CFTC Update: High-Frequency Trading, Customer Protection, & Position Limits

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Three Recent CFTC Actions

- Concept Release on Risk Controls and System Safeguards for Automated Trading Environments
- Final Rule on Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivative Clearing Organizations
- Proposed Rule on Position Limits for Futures and Swaps for Agricultural, Energy, and other physical commodities

Concept Release on Risk Controls and System Safeguards for Automated Trading Environments

78 Fed. Reg. 56532 (Sept. 12, 2013)

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Background for Concept Release

Recent events in derivative and securities markets involving automated trading systems ("ATS") and high-frequency trading ("HFT") have raised concerns regarding the adequacy of controls over these systems. These events include:

- **Flash crash of May 2010**: equity indices in futures and securities markets lost more than 5% in value in a matter of minutes following large automated order
- **Knight Capital Group software malfunction**: Errant computer buying and selling of millions of shares caused price swings in more than 150 securities
- **NASDAQ technical issues with Facebook IPO:** Computer issues delayed start of trading and prevented many investors from buying shares; many investors did not know status of their trades

Concerns Underlying Concept Release

Four main areas of concern:

- **Systemic risk** (i.e., avoid “flash crash”)
- **Market integrity** (i.e., ensure integrity of price discovery process)
- **Fairness** (i.e., equal access/latency issues)
- **Transparency** (accuracy/significance of market metrics)

CFTC and Industry Actions to Date

Various CFTC regulations have addressed ATS/HFT issues:

- SDs, MSPs, and FCMs: Clearing members must establish risk-based limits for all accounts, and provide automated means to screen orders
- SDs and MSPs: Must supervise, maintain, and test trading programs
- DCMs: Must establish risk control mechanisms and pre-trade limits
- DCMs / SEFs: Must impose trading pause and halt requirements
- DCMs with Direct Market Access: Must have systems to facilitate FCMs' risk management
- Anti-manipulation rule (180.1)
- Guidance on disruptive trading practices

Industry has undertaken various initiatives to address ATS/HFT:

- FIA Working Groups
- Exchanges have adopted control mechanisms

Purpose of Concept Release

The Concept Release is intended to provide CFTC with information and public input on what has been done so far to address ATS/HFT issues and on their implementation:

- What initiatives have market participants undertaken?
- To what extent have those initiatives been implemented?
- Have they been implemented in a uniform manner?
- Are they being applied consistently across all levels?
- Are regulatory standards needed to ensure initiatives are implemented?
- Are other measures needed?
- Should ATS or HFT be licensed or registered?
- Should any regulation be prescriptive or principles-based?

124 Questions

The Concept Release seeks comment on 124 questions relating to, among other things, the following:

- Specific categories of pre-trade risk controls, post-trade reports and measures, system safeguards, and additional risk-mitigating measures
- Whether the controls described are already in use
- The utility, costs and benefits associated with the controls described
- The value of, and extent to which, redundant controls should be imposed upon different types of market participants
- High-frequency trading
- Latency differences in order handling or trade reporting that provide opportunities for informational advantage, and communications between exchanges' informational technology systems

Specific Areas of Interest

Specific areas of CFTC interest include:

- Challenges / benefits of HFT, including its definition
- Latency differences due to exchange processes for message transmission that provide informational advantages
- Market interconnectedness – benefits of standardizing various risk controls and safeguards across markets
- Role of manual controls and safeguards in supervision / risk mitigation

Potential Risk Controls Discussed

- Pre-Trade Controls
  - Message & Execution Throttles
  - Volatility Awareness Alerts
  - Self-Trade Controls
  - Price Collars
  - Maximum Order Sizes
  - Trading Pauses
  - Credit Risk Limits
- Post-Trade Controls
  - Order, Trade & Position Reports
  - Trade Cancellation & Adjustment Policies
- System Safeguards
  - Order Placement Controls
  - Policies & Procedures
  - Self-Certifications and Notifications
  - ATS or Algo Identification
  - Data Reasonability Checks
- Other Protections
  - Market Quality Data
  - Market Quality Incentives
  - Related Contracts P&P
  - Standardize & Simplify Order Types

Technology Advisory Committee

Issues raised by participants in fall meeting:

- Nature of Forthcoming Regulatory Framework
- Concept Release’s Emphasis on Speed and HFT
- Risk Control Considerations
- Managing Expectations Regarding Risk Mitigation

Final Rule on Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivative Clearing Organizations

78 Fed. Reg. 68506 (Nov. 14, 2013)

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Customer Protection

Final rule approved Oct. 30, 2013 imposes new requirements for:

- Residual interest
- Standardized Depository Acknowledgment letters
- FCM risk management and disclosure
- Accounts for foreign futures and foreign options customers (secured accounts)
- FCM reporting and oversight
- FCM net equity requirements
- Minimum qualifications of accountants
- Permitted investments by FCMs

Residual Interest Requirement

- Based on CEA Section 4d(a)(2), which prohibits an FCM from using the funds from one customer to margin or guarantee the trades of other customers.

- Final rule requires an FCM to maintain a “residual interest” (i.e. its own funds) in an amount at least equal to its customers’ total undermargined amounts for the prior trade date.

- Phase-in to address cost concerns.

Residual Interest Phase-In

- 1 year from date of rule publication (Nov. 2014): FCM must hold the required residual interest by 6 PM EST on the next business day after the trade date ("T+1").
- 30 months (May 2016): CFTC to publish report for public comment on the feasibility of moving the deadline for full implementation.
- 9 months after publication of report (Jan. 2017): CFTC to adopt new phase-in period.
- 5+ years (Dec. 31, 2018): If CFTC takes no further action, the phase-in period will expire and an FCM must hold the residual interest prior to the time of daily settlement (typically 7-9 am on the date after the trade date).

Depository Acknowledgment Letters

- To be standardized, per CFTC format.
- Depositories must agree:
  - To provide CFTC with direct electronic access to information about transactions and balances in customer accounts
  - That accounts may be examined at any reasonable time by CFTC
  - To reply promptly to CFTC requests for information
- Customer funds deposited by an FCM or DCO must be immediately available for withdrawal upon demand by the FCM or DCO.

FCM Requirements

- Risk management program
  - Written policies and procedures to ensure segregation of customer funds
  - Policies must address all applicable risks of FCM business
- Daily segregation reports
- Quarterly risk exposure reports
- Enhanced risk disclosure
  - General disclosure of risks
  - Disclosure of risks of the specific FCM
  - Disclosure on website of FCM financial information

Proposed Rule on Position Limits for Futures and Swaps for Agricultural, Energy, and other physical commodities

(Approved Nov. 5, 2013)

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Proposed Rule

- In September 2012, the US District Court vacated the position limits rule that the Commission had approved in November 2011.
- On November 5, 2013, the Commission voted to re-propose position limits, which:
  - Expand list of futures contracts beyond legacy agricultural contracts; and
  - Apply limits to economically equivalent swaps contracts.
- Market participants will have 60 days after publication of rules in Federal Register to comment.

28 Commodities

- **Agricultural (including Legacy)**:
  - **CBOT** Corn, Oats, Soybeans, Soybean Meal, Soybean Oil, Wheat, Rough Rice;
  - **CME** Class II Milk, Feeder Cattle, Lean Hog, Live Cattle;
  - **ICE** Cotton No. 2, Cocoa, Coffee C, FCOJ-A, US Sugar No. 11, US Sugar No. 16;
  - **KCBT** Hard Winter Wheat; and
  - **MGEX** Hard Red Spring Wheat.
- **Energy**:
  - **NYMEX** Henry Hub Natural Gas, Light Sweet Crude Oil, RBOB Gasoline, NY Harbor ULSD.
- **Metal**:
  - **COMEX** Copper, Gold, Silver; and
  - **NYMEX** Palladium, Platinum.

Calculation of Limits

- ***Spot-Month Limits***:
  - 25% of estimated deliverable supply.
    - Based on estimated deliverable supply data from DCMs.
  - Limits apply separately to physical-delivery and cash-settled contracts (i.e., no netting).
    - For Participants with only cash-settled contracts, limit can be up to five times higher.
- ***Non-Spot-Month Limits***:
  - 10/2.5% formula:
    - 10% of the contract's first 25,000 of open interest, and
    - 2.5% of any open interest above 25,000.
  - Applies to positions a trader may have in all contract months combined, or in a single contract month.
  - Based on data from reporting pursuant to Parts 16, 20, & 45.
  - Can net positions across futures, options, economically equivalent swaps, and linked contracts offered by FBOTs.

Proposed Rule on Aggregation

- **Requires aggregation in accounts where trader:**
  - Holds or controls trading of ≥ 10% of account; or
  - Holds or controls trading in multiple accounts with substantially identical trading strategies.
- **Aggregation exemptions include those for:**
  - Some positions managed by "Independent Account Controller."
  - Passive investors in pools (e.g., limited partners).
  - Entities owning ≤ 50% in affiliate whose trading is independently controlled (e.g., physical separation).
  - Entities owning > 50% in a non-consolidated entity whose trading is independently controlled and where its positions are bona-fide hedges or are ≤ 20% of any position limit.
  - BD that acquires ≤ 50% interest solely due to its BD activities.
  - Where aggregation creates reasonable risk of violating law.

Bona Fide Hedging

- **General Requirements:**
  - Purpose of position must be to offset price risks incidental to commercial cash, spot, or forward operations; and
  - Position must be established / liquidated in an orderly manner with sound commercial practices (i.e., w/o disruption).
- **Enumerated Hedging Positions**:
  - **Similar to Current Definition** – hedges of: inventory and fixed-price cash commodity purchase contracts, fixed-price cash commodity sales contracts, positions held by agents.
    - **And Subject to 5-Day Rule* –** hedges of: unfilled anticipated requirements, cross-commodity, unsold anticipated production, offsetting unfixed-price cash commodity sales and purchases.
  - **Change to Current Definition (& Subject to 5-Day Rule *)** – hedges of: unfilled anticipated requirements for resale by a utility, anticipated royalties, service contracts.

* ***Cannot be held into the lesser of spot month or last 5 trading***

Bona Fide Hedging (cont'd)

- **Hedges of Excluded Commodities (IRS, FX, etc.)** – must be:
  - Economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise;
  - <u>And</u> either:
    - An enumerated hedging position; <u>or</u>
    - Defined as a BFH by DCM/SEF (inclu. risk management exempt.).
- **Hedges of Physical Commodities:**
  - Must:
    - Represent a substitute for positions taken later in a physical marketing channel;
    - Be economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise;
    - Be an enumerated hedging position; and
    - Arise from potential change in value of assets, liabilities or services.
  - <u>Pass-Through Swaps</u>: Applies to (a) a position that reduces the risk of underlying swap opposite counterparty with a BFH position; and (b) the underlying swap (to the extent it was offset). Subject to 5-Day Rule.

Other Exemptions

Other exemptions include those for:

- Entities facing financial distress (e.g., potential customer default).
- For spot month limits, entities that only hold cash-settled contracts (allowed up to 5X the limit).
- Non-spot month pre-enactment / transition positions that are established in good faith.
- Other risk-reducing activities that are not defined as bona fide hedging.

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