CFTC Staff Finalizes Guidance on Anti-Disruptive Trading Practices

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The Commodity Futures Trading Commission (CFTC or Commission) has issued final interpretive guidance[1] (Guidance) on prohibitions on certain disruptive trading practices added by the Dodd-Frank Act.[2] The Guidance is applicable to all persons who trade on futures markets or on the coming swap execution facilities (SEFs). In particular, persons trading on these facilities should be aware that certain trading practice prohibitions may be violated without a finding of intent.

What are the New Trading Prohibitions?

New Section 4c(a)(5) of the Commodity Exchange Act (Act) makes it 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).

The Guidance, which will be effective immediately upon publication in the Federal Register, clarifies how the Commission will apply these three provisions. The Guidance makes clear that although Section 4c(a)(5) applies to *any* registered entity, it does not apply to block trades or exchanges for related positions (EFRPs) that are transacted in accordance with Commission Regulation 1.38.

Significantly, the Commission has declined requests to read a manipulative intent requirement into the statute, stating that requiring such intent would be counter to the language of Section 4c(a)(5).[3] As discussed below, the Guidance explains that Section 4c(a)(5)(A) (violating bids or offers) is a strict liability provision. Additionally, a showing of recklessness will suffice for a violation of Section 4c(a)(5)(B) (demonstrating reckless disregard for the orderly execution during the closing period), while a showing of intent must be made for a violation of Section 4c(a)(5)(C) (“spoofing”).

Guidance on Specific Provisions of Section 4c(a)(5)

(a) Section 4c(a)(5)(A) (violates bids or offers)

What mental state and conduct are required to violate bids and offers?

A Section 4c(a)(5)(A) violation is a *per se* offense requiring no showing of intent to disrupt fair and equitable trading. A person is prohibited from buying a contract at a price that is higher than the lowest available offer price and/or from selling a contract at a price that is lower than the highest available bid price, irrespective of intent. However, the Commission has stated that it does not intend to bring an enforcement action under this provision when a one-off violation is purely accidental.

When does the prohibition against the violation of bids and offers apply?

The prohibition applies in any trading environment where a person exercises some control over the selection of bids and offers against which the person transacts, including the use of an automated trading system that operates without pre-determined (i.e., automatic) matching algorithms. Conversely, this prohibition does not apply when a person is using an automatic order matching algorithm and is thus unable to violate a bid or offer, or when a person is executing a sequence of trades to buy all available bids or sell to all available offers on an order book in accordance with the rules of the facility where the trades are being executed.

The prohibition does not span multiple registered entities, different trading systems or platforms within a particular registered entity, or swaps cleared by different clearing houses. It also does not apply to a SEF’s RFQ (request for quote) order execution functionality or to transactions in uncleared swaps.

(b) Section 4c(a)(5)(B) (disregard for orderly execution)

What mental state and conduct are required to disregard the orderly execution of transactions during the closing period?

The standard for a violation of Section 4c(a)(5)(B) is recklessness. Recklessness is defined as conduct that “departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing.” Accidental, or even merely negligent trading, is not a sufficient basis for a violation.

Orders need not be executed to be in violation of this provision. Because they could send false signals to the marketplace that would consequently affect the trading behavior of market participants in the closing period, bids and offers submitted by market participants that disrupt fair and equitable trading during the closing period may also violate this provision. In addition, bids and offers submitted by a person who intends to cancel the bid or offer before execution may not only violate this provision but may also qualify as "spoofing."

Conduct outside the closing period may also violate this provision if that conduct disrupts the orderly execution of transactions during the closing period.

When is the closing period?

The CFTC has defined the closing period as the period in the contract or trade when the settlement price is determined under the rules of that registered entity—the SEF or designated contract market (DCM). Examples include: 1) the time period in which a daily settlement price is determined; 2) the expiration day for a futures contract; and 3) any period of time in which the cash-market transaction prices for a physical commodity are used in establishing a settlement price for a futures contract, option or swap (if a DCM or SEF determines that a settlement or pricing period exists for that particular swap).

How will the CFTC make a violation determination?

To determine whether a violation occurred, the CFTC will evaluate the facts and circumstances as of the time the person engaged in the trading, practices or conduct, looking at what the person knew or should have known, and the information available at the time he or she was engaging in the relevant conduct. In making determinations regarding the functioning of an orderly market, the CFTC will be guided, but not controlled, by judicial precedent discussing orderly markets with respect to securities markets.[4]

(c) Section 4c(a)(5)(C) ("spoofing")

What mental state and conduct are required to engage in "spoofing"?

A person must *intend* to cancel a bid or offer before execution to engage in "spoofing." Recklessness is not enough for a violation of this provision. Orders, modifications or cancellations will not be considered "spoofing" if they were submitted as part of a legitimate, good-faith attempt to consummate a trade. While partial fills are not automatically exempt from being classified as "spoofing," legitimate, good-faith cancellations of partially filled orders would not violate this provision.

A violation does not require a pattern of activity; even a single instance of trading activity can amount to a violation. The Commission will evaluate the market context, examining the person's pattern of trading activity (including fill characteristics), and other relevant facts and circumstances.

What activity is subject to this prohibition?

Section 4c(a)(5)(C) covers bid and offer activity on all registered entities—including DCMs and SEFs—and includes all bids and offers in pre-open periods or during exchange-controlled trading halts. The applicability of this provision is not restricted to trading platforms and venues only having order book functionality. Rather, "spoofing" may occur on any trading platform or venue where a market participant has the ability to either send executable bids and offers to market participants or transact against resting orders. Non-executable market communications such as requests for quotes and other authorized pre-trade communications do not qualify as "spoofing."

What are some examples of "spoofing" behavior?

The CFTC provides four non-exclusive examples of "spoofing" behavior: 1) submitting or cancelling bids or offers to overload the quotation system of a registered entity; 2) submitting or cancelling bids or offers to delay another person's execution of trades; 3) submitting or cancelling multiple bids or offers to create an appearance of false market depth; and 4) submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards.

Conclusion

All traders should be mindful that the Dodd-Frank Act added a number of prohibited trading practices, about which the Commission has provided interpretive guidance. Different standards of *scienter* apply to each. Intent is required to violate the anti "spoofing" provision and recklessness is required to violate the provision dealing with disregarding the orderly execution of transactions during the close. However, no finding of intent is required for violating bids or offers. Market participants will need to take care to ensure that their trading conduct does not run afoul of these new provisions of the Act and the Commission's interpretive guidance thereunder.

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[1] Antidisruptive Practices Authority, Commodity Exchange Act Release No. 3038-AD96 (May 20, 2013).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act").

[3] For a discussion of the CFTC's rules pursuant to Section 753, see WilmerHale Client Alert, The Commodity Futures Trading Commission Issues Sweeping New Rules to Prohibit Fraud and Manipulation in the Swaps, Cash, and Futures Markets (Jul. 28, 2011) http://www.wilmerhale.com/pages/publicationsandnewsdetail.aspx?NewsPubId=88783.

[4] Characteristics of an orderly market include, among other things, parameters such as a rational relationship between consecutive prices, a strong correlation between price changes and the volume of trades, levels of volatility that do not dramatically reduce liquidity, accurate relationships between the price of a derivative and the underlying such as a physical commodity or financial instrument, and reasonable spreads between contracts for near months and for remote months. Guidance, *supra* note 1, at 22.

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