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CROSS-BORDER LITIGATION SERIES
CFTC Requests Comment on its Proposed Interpretations of Statutory Disruptive Practices

Background

As part of last year's financial reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[1] Congress amended the Commodity Exchange Act ("CEA")[2] to prohibit three trading practices it deemed "disruptive to fair and equitable trading" on registered futures and swaps markets. These new prohibitions will become effective on July 16, 2011. Specifically, the Dodd-Frank Act amends Section 4c(a) by adding subsection (5), which provides that:

> "It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that –
>
> (A) violates bids or offers
>
> (B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or
>
> (C) is, is of the character of, or is commonly known to the trade as, 'spoofing' (bidding or offering with the intent to cancel the bid or offer before execution)."[3]

New Section 4c(a)(6) empowers the Commodity Futures Trading Commission ("CFTC") to promulgate whatever rules it deems reasonably necessary to prohibit the three statutory disruptive trading practices above, as well as any other trading practice that is "disruptive of fair and equitable trading."

Late last year, the CFTC requested public comment on all aspects of 4c(a)(5) and hosted a roundtable panel to solicit market guidance before exercising its rulemaking power.[4] The commenters and panelists sought clarification on several common issues: (i) the scope of prohibited conduct; (ii) statutory definitions; and (iii) the requisite scienter for each disruptive trading practice.

On March 18, 2011, the CFTC published a Proposed Interpretive Order ("the Order") to clarify 4c(a)(5)'s reach and application.[5] The Order, originally issued on February 24, 2011, seeks further public comment on the CFTC's proposed interpretations, in anticipation of eventual rulemaking efforts. Comments are due by May 17, 2011 (see below for submission instructions).

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[1] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 747, 124 Stat. 1376, 1739 (2010).

[2] 7 U.S.C. 1 *et seq.*

[3] § 747, 124 Stat. at 1739.

[4] *See* Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 67301 (Nov. 2, 2010).

[5] *See* Antidisruptive Practices Authority, 76 Fed. Reg. 14826 (Mar. 18, 2011).

The Proposed Interpretive Order

The Order clarifies that the term "registered entity" in 4c(a)(5) refers to designated contract markets and swap execution facilities ("SEFs"), and that 4c(a)(5) applies to any trading, practices, or conduct on those two platforms, except for block trades or exchanges for related positions ("EFRPs"). 4c(a)(5) will not apply to privately negotiated bilateral swap transactions.

4c(a)(5)(A): Violating Bids and Offers

The Order explains that 4c(a)(5)(A) prohibits the purchase of a contract at any price higher than the lowest price available, and the sale of a contract at any price lower than the highest price available.

4c(a)(5)(A) is a *per se* offense: a market participant violates the statute simply by engaging in the prohibited behavior, as long as that participant has at least "some control" over the bids and offers he or she transacts against. Thus, 4c(a)(5)(A) applies to manual trading systems, as well as to automated trading systems that do not operate on "pre-determined matching algorithm[s]." Notably, the Order does not specify that to violate bids or offers, a market participant must be aware of the relevant lowest or highest available price, or even that the best available price be published.

The CFTC will not apply a "best execution" standard across markets, and the obligation not to violate bids or offers applies only to the trading venue a participant is using to transact at a given time. The Order also notes that 4c(a)(5)(A) does not apply to the practice of "buying the board," whereby a market participant purchases all available bids or offers in a given order book.

4c(a)(5)(B): Disregard for the Orderly Execution of Transactions During the Closing Period

According to the Order, Section 5(B) prohibits trades executed and bids or offers submitted during the closing period ("the period in the contract or trade when the daily settlement price is determined under the rules of that trading facility") that affect the orderly execution of transactions during that period. However, liability under Section 5(B) does not require actual disruption: Section 5(B) also applies to "*potential* disruptive conduct" outside the closing period, and to orders, bids, or offers submitted "*for the purposes of* disrupting fair and equitable trading."

Scienter appears to be a critical element of Section 5(B) liability. To trigger liability, a trader must—at the time of the transaction—intentionally or recklessly disregard its potentially disruptive effect: they knew or should have known of the potential for disruption. The Order states that (5)(B) does not prohibit accidental or negligent conduct, or other legitimate, good faith trading behavior, even when it actually disrupts the orderliness of the market during closing.

In distinguishing reckless from legitimate conduct, the CFTC will consider all relevant facts and circumstances as of the time of the transaction. The Order suggests that a party demonstrates good faith by "assess[ing] market conditions and consider[ing] how their trading practices and conduct affect the orderly execution of transactions during the closing period." Notably, the Order proposes that evidence of the subsequent orderliness of the relevant market will be relevant in assessing whether an individual trader's behavior was violative.

4c(a)(5)(C): Spoofing

The Order emphasizes the statutory definition of spoofing as any trading, practice, or conduct in which a person *intends* to cancel a bid or offer before execution. Reckless, negligent, or accidental trading, practices, or conduct will not violate the statute. Nor will orders, modifications, or cancellations submitted as part a legitimate, good faith attempt to consummate a trade. Rather, the relevant conduct is bad faith at the time of the submission of a bid or order.

That distinction exempts "partial fills" (cancellation of a partially filled order) when executed in good faith. However, a person that submits a bid or offer with the intent to cancel the order prior to execution engages in spoofing even if the order is ultimately filled. When distinguishing spoofing from legitimate partial fills, the CFTC will examine all relevant facts and circumstances, including market context and the participant's trading patterns (though spoofing does not require a prior pattern of activity).

The Order specifies that 4c(a)(5)(C) covers trades, bids, and offers, but does not apply to requests for quotes ("RFQs") or other non-executable market communications.

Unresolved Issues

The Order addresses only some of the commenters' and panelists' concerns, and leaves some of the CFTC's own questions unanswered. For example, when it solicited public comment, the CFTC asked whether 4c(a)(5) should obligate brokers to "ensure that customer trades are not disruptive trade practices."[6] However, the Order does not answer that question, or indeed refer to brokers at all. For now, it remains unclear whether brokers can be liable for not preventing their customers' disruptive trading practices.

The Interpretive Order also raises some new questions. As to Section 5(B), the Order prohibits at least three trading practices and identifies two scienters, but does not elaborate on the relationship between them. The mere failure to consider potential market disruption during the closing might violate Section 5(B), even where no disruption occurs. Moreover, the Order seems to suggest that where the CFTC believes a market to be disorderly, market participants might have to affirmatively demonstrate that they acted in good faith in order to avoid prosecution. If good faith necessarily requires an assessment of market conditions, as the Order suggests, then the CFTC should address what would constitute adequate assessment, and how to demonstrate that the assessment was made, particularly in the context of a fast-paced trading environment.

Further, though RFQs are expressly carved out of the 4c(a)(5)(C) spoofing provision, it is not clear whether RFQs and other non-executable market communications can violate bids or offers, or be potentially disruptive to orderly transactions during the closing period. Hopefully, these and other issues will be addressed in comments, and the CFTC will further clarify 4c(a)(5).

The CFTC's Request for Comments

The CFTC is accepting comment on all aspects of 4c(a)(5) until May 17, 2011. Interested parties can submit comments in any of the following ways:

- Online via the CFTC website's "Comments Online" section: http://comments.cftc.gov
- Online via the Federal eRulemaking Portal: http://www.regulations.gov
- Mail, hand delivery, or courier to: David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, D.C. 20581

This may be a final opportunity for market participants to add their voice to the debate over what constitutes prohibited disruptive trading practices under the CEA. After the comment period closes, the CFTC will consider whether to issue a Final Interpretive Order, which will have binding effect.

[6] *See* 75 Fed. Reg. 67302