

**COMMODITY FUTURES TRADING COMMISSION**

**Antidisruptive Practices Authority**

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Proposed Interpretive Order.

**SUMMARY:** The Commodity Futures Trading Commission (“Commission” or “CFTC”) is proposing this interpretive order to provide interpretive guidance regarding the three statutory disruptive practices set forth in new section 4c(a)(5) of the Commodity Exchange Act (“CEA”) pursuant to section 747 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The Commission requests comment on all aspects of the proposed interpretive order.

**DATES:** Comments must be received on or before [INSERT 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

**ADDRESSES:** Comments, identified by RIN number, may be sent by any of the following methods:

- Agency web site, via its Comments Online process: <http://comments.cftc.gov>. Follow the instructions for submitting comments through the web site.
- Mail: David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.
- Hand Delivery/Courier: Same as mail above.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.

**FOR FURTHER INFORMATION CONTACT:** Robert Pease, Counsel to the Director of Enforcement, 202-418-5863, [rpease@cftc.gov](mailto:rpease@cftc.gov); Steven E. Seitz, Attorney, Office of the General Counsel, 202-418-5615, [sseitz@cftc.gov](mailto:sseitz@cftc.gov); or Mark D. Higgins, Counsel to the Director of Enforcement, 202-418-5864, [mhiggins@cftc.gov](mailto:mhiggins@cftc.gov), Commodity Futures Trading Commission, Three Lafayette Centre, 1151 21st Street, N.W., Washington, DC 20581.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to [www.cftc.gov](http://www.cftc.gov). You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that may be exempt from disclosure under the Freedom of Information Act (“FOIA”),<sup>1</sup> a petition for confidential treatment of the exempt information may be submitted according to the established procedures in § 145.9 of the CFTC’s regulations.<sup>2</sup> The Commission reserves the right, but shall have no obligation, to review, prescreen filter, redact, refuse, or remove any or all of your submission from [www.cftc.gov](http://www.cftc.gov) that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under FOIA.

**SUPPLEMENTARY INFORMATION:**

**Prohibition of Disruptive Practices**

**I. Statutory and Regulatory Authorities**

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and

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<sup>1</sup> 5 U.S.C. 552.

<sup>2</sup> 17 CFR 145.9.

Consumer Protection Act (“Dodd-Frank Act”).<sup>3</sup> Title VII of the Dodd-Frank Act<sup>4</sup> amended the Commodity Exchange Act (“CEA”)<sup>5</sup> to establish a comprehensive new regulatory framework for swaps and security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: 1) providing for the registration and comprehensive regulation of swap dealers and major swap participants; 2) imposing clearing and trade execution requirements on standardized derivative products; 3) creating robust recordkeeping and real-time reporting regimes; and 4) enhancing the Commission’s rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission’s oversight.

Section 747 of the Dodd-Frank Act amends section 4c(a) of the CEA to add a new section entitled “Disruptive Practices.” New CEA section 4c(a)(5) 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).

Dodd-Frank Act section 747 also amends section 4c(a) by granting the Commission authority under new CEA section 4c(a)(6) to promulgate such “rules and regulations as, in the judgment of the Commission, are reasonably necessary to prohibit the trading practices”

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<sup>3</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at <http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm>.

<sup>4</sup> Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the “Wall Street Transparency and Accountability Act of 2010.”

<sup>5</sup> 7 U.S.C. 1 et seq.

enumerated therein “and any other trading practice that is disruptive of fair and equitable trading.”

The Commission is issuing this proposed interpretive order to provide market participants and the public with guidance on the scope of the statutory prohibitions set forth in section 4c(a)(5). The Commission requests comment on all aspects of this proposed interpretive order, as well as comment on the specific provisions and issues highlighted below.

## **II. Background**

On November 2, 2010, the Commission issued an advance notice of proposed rulemaking (“ANPR”) asking for public comment on all aspects of Dodd-Frank Act section 747.<sup>6</sup> When the ANPR was issued, the Commission was considering whether to adopt regulations regarding the disruptive practices set forth in new CEA section 4c(a)(5). After reviewing the ANPR comments, the Commission determined that it was appropriate to address the statutory disruptive practices through a proposed interpretive order. Accordingly, a Commission document terminating the ANPR is being published elsewhere in the proposed Rule section of this issue of the Federal Register. Notwithstanding that termination, the Commission considered all of the ANPR commentary in developing this proposed interpretive order.

In the ANPR, commenters were encouraged to address the nineteen specific questions posed by the Commission in the ANPR.<sup>7</sup> The ANPR requested, among other things, comment on section 747 (A) (“violating bids and offers”), section 747 (B) (“the disorderly execution of transactions around the closing period”), section 747 (C) (“spoofing”), the role of executing brokers, and the regulation of algorithmic and automated trading systems.<sup>8</sup> The questions in the

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<sup>6</sup> 75 FR 67301, Nov. 2, 2010.

<sup>7</sup> The ANPR may be accessed through: <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=893>.

<sup>8</sup> 75 FR 67302, Nov. 2, 2010.

ANPR also formed the basis for a December 2, 2010, roundtable held by Commission staff in Washington, D.C.<sup>9</sup> The full-day roundtable consisted of three panels<sup>10</sup> that addressed the ANPR questions, the role of exchanges in CFTC-regulated markets, and whether there are other potential disruptive trading practices that the Commission should prohibit. The ANPR set a deadline of January 3, 2011, by which comments had to be submitted.<sup>11</sup> In response to the ANPR, the Commission received 28 comments from interested parties,<sup>12</sup> including industry members, trade associations, consumer groups, exchanges, one member of the U.S. Congress, and other interested members of the public.<sup>13</sup> The Commission has carefully considered all of the ANPR comments, as well as the roundtable discussion, in proposing this interpretive order.

Throughout the roundtable discussion and comment letters, there was widespread support for the Commission's goal of preventing disruptive trading practices and ensuring fair and equitable markets.<sup>14</sup> Several themes emerged from the roundtable discussion and the comment letters, which are discussed below in the following sections.

a. Market Participants Request Additional Guidance Regarding the Scope and Application of Section 747's Provisions

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<sup>9</sup> See Appendix III for a list of roundtable participants and discussion panels. A verbatim transcript of the disruptive trading practices roundtable may be accessed at [http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission24\\_120210-transcri.pdf](http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission24_120210-transcri.pdf).

<sup>10</sup> Note that citations to statements by the panelists at the public roundtable will be cited as [Panelist name at page X of roundtable transcript].

<sup>11</sup> 75 FR 67301, Nov. 2, 2010.

<sup>12</sup> See Appendix IV for a list of parties submitting comment letters in response to the ANPR.

<sup>13</sup> The comment letters received by the Commission in response to the ANPR may be accessed through: <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=893>.

<sup>14</sup> Liam Connell at 40 ("Allston Trading supports the mission of the CFTC to maintain orderly markets and to prohibit deceptive practices and manipulative trading."); Rajiv Fernando at 17 ("I support the CFTC's effort to ensure that markets operate in an orderly way that's fair for all participants."); Argus at 1 ("Argus supports the important goal of preventing disruptive trade practices in CFTC jurisdictional markets.").

Throughout the Commission roundtable, panelists stated that the provisions of section 747 were vague<sup>15</sup> and did not provide market participants with adequate notice of the type of trading, practices, and conduct that is prohibited by section 4c(a)(5).<sup>16</sup> Several comment letters also raised concerns about vagueness and believed that Dodd-Frank Section 747 was susceptible to constitutional challenge.<sup>17</sup> Comment letters requested that the Commission provide additional guidance concerning the conduct and trading practices that constitute violations under the statute.<sup>18</sup> During the roundtable discussion, panelists also requested additional clarity and refinement in the definition of terms such as “the orderly execution of transactions,”<sup>19</sup> “closing period,”<sup>20</sup> and “spoofing.”<sup>21</sup> The comment letters reiterated this concern and expressed the need for the Commission to define these terms and other concepts such as violating bids and offers.<sup>22</sup>

Panelists and commenters also sought clarity on whether scienter is required for each of the enumerated practices of section 4c(a)(5), and if so, specificity as to the degree of intent

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<sup>15</sup> See, e.g., Gary DeWaal at 57 (“This is an incredibly vague provision.”); Greg Mocek at 170 (“There are a lot of issues on vagueness.”).

<sup>16</sup> See, e.g., Adam Nunes at 20 (“Additional guidance... is going to be necessary.”); Ike Gibbs at 157 (“We would really prefer to see a scenario where the Commission is not overly prescriptive [and] we’re given guidance as to what’s appropriate and what’s not appropriate.”).

<sup>17</sup> See, e.g., Managed Funds Association at 4 (“Dodd-Frank Act Section 747 as written is vague and particularly vulnerable to constitutional challenge by market participants.”); CME Group at 2 (“As written, Section 747 is vague and susceptible to constitutional challenge.”).

<sup>18</sup> See, e.g., American Petroleum Institute at 2 (“The Commission should provide specific guidance regarding the scope of the trading practices listed in 747.”); Investment Company Institute at 2 (Recommending that the “Commission provide additional guidance as to the types of conduct that would constitute violations under the statute.”); HETCO at 4 (“The Commission should resolve the ambiguity in Section 4c(a)(5) by articulating the specific types of disruptive practices that prompted it to request the new enforcement authority in Section 747.”).

<sup>19</sup> See, e.g., Adam Nunes at 26 (“When we look at disruptive trading practices and the intentional reckless disregard for orderly execution that is going to be very difficult to define.”).

<sup>20</sup> See, e.g., Don Wilson at 46 (“The definition of those rules around what is and is not acceptable in the closing period needs to be carefully considered.”).

<sup>21</sup> See, e.g., Gary DeWaal at 64 (“I’m not sure the definition of spoofing can be agreed upon by the ten people around this table.”); John J. Lothian at 82 (Referring to ‘spoofing’ as a “very undefined type of term within the industry.”).

<sup>22</sup> See, e.g., Futures Industry Association at 3 (“Definitions such as ‘orderly execution,’ ‘violates bids or offers’ and ‘spoofing’ in Sections 4c(a)(5)(A), (B) and (C), respectively, require refinement and clarification by the Commission.”).

required. Roundtable panelists<sup>23</sup> and commenters<sup>24</sup> stated that a showing of bad intent should be necessary to distinguish prohibited conduct from legitimate trading activities. Panelists further stressed that any evaluation of trading behavior must consider the historical trading patterns and practices of market participants.<sup>25</sup>

In response to these comments, the Commission is proposing this Interpretive Order to provide additional guidance to market participants and the public on the types of trading, conduct, and practices that will constitute violations of section 4c(a)(5). This proposed interpretive order addresses the concerns expressed by the commenters regarding market uncertainty by clarifying how the Commission will interpret and implement the provisions of section 4c(a)(5). By the terms of the statute, 4c(a)(5) applies to trading, practices or conduct on or subject to the rules of a registered entity: a designated contract market or a swap execution facility (“SEF”).<sup>26</sup> The Commission interprets that section 4c(a)(5) will not apply to block trades or exchanges for related positions (“EFRPs”) transacted in accordance with the rules of a designated contract market or SEF or bilaterally negotiated swap transactions.

The Commission stresses the important role and unique position of exchanges and self-regulatory organizations to ensure that markets operate in a fair and equitable manner without

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<sup>23</sup> See, e.g., Adam Nunes at 36 (“The intent to manipulate...[is] critically important.”); Cameron Smith at 37 (“What really needs to be there in my mind is some notions of intent or phrases like “for the purpose of.”); Don Wilson at 47 (“I think it really comes down to intent.”); Mark Fabian at 163 (“I think everyone has agreed that intent is something that is required.”).

<sup>24</sup> See, e.g., Chopper Trading at 3 (“Any definition of spoofing must include an element of an intent to manipulate the market.”); FIA at 4 (“The Commission should clarify that manipulative intent to create an artificial price is required to violate 5(A)’s prohibition on violating bids or offers...[and] that manipulative intent is necessary under 5(B)’s prohibition.”); International Swaps and Derivatives Association at 3 (“Manipulative intent is a necessary element of ‘manipulative’ or ‘disruptive’ conduct.”).

<sup>25</sup> See, e.g., Adam Nunes at 94 (“[I]t’s really a pattern and practice of activity.”); John Hyland at 147 (“It’s patterns and practices, facts and circumstances.”); Mark Fabian at 163 (“A pattern is also required.”).

<sup>26</sup> The Commission does not believe that a trade becomes subject to 4c(a)(5) solely because it is reported on a swap data repository, even though a swap data repository is a registered entity.

disruptive trading practices.<sup>27</sup> The Commission agrees with commenters and panelists that a multi-layered, coordinated approach is required to prevent disruptive trading practices and ensure fair and equitable trading through enforcement of these provisions.<sup>28</sup>

i. Violating Bids and Offers.

1. Comments from ANPR and Roundtable.

During the roundtable discussion, panelists questioned how the concept of violating bids and offers applies across various trading platforms and markets.<sup>29</sup> Commenters expressed a similar concern<sup>30</sup> and requested that the Commission clarify how the prohibition against violating bids and offers applies to swaps,<sup>31</sup> open outcry pits,<sup>32</sup> infrequently traded over-the-counter products,<sup>33</sup> and electronic trading venues where the best bid and offer are matched automatically by algorithm.<sup>34</sup>

2. Commission Guidance.

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<sup>27</sup> See, e.g., CME Group Rule 432B.2 (“It shall be an offense...to engage in conduct or proceedings inconsistent with just and equitable principles of trade.”).

<sup>28</sup> See, e.g., FIA at 10 (“FIA strongly believes that a multi-layered enforcement approach, which implements policies and procedures at the firm, exchange and clearing level, will most effectively mitigate the risk of market disruptions.”).

<sup>29</sup> See, e.g., Greg Mocek at 173 (“There’s more practical issues to think about in the context of the concepts themselves and how the industry is structured, like violating a bid and an offer.”); Ken Raisler at 176 (generally asking how the concept of violating bids and offers applies to over-the-counter markets, swap execution facilities, and block trades).

<sup>30</sup> See, e.g., CME Group at 4 (“The Commission should make clear that the prohibition on violating bids or offers is not intended to create a best execution standard across venues as any such standard would be operationally and practically untenable.”).

<sup>31</sup> See, e.g., ISDA at 2 (“The phrase ‘violating bids and offers’ simply has no meaning in most if not all swaps markets. The pricing and trading of many swaps involves a variety of factors (e.g., size, credit risk) which, taken together, render the concept of “violating bids or offers” as inapposite.”).

<sup>32</sup> See, e.g., CME Group at 4 (generally discussing how the concept of violating bids and offers applies to open outcry trading environments).

<sup>33</sup> See, e.g., FIA at 4 (“The Commission should clarify that the prohibition on violating bids or offers does not apply in the over-the-counter markets.”).

<sup>34</sup> See, e.g., CME Group at 4 (“Order matching algorithms on electronic platforms preclude bids and offers from being violated.”); FIA at 4 (“Matching engines make it impossible to sell or buy except at the best available quote.”); MFA at 5 (“The term ‘violate bids or offers’... has virtually no application to electronic trading where systems buy or sell at the best available quote.”).



The Commission interprets section 4c(a)(5)(A) as prohibiting any person from buying a contract at a price that is higher than the lowest available offer price and/or selling a contract at a price that is lower than the highest available bid price. Such conduct, regardless of intent, disrupts the normal forces of supply and demand that are the foundation of fair and equitable trading. This proposed interpretive order is consistent with exchange rules that prohibit the violation of bids and offers.<sup>35</sup> Notably, Congress did not include an intent requirement in section 4c(a)(5)(A) as it did in both sections 4c(a)(5)(B) and (C). Accordingly, the Commission interprets section 4c(a)(5)(A) as a *per se* offense, that is, the Commission is not required to show that a person violating bids or offers did so with any intent to disrupt fair and equitable trading.

The Commission agrees that section 4c(a)(5)(A) does not apply where a person is unable to violate a bid or offer –*i.e.* when a person is utilizing an electronic trading system where algorithms automatically match the best bid and offer.<sup>36</sup> Section 4c(a)(5)(A) will operate in any trading environment where a person exercises some control over the selection of the bids or offers against which they transact, including in an automated trading system which operates without pre-determined matching algorithms. The Commission recognizes that at any particular time the bid-ask spread in one trading environment may differ from the bid-ask spread in another trading environment. Accordingly, in the view of the Commission, section 4c(a)(5)(A) does not create any sort of best execution standard across multiple trading platforms and markets; rather, a person’s obligation to not violate bids or offers is confined to the specific trading venue which he or she is utilizing at a particular time. Finally, section 4c(a)(5)(A) does not apply where an individual is “buying the board” – that is, executing a sequences of trades to buy all available

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<sup>35</sup> See, e.g., New York Mercantile Exchange Rule 514.A.3; Minneapolis Grain Exchange Rule 731.00.

<sup>36</sup> See, e.g., CME Group at 4 (“Order matching algorithms on electronic platforms preclude bids and offers from being violated.”).

bids or offers on that order book in accordance with the rules of the facility on which the trades were executed.

ii. Orderly Execution of Transactions During the Closing Period.

1. Comments from ANPR and Roundtable.

Roundtable panelists expressed the view that additional clarity was needed for the definitions incorporated in section 747(B), in particular, terms such as “closing period.”<sup>37</sup> Commenters also requested clarification on the definition of closing period and requested Commission guidance on whether the prohibition on disorderly execution of transactions extends to conduct occurring outside the closing period.<sup>38</sup> More specifically, some commenters requested that the prohibitions in section 747(B) be limited to manipulative conduct such as “banging” or “marking the close.”<sup>39</sup>

2. Commission Guidance.

New CEA section 4c(a)(5)(B) prohibits any trading, practices, or conduct on or subject to the rules of a registered entity that “demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period.” In the view of the Commission, Congress’s inclusion of a *scienter* requirement means that accidental, or even negligent, trading conduct and practices will not suffice for a claim under section 4c(a)(5)(B); rather a market participant must

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<sup>37</sup> See, e.g., Greg Mocek at 173 (“It’s easy to define the term ‘closing period’ presumably in a designated contract market. Are you planning on defining that period in a SEF?”).

<sup>38</sup> See, e.g., API at 12 (“Trading practices or conduct outside the closing period are not relevant to determine whether conduct inside the closing period is deemed ‘orderly’.”); HETCO at 7 (“HETCO urges the Commission to refrain from applying the prohibition against disorderly trading to an overly broad trading time period.”); CEF at 6 (“The Commission should refrain from looking at trading practices outside of the closing period.”).

<sup>39</sup> See, e.g., FIA at 5 (“The Commission should clarify that traditionally accepted types of market manipulation, such as ‘banging the close,’ ‘marking the close’ and pricing window manipulation fall under the prohibition of 5(B).”).

at least act recklessly.<sup>40</sup> Accordingly, section 4c(a)(5)(B) will not capture legitimate trading behavior and is not “a trap for those who act in good faith.”<sup>41</sup>

The Commission interprets the closing period to be generally defined as the period in the contract or trade when the daily settlement price is determined under the rules of that trading facility.<sup>42</sup> While the Commission interprets the prohibition in section 4c(a)(5)(B) to encompass any trading, conduct, or practices occurring inside the closing period that affects the orderly execution of transactions during the closing period, potential disruptive conduct outside that period may nevertheless form the basis for an investigation of potential violations under this section and other sections under the Act. With respect to swaps executed on a SEF, a swap will be subject to the provisions of section 4c(a)(5)(B) if a closing period or daily settlement price exists for the particular swap. Additionally, section 4c(a)(5)(B) violations will include executed orders as well as any bids and offers submitted by individuals for the purposes of disrupting fair and equitable trading.

Similar to other intent-based violations of the CEA, the Commission will consider all of the relevant facts and circumstances in determining whether a person violated section 4c(a)(5)(B). The Commission will evaluate the facts and circumstances as of the time the person engaged in the relevant trading, practices, or conduct (i.e. the Commission will consider what the person knew, or should have known, at the time he or she was engaging in the conduct at issue).

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<sup>40</sup> See, e.g., Hammond v. Smith Barney, Harris Upham & Company, Inc., [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,617 (CFTC Mar. 1, 1990) (scienter requires proof that a defendant committed the alleged wrongful acts “intentionally or with reckless disregard for his duties under the Act”); Drexel Burnham Lambert, Inc. v. CFTC, 850 F.2d 742, 748 (D.C.Cir. 1988) (holding that recklessness is sufficient to satisfy scienter requirement and that a reckless act is one where there is so little care that it is “difficult to believe the [actor] was not aware of what he was doing”) (quoting First Commodity Corp. v. CFTC, 676 F.2d 1, 7 (1st Cir. 1982)).

<sup>41</sup> United States v. Ragen, 314 U.S. 513, 524 (1942).

<sup>42</sup> Closing periods may include the time period in which a daily settlement price is determined, the expiration day for a futures contract, and 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 (as defined by the CEA).

The Commission will use existing concepts of orderliness of markets when assessing whether trades are executed, or orders are submitted, in an orderly fashion in the time periods prior to and during the closing period. In the view of the Commission, an orderly market may be characterized by, 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 materially 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.<sup>43</sup> Participants and regulators in the commodity and securities markets are already familiar with these assessments of orderliness in connection with issues of market manipulation<sup>44</sup> and risk mitigation. The Commission believes that market participants should assess market conditions and consider how their trading practices and conduct affect the orderly execution of transactions during the closing period.<sup>45</sup>

### iii. Spoofing.

#### 1. Comments from ANPR and Roundtable

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<sup>43</sup> Concepts applicable to the securities markets are useful in analyzing commodity markets because of similarities between the two areas. Concerning orderliness of markets, see, e.g., In re NYSE Specialists Securities Litigation, 503 F.3d 89 (2d Cir. 2007) (discussing role of specialists in maintaining orderly market and various circumventions of that role); Last Atlantis Partners, LLC v. AGS Specialist Partners, 533 F.Supp. 2d 828 (N.D. Ill. 2008) (allegation that trading specialists disengaged automated order execution mechanism to discriminate against customers having direct access to markets); LaBranche & Co., NYSE AMEX Hearing Board Decisions 09-AMEX-28, -29, and -30 (Oct. 2009) and NYSE Member Education Bulletin 2006-19 (discussing the proper design and use of specialist algorithms to avoid taking liquidity from the market at and surrounding the prevailing market price).

<sup>44</sup> See, e.g., Cargill, Inc. v. Hardin, 452 F.2d 1154, 1170-71 (8th Cir. 1971) (market disruption through “squeeze” of shorts characterized by extraordinary price fluctuations, with little relationship to basic supply and demand factors for wheat; other markets not similarly affected; long employed unusual mechanism to liquidate position).

<sup>45</sup> For example, absent an intentional or reckless disregard for the orderly execution of transactions during the closing period, a person would not be liable under 4c(a)(5)(B) upon executing an order during the closing period simply because the transactions had a substantial effect on the settlement price.

Roundtable panelists commented that there is no commonly-accepted definition of “spoofing” throughout the industry.<sup>46</sup> Some commenters expressed a similar concern<sup>47</sup> and requested additional Commission guidance that any definition of “spoofing” set forth in section 4c(a)(5)(C) would not capture legitimate trading behavior.<sup>48</sup> In particular, several comment letters also expressed views on whether partial fills should be exempt from the definition of “spoofing.”<sup>49</sup>

## 2. Commission Guidance

New CEA section 4c(a)(5)(C) prohibits any trading, practice, or conduct that “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).” To violate section 4c(a)(5)(C), a market participant must act with some degree of intent, or scienter, to engage in the “spoofing” trading practices prohibited by section 4c(a)(5)(C). In the view of the Commission, a 4c(a)(5)(C) “spoofing” violation requires that a person intend to cancel a bid or offer before execution; therefore, the Commission believes that reckless trading, conduct, or practices will not result in violations of section 4c(a)(5)(C).<sup>50</sup> Furthermore, orders, modifications, or cancellations will not

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<sup>46</sup> See, e.g., John J. Lothian at 82 (referring to spoofing as “a very undefined type of term within the industry”).

<sup>47</sup> See, e.g., Chopper Trading at 3 (“The Commission must consider that spoofing does not have a generally understood definition in the futures markets.”).

<sup>48</sup> See, e.g., CME Group at 8 (“The statute’s definition of ‘spoofing’ as ‘bidding or offering with the intent to cancel the bid or offer before execution,’ is too broad and does not differentiate legitimate market conduct from manipulative conduct that should be prohibited. The distinguishing characteristic between ‘spoofing’ that should be covered by paragraph (C) and the legitimate cancellation of other unfilled or partially filled orders is that ‘spoofing’ involves the intent to enter non bona fide orders for the purpose of misleading market participants and exploiting that deception.”); HETCO at 7 (“The Commission should describe, with specificity, what trade practices constitute spoofing, particularly where this is not a concept familiar to the markets for commodities and derivatives.”); ICE at 8 (generally discussing the practice of “spoofing” as defined in paragraph (C) of Section 747 may capture legitimate trading behavior).

<sup>49</sup> See, e.g., API at 14 (“The Commission has requested comment on whether a “partial fill of an order . . . necessarily exempts that activity from being defined as ‘spoofing.’ The answer is yes.”); HETCO at 8 (“A partial fill of an order or series of orders should *not* exempt the activity described above from being defined as ‘spoofing.’”).

<sup>50</sup> Similar to violations under section 4c(a)(5)(B), accidental or negligent trading, practices, and conduct will not constitute violations of section 4c(a)(5)(C).

be classified as “spoofing” if they were submitted as part of a legitimate, good-faith attempt to consummate a trade. Thus, the legitimate, good-faith cancellation of partially filled orders would not violate section 4c(a)(5)(C). However, a partial fill does not automatically exempt activity from being classified as “spoofing.” When distinguishing between legitimate trading involving partial executions and “spoofing” behavior, the Commission will evaluate the market context, the person’s pattern of trading activity (including fill characteristics), and other relevant facts and circumstances. For example, if a person’s intent when placing a bid or offer was to cancel the entire bid or offer prior to execution, regardless of whether such bid or offer was subsequently filled, that conduct may violate section 4c(a)(5)(C). Accordingly, under this interpretation, section 4c(a)(5)(C) will not capture legitimate trading.

This “spoofing” prohibition covers bid and offer activity on all registered entities, including all regulated futures, options, and swap execution facilities, including all bids and offers in pre-open periods or during other exchange-controlled trading halts. “Spoofing” also includes, but is not limited to: (i) submitting or cancelling bids or offers to overload the quotation system of a registered entity, (ii) submitting or cancelling bids or offers to delay another person’s execution of trades; and (iii) submitting or cancelling multiple bids or offers to create an appearance of false market depth.<sup>51</sup> However, the “spoofing” provision is not intended to cover non-executable market communications such as requests for quotes and other authorized pre-trade communications.

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<sup>51</sup> See, e.g., Trillium Brokerage Services, LLC, Letter of Acceptance, Waiver and Consent, No. 2007007678201, from the Financial Industry Regulatory Authority (“FINRA”) (issued September 12, 2010) for a discussion of a “spoofing” case involving an illicit high frequency trading strategy. Under their “spoofing” strategy, Trillium entered numerous layered, non-bona fide market moving orders to generate selling or buying interest in specific stocks. By entering the non-bona fide orders, often in substantial size relative to a stock’s overall legitimate pending order volume, Trillium traders created a false appearance of buy- or sell-side pressure. This trading strategy induced other market participants to enter orders to execute against limit orders previously entered by the Trillium traders. Once their orders were filled, the Trillium traders would then immediately cancel orders that had only been designed to create the false appearance of market activity. The Letter of Acceptance, Waiver and Consent and accompanying press release from FINRA can be accessed at <http://www.finra.org/Newsroom/NewsReleases/2010/P12195>.

As with other intent-based violations, the Commission distinguishes between legitimate trading and “spoofing” by evaluating all of the facts and circumstances of each particular case, including a person’s trading practices and patterns. Notably, a section 4c(a)(5)(C) violation does not require a pattern of activity, even a single instance of trading activity can be disruptive of fair and equitable trading.

Issued in Washington, DC on February 24, 2011, by the Commission.



David A. Stawick,  
Secretary of the Commission

Appendices to Antidisruptive Practices Authority—Commission Voting Summary; Statements of Commissioners; List of Roundtable Participants and Commenters

#### Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn, Chilton and O’Malia voted in the affirmative; Commissioner Sommers voted in the negative.

#### Appendix 2—Statement of Chairman Gary Gensler

I support the proposed interpretive order regarding disruptive practices on designated contract markets or swap execution facilities. Congress expressly prohibited three trading practices that it deemed were disruptive of fair and equitable trading. Today’s order provides additional guidance to market participants and the public on the trading, practices and conduct that violate these statutory provisions. The order also addresses comments received by the Commission at the December 2<sup>nd</sup> roundtable and in response to the Advanced Notice of Proposed Rulemaking on disruptive trading practices. The order addresses the comments by clarifying how the Commission will interpret and implement the provisions of Section 747. I look forward to hearing from the public in response to this proposed interpretive order. The comment letters and staff roundtable were extremely helpful in formulating this proposed order.

## Appendix III

### DECEMBER 2, 2010 CFTC STAFF ROUNDTABLE ON DISRUPTIVE TRADING PRACTICES

- I. Panel One: Opportunities and Challenges to Fair and Equitable Trading**
    - i. Ensuring Fair and Equitable Trading at the Close**
    - ii. Exploring “the character of” Spoofing**
  - a. Panelists: John Hyland – U.S. Natural Gas Fund; Rajiv Fernando – Chopper Trading LLC; Adam Nunes – Hudson River Trading Group; Cameron Smith – Quantlab Financial, LLC; Liam Connell – Allston Trading, LLC; Don Wilson – DRW Trading Group; Joel Hasbrouck – New York University; Gary DeWaal – Newedge USA, LLC; Mark Fisher – MBF Clearing Corp; John Lothian – John J. Lothian & Company
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- II. Panel Two: Rules “Reasonably Necessary” to Prohibit Disruptive Trading**
  - a. Panelists: Tom Gira – Financial Industry Regulatory Authority; Chris Heymeyer – National Futures Association; Ike Gibbs – ConocoPhillips; Dean Payton – Chicago Mercantile Exchange; Mark Fabian – IntercontinentalExchange; Joe Mecane – New York Stock Exchange; Greg Mocek – McDermott Will & Emery; Ken Raisler on behalf of Futures Industry Association – Sullivan and Cromwell LLP; Micah Green – Patton Boggs LLP; Tyson Slocum – Public Citizen; Andrew Lo – Massachusetts Institute of Technology
- 
- III. Panel Three: Exchange Perspectives on Disruptive Trading; Potential New Disruptive Trading Practices**
  - a. Panelists: Tom Gira – Financial Industry Regulatory Authority; Chris Heymeyer – National Futures Association; Dean Payton – Chicago Mercantile Exchange; Mark Fabian – IntercontinentalExchange; Joe Mecane – New York Stock Exchange; Andrew Lo – Massachusetts Institute of Technology



## Appendix IV

### Parties Submitting Comment Letters in Response to Disruptive Trading Practices ANPR:

A. Flachman  
American Petroleum Institute (API)  
Argus Media, Inc. (Argus)  
Better Markets (BM)  
Bix Weir  
Chopper Trading, LLC (Chopper Trading)  
CME Group, Inc. (CME Group)  
Commodity Markets Council (CMC)  
David S. Nichols  
DeWitt Brown  
Edison Electric Institute (EEI)  
Emilie Laurant  
Futures Industry Association (FIA)  
Hess Energy Trading Company, LLC (HETCO)  
IntercontinentalExchange, Inc., and ICE Futures U.S., Inc. (collectively, ICE)  
International Swaps and Derivatives Association, Inc. (ISDA)  
Investment Company Institute (ICI)  
Managed Funds Association (MFA)  
Minneapolis Grain Exchange, Inc. (MGEX)  
Newedge USA, LLC (Newedge USA)  
Nicole Provo  
Peter J. Carini  
Petroleum Marketers Association of America (PMAA)  
Rebecca Washington  
Securities Industry and Financial Markets Association (SIFMA)  
U.S. Senator Carl Levin  
West Virginia Oil Marketers & Grocers Association (OMEGA)  
Working Group of Commercial Energy Firms (CEF)