.81 would also require each AT Person

18   to implement written policies and procedures to

19   designate and train its staff responsible for

20   algorithmic trading.

21   MR. PUJOL: In addition to the

22   provisions described by Marilee regarding

1   pre-trade and other risk controls, Reg AT also

2   includes several important initiatives addressing

3   transparency, market maker and trading incentive

4   programs, and self-trading on DCMs. Each of these

5   has come into greater focus through the increased

6   automation of markets and market participants.

7   With respect to transparency, Reg AT

8   would codify two important requirements. First,

9   the proposed rules would amend existing Commission

10   regulations to enhance transparency around the

11   design and operation of DCMs' electronic matching

12   platforms. Existing Commission Regulation 38.401

13   requires DCMs to disclose to both the Commission

14   and the public information regarding the rules and

15   specifications of their electronic matching

16   platforms. The proposed amendments to 38.401

17   would clarify that a DCM's obligations include

18   disclosure of any known attributes of a platform

19   that materially impact market participant orders.

20   This could include, for example, attributes that

21   impact the time or the priority of an order or

22   attributes that impact the dissemination of market

1   data or confirmations to market participants.

2   Second, Reg AT would require DCMs to

3   provide the Commission and the public with

4   additional information regarding their market

5   maker and trading incentive programs. Again,

6   building on existing Commission requirements,

7   proposed Regulation 40.25 would require DCMs to

8   provide information regarding eligibility

9   criteria, program payments or benefits, and market

10   participants' obligations pursuant to a market

11   maker or trading incentive program. The proposed

12   rules would also require DCMs to implement

13   policies and procedures reasonably designed to

14   prevent the payment of program benefits for trades

15   between accounts that are known to the DCM as

16   being under common ownership.

17   With respect to self-trading, Reg AT

18   focuses on both transparency and prevention. The

19   proposed rules would require a new Regulation

20   40.23 that DCMs provide or apply tools reasonably

21   designed to prevent self-trading. The proposed

22   rules define self-trading as the matching of

1   orders for accounts that have common beneficial

2   ownership or are under common control as known by

3   the DCM or identified to it by market

4   participants.

5   In response to public comments on the

6   Concept Release, the proposed rules would allow

7   DCMs to exercise discretion in the design and

8   implementation of their self-trade prevention

9   tools. For example, DCMs would have latitude to

10   permit self-trades between accounts under common

11   ownership if such trades were originated by

12   independent decision makers. While allowing for

13   such permitted self-trades, the rules would

14   require DCMs to publish quarterly statistics

15   regarding the amount of permitted self-trading

16   occurring on their markets.

17   Finally, to help ensure that Reg AT

18   remains current as markets and trading

19   technologies evolve, the proposed rules would

20   leverage the role of registered futures

21   associations, such as the NFA, in the Commission's

22   oversight regime. Reg AT would require a new

1   Regulation 170.18 that all AT Persons become

2   members of an RFA. The proposed rules would

3   further require RFAs to consider membership rules

4   addressing algorithmic trading for each category

5   of member in the RFA. Taken together, these

6   provisions would allow RFAs to supplement elements

7   of Reg AT in the future in response to industry

8   developments.

9   Mr. Chairman and members of the

10   Commission, this concludes staff's presentation of

11   Regulation Automated Trading. We note that the

12   Notice of Proposed Rulemaking includes over 160

13   questions on almost every aspect of the proposal.

14   Reg AT would be open for a 90-day comment period,

15   and all comments and responses are highly welcome.

16   Thank you very much for your time and

17   for your attention. And we would be happy to

18   answer any questions that you may have for us.

19   CHAIRMAN MASSAD: Thank you, Sebastian,

20   Marilee, and everyone on the team for those very

21   informative presentations.

22   To begin the Commission's discussion and

1   consideration of this rulemaking I will now

2   entertain a motion to adopt the proposed rule as

3   presented by the staff.

4   COMMISSIONER BOWEN: So moved.

5   CHAIRMAN MASSAD: Is there a second?

6   COMMISSIONER GIANCARLO: Second.

7   CHAIRMAN MASSAD: Let me begin then.

8   We'll each have time for questions or further

9   statements. I don't have any questions. I will

10   make a few comments. I will be issuing a written

11   statement in support of the rule -- or the

12   proposal.

13   Let me just say I strongly support the

14   proposal. I think it contains a number of

15   commonsense risk controls that I believe recognize

16   the benefits that automated trading has brought to

17   our markets while also seeking to protect against

18   the possibility of breakdowns and disruptions that

19   can come with it.

20   I think the multilevel approach, of

21   having controls at the exchange, the clearing

22   member, and the trading firm level is the right

1   one.

2   And I also believe the proposal does a

3   good job of reflecting industry-based best

4   practices and devising standards that are

5   principles-based and not overly prescriptive. And

6   in this regard, I will just note the release we

7   are issuing today is close to 500 pages. The rule

8   itself is 19 pages.

9   The 465 pages, of course, include the

10   preamble, 150 questions which I think appear

11   twice, the cost-benefit considerations, the

12   Paperwork Reduction Act analysis, the Regulatory

13   Flexibility analysis -- all very important

14   elements. The rule itself is 19 pages.

15   I commend the staff for their hard work

16   and diligence, particularly in incorporating

17   feedback from market participants on the Concept

18   Release. The proposal will be subject to public

19   comment for 90 days and I look forward to hearing

20   from market participants and members of the

21   public.

22   I want to just highlight a couple of

1   features of the rule. The first, of course, is

2   the registration requirement for proprietary

3   traders who access the market directly and who

4   engage in algorithmic trading on regulated

5   exchanges. This would ensure that all those with

6   direct electronic access to our markets are

7   complying with pre-trade risk controls, testing,

8   and other requirements. And it would enhance the

9   Commission's ability to carry out its oversight

10   responsibilities.

11   I look forward to public comment on this

12   requirement. Among the questions we have asked

13   are whether there are additional characteristics

14   of algorithmic trading firms that should be taken

15   into consideration for registration purposes. And

16   alternatively, should all firms trading through

17   direct electronic access be required to register,

18   even if they are not using algorithmic trading?

19   Many of the requirements we are

20   proposing, as the staff noted, for trading firms

21   represent the best practices already followed by

22   many firms, including larger firms. We know,

     1   however, that a faulty algorithm at a single firm,

     2   regardless of size, can potentially cause a

     3   significant problem. And as a result, we have

     4   proposed standards that are applicable regardless

     5   of size or similar attributes of a trading firm.

     6   We are cognizant of the importance of

     7   establishing effective standards without creating

     8   barriers to entry for small firms. And,

     9   therefore, I look forward to public comment on

    10   whether the requirements we are proposing for

    11   trading firms should vary in any way, depending on

    12   size or activity level.

    13   We've also proposed certain risk

    14   controls at the clearing member Futures Commission

    15   Merchant level with respect to their customers

    16   engaged in algorithmic trading. FCMs play a

    17   critical role in overall risk management, and I

    18   support the requirements we are proposing today to

    19   help achieve an effective multilayered approach.

    20   But I look forward to public comment on whether

    21   there are any aspects of those required controls

    22   that may pose an undue burden on clearing member

1   FCMs or that are unnecessary for reducing the

2   risks associated with algorithmic trading. We've

3   also asked about what technological development

4   would be required by clearing members to comply

5   with some requirements of this proposal.

6   I've said often that it's very important

7   that we have a robust clearing member industry and

8   that all customers, particularly smaller ones, are

9   able to access the markets effectively and

10   efficiently. And so we want to make sure this

11   proposal is consistent with achieving that

12   objective. It's important that we achieve a

13   proper balance between controls and measures at

14   the exchange, clearing member, and trading firm

15   level. And so we will seek efficiency and avoid

16   conflicting or unnecessary requirements among

17   those controls. On this and many other issues,

18   public comment will be very helpful.

19   So let me just conclude by saying that I

20   support the proposal as an important step to

21   ensure that we are meeting our responsibility to

22   put forth commonsense regulation that will

1 minimize the potential for problems that may arise

2 from automated trading. And I again wish to thank

3 the staff for their excellent work.

4 I would now like to open the floor to

5 allow the Commissioners to ask any questions or

6 make any further statements that they have. And I

7 will turn first to Commissioner Bowen.

8 COMMISSIONER BOWEN: Yes, thank you. I,

9 too, have submitted a statement for your review,

10 but I want to highlight a concern that I have that

11 we may not be asking enough of our registrants,

12 particularly for them to submit information in

13 their annual reports pursuant to Section 1.83(a).

14 We've all read accounts about firms

15 going to Silicon Valley and colleges to recruit

16 quants. So I think it would be helpful for us to

17 ask a little bit more about the adequacy of the

18 training of these employees. And so I would hope

19 that with the final regulation that we would

20 expand the scope of some of the questions that we

21 would be asking these firms to certify on an

22 annual basis.

         1   CHAIRMAN MASSAD: Commissioner

         2   Giancarlo.

         3   COMMISSIONER GIANCARLO: Thank you,

         4   Chairman. I'd like to ask a few questions

         5   perhaps, Sebastian, of you, if I may.

         6   My understanding is that currently the

         7   Commission or the Justice Department may only

         8   obtain source code from a market participant

         9   pursuant to a subpoena or consent of that party.

        10   Is that correct?

        11   MR. McGONAGLE: Yes. Good morning,

        12   Commissioner. So to the extent that the records

        13   are maintained by the certain category of

        14   registrants under 1.31, the Commission has

        15   authorization potentially under the Commodity

        16   Exchange Act Section 4g, as well as under

        17   Regulation 1.31 for inspection of records. There

        18   is a difference between CFTC's staff investigative

        19   rights and ability to obtain copies of

        20   information, if necessary. And, of course, that's

        21   going to be in furtherance of staff's

        22   responsibilities to evaluate compliance with the

1   Commodity Exchange Act and the regulations.

2   Separately, the Department of Justice,

3   to the extent that records are available for

4   inspection, under 1.31 the Department of Justice

5   can otherwise inspect certain records as set forth

6   in the regulations. And then --

7   COMMISSIONER GIANCARLO: Vince. Excuse

8   me.

9   MR. McGONAGLE: Yes.

10   COMMISSIONER GIANCARLO: Records I

11   understand. Records are records of past

12   activities. But source code, intellectual

13   property of market participants, would that

14   require a subpoena or can that be obtained

15   similarly in the way you're describing?

16   MR. McGONAGLE: So I think during the

17   course of the comment period there will be some

18   articulation and questions, comments raised about

19   the nature and scope of 1.31 and how far into

20   transactions or records you would be otherwise

21   entitled to reach as part of a regular inspection

22   authority. Certainly, if there is a subpoena

1   that's involved, then that would be pursuant to

2   whatever authorization issues in connection with

3   the subpoena.

4   COMMISSIONER GIANCARLO: Sure, but, you

5   know, neither of us are technologists, but I think

6   basic technology would say that a software

7   algorithm is different than a record. One is an

8   operating system, a protocol, another one is a

9   record of historic or current events. I think

10   there's a distinction when you're asking for

11   information that concerns positions of a market

12   participant, but then that's different than an

13   algorithm that would show in the event of certain

14   future events what that market participant would

15   do, what positions they would take in the event of

16   certain events in the future.

17   Are you saying that's subject to

18   interpretation, however?

19   MR. McGONAGLE: So I certainly

20   appreciate the comment and the question about what

21   is the scope of the recordkeeping responsibility

22   and whether a record is actually an electronic

1   file. And then if so, does that reach to the

2   source code?

3   And so I think that further analysis

4   under 1.31 would tease out the applicability of

5   the books and records requirements. There is a

6   provision in connection with Reg AT that would

7   treat the source code as a books-and-record

8   pursuant to 1.31. So I do think that that

9   potentially calls in the right to inspection.

10   COMMISSIONER GIANCARLO: Do you know

11   whether the SEC has the right to obtain source

12   code or algorithms from their registrants?

13   MR. PUJOL: We have looked at some of

14   the measures that the SEC has done that are in

15   parallel to Reg AT. I'm not aware of measures

16   within that particular sort of channel, but I

17   don't know whether SEC authorities more broadly

18   would allow them to treat this as a book and

19   record.

20   COMMISSIONER GIANCARLO: Certainly the

21   law of either intellectual property or accountancy

22   would treat algorithm software as intellectual

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 1    property and not as books and records.  Do you

 2    know of any other federal agency that has the

 3    right to obtain intellectual property of

 4    registrants without a subpoena?  Does the Food and

 5    Drug Administration, for example, have the right

 6    to obtain, say, Coca-Cola's special formula

 7    without a subpoena?

 8             MR. McGONAGLE:  So I appreciate that

 9    question and I would say that I'm not an expert in

10    that area of the law, so I'm not able to address

11    that.  But for systems safeguards, for example, an

12    expectation is that the Commission oversight

13    responsibility, that we would have the ability to,

14    again, ensure that there is compliance with the

15    Commodity Exchange Act and the regulations

16    recognize that there are significant issues with

17    respect to proprietary information and the need to

18    maintain confidentiality and the balance for

19    regulatory responsibilities.

20             And so I think, you know, as we propose

21    an NPRM, we are looking for comment with respect

22    to access to, and utilization of, this information
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1   in furtherance of our responsibilities.

2   COMMISSIONER GIANCARLO: So let's say

3   that this proposal goes forward as you would

4   interpret it and we have this right to obtain

5   intellectual property, algorithms, source code

6   without a subpoena, I guess pursuant to a special

7   call process. Do we have the capabilities here at

8   the Commission to actually do anything with that

9   source code? Can we interpret it? Do we know how

10   to read it? What would we do with it?

11   MR. McGONAGLE: So the ability to pull

12   in the information, you know, on an as-needed

13   basis, so that would have to be evaluated as

14   needed. What is, you know, the nature of the

15   request? Does the coding methodology -- is it

16   consistent? Is it generating trading activity

17   that is in violation of the Act and the regs. And

18   so I would be in close coordination with the

19   Division of Enforcement, for example, to the

20   extent that they undertook an inquiry, that they

21   have the relevant expertise to evaluate, cabin,

22   and ensure the security of information.

         1   You know, we discussed the fact of

         2   inspection, so inspection doesn't mean transfer.

         3   It doesn't need to mean transfer, so the ability

         4   to go to the facility and get further information

         5   about how that code is being utilized is one of

         6   the aspects of Regulation 1.31. So I would say

         7   that we don't -- in all instances would require

         8   that source code be transferred over.

         9   And also, as I mentioned earlier, in

        10   looking at oversight from the CFTC perspective,

        11   it's in furtherance of our obligations under the

        12   Act and the regs, so whether there would be some

        13   -- you know, the nature and scope of the review of

        14   that source code would have to be determined

        15   through the Division of Market Oversight, with

        16   interaction, with the other divisions to the

        17   extent that they thought it was important with

        18   respect to their regulatory responsibilities.

        19   COMMISSIONER GIANCARLO: As I read the

        20   rule, though, Vince, I do understand we have the

        21   right not only to inspect, but to obtain the

        22   source code.

1   MR. McGONAGLE: Exactly. That's exactly

2   correct, Commissioner.

3   COMMISSIONER GIANCARLO: So if we were

4   to obtain the source code, it's unfortunate, but I

5   don't think the federal government or its

6   regulatory agencies have a great deal of

7   credibility with the American public in terms of

8   their ability to maintain the confidentiality of

9   intellectual property and data. How comfortable

10   or how -- what assurances can we give the public

11   if we do obtain source code from market

12   participants that that source code will remain

13   safe and out of the hands of not just their

14   competitors, but cyber threats to the marketplace.

15   MR. McGONAGLE: Commissioner, I

16   certainly appreciate the Commission's

17   responsibility to be ever-vigilant with respect to

18   the obligations that it seeks to discharge. We

19   routinely receive confidential information as part

20   of the regular business practices of this

21   organization and we would need to be ever vigilant

22   with respect to those responsibilities.

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 1              COMMISSIONER GIANCARLO:  Thank you.

 2    Thanks.  Let me close by thanking the team for

 3    their hard work on this.  I've gone into this

 4    issue because I do think it is probably one of the

 5    more critical elements of this proposal.  I think

 6    it's something that merits thoughtful

 7    consideration by the public.  It's certainly an

 8    area where I will be looking carefully.

 9              We did a little bit of research in the

10    small amount of time we had.  We can't find any

11    other precedent for federal agencies obtaining

12    such sensitive intellectual property of market

13    participants, so I'll be interested for the

14    public's comment on that and certainly in the

15    weeks and months to come, to educate ourselves

16    better on that.  Thank you.

17              CHAIRMAN MASSAD:  Okay.  Did you have

18    anything else?

19              COMMISSIONER BOWEN:  No.

20              CHAIRMAN MASSAD:  Just to follow up.

21    Certainly, the confidentiality of information is

22    always a key requirement of the law, as well as a
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1   thing we always must keep our eyes on. There's

2   plenty of commercially sensitive information, I

3   think, that we get in the course of our oversight

4   activity and our supervision activity. And I'm

5   certainly happy to look further at the rules'

6   implications with respect to source code, but I

7   think it's -- I'm not sure that I see that there's

8   a difference in -- qualitatively, if you will,

9   given that we are constantly receiving all sorts

10   of confidential and highly commercially sensitive

11   information.

12   As to our ability to analyze an

13   algorithm, I've said repeatedly that we need to

14   invest more in IT to enhance our systems generally

15   given the electronification and increasing

16   automation of the markets. But I think given the

17   outstanding work of our Enforcement Division, in

18   looking at matters involving spoofing and so

19   forth, I would expect that they've done plenty of

20   analysis of algorithms and deconstruction of

21   algorithms in their cases.

22   If there are no other questions, I would

1   again like to thank the staff for their work and

2   presentations today. And having concluded the

3   discussion would any Commissioner like to make any

4   further statements before we proceed to a vote?

5   All right. If the Commissioners are

6   prepared to vote, if so, Mr. Kirkpatrick will you

7   call the roll?

8   MR. KIRKPATRICK: The motion now before

9   the Commission is on the adoption of the Notice of

10   Proposed Rulemaking on Regulation Automated

11   Trading.

12   Commissioner Giancarlo?

13   COMMISSIONER GIANCARLO: Aye.

14   MR. KIRKPATRICK: Commissioner

15   Giancarlo, aye. Commissioner Bowen?

16   COMMISSIONER BOWEN: Aye.

17   MR. KIRKPATRICK: Commissioner Bowen,

18   aye. Chairman Massad?

19   CHAIRMAN MASSAD: Aye.

20   MR. KIRKPATRICK: Chairman Massad, aye.

21   Mr. Chairman, on this matter, the ayes have three,

22   the no's have zero.

1   CHAIRMAN MASSAD: Thank you. The ayes

2   have it, and the motion to adopt the proposed rule

3   is approved.

4   Is there any other Commission business?

5   There being no further business, I would entertain

6   a motion to adjourn the meeting.

7   COMMISSIONER BOWEN: So moved.

8   CHAIRMAN MASSAD: All in favor?

9   COMMISSIONER GIANCARLO: Second.

10   GROUP: Aye.

11   CHAIRMAN MASSAD: The motion is

12   approved. The meeting is adjourned. And again,

13   thank you all very much.

14   (Whereupon, at 9:49 a.m., the

15   PROCEEDINGS were adjourned.)

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1              CERTIFICATE OF NOTARY PUBLIC

2                  DISTRICT OF COLUMBIA

3          I, Mark Mahoney, notary public in and

4    for the District of Columbia, do hereby certify

5    that the forgoing PROCEEDING was duly recorded and

6    thereafter reduced to print under my direction;

7    that said transcript is a true record of the

8    testimony given by witnesses; that I am neither

9    counsel for, related to, nor employed by any of

10   the parties to the action in which this proceeding

11   was called; and, furthermore, that I am not a

12   relative or employee of any attorney or counsel

13   employed by the parties hereto, nor financially or

14   otherwise interested in the outcome of this

15   action.

16                 (Signature and Seal on File)

17                 ----------------------------------

18   Notary Public, in and for the District of Columbia

19   My Commission Expires: March 14, 2018

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