

MEMO# 27269

June 4, 2013

CFTC Issues Final Interpretive Guidance and Policy Statement Regarding Anti-Disruptive Practices Authority

[27269]

June 4, 2013

TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 45-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 40-13
INVESTMENT ADVISER MEMBERS No. 34-13
SEC RULES MEMBERS No. 50-13 RE: CFTC ISSUES FINAL INTERPRETIVE GUIDANCE AND
POLICY STATEMENT REGARDING ANTI-DISRUPTIVE PRACTICES AUTHORITY

Recently, the Commodity Futures Trading Commission (“CFTC” or “Commission”) issued its Final Interpretive Guidance and Policy Statement regarding implementation of Section 747 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), which amends Section 4c of the Commodity Exchange Act (“CEA”) to prohibit certain disruptive trading, practices, and conduct. [\[1\]](#) The Final Interpretive Guidance aims to provide guidance on the scope and application of the CEA’s prohibitions on anti-disruptive practices. [\[2\]](#) The Commission’s Guidance on anti-disruptive practices will apply to all those who trade on or subject to the rules of a “registered entity,” including designated contract markets (“DCMs”), swap execution facilities (“SEFs”), swap data repositories (“SDRs”), and derivatives clearing organizations (“DCOs”). [\[3\]](#) A summary of the final interpretive guidance is provided below.

The New Anti-Disruptive Prohibitions

In response to Dodd-Frank’s goal of promoting market integrity by enhancing the CFTC’s rulemaking and enforcement authority, new CEA Section 4c(a)(5) broadens the CFTC’s oversight of registered entities and market participants by making it unlawful for any person to engage in any trading, practice, or conduct on a registered financial entity, 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” (defined as

bidding or offering with the intent to cancel the bid or offer before execution). [\[4\]](#)

General Applicability of the Anti-Disruptive Prohibitions

The Commission provided final guidance on three areas of general applicability:

- **Applicability beyond Order Book Functionality** - Under the CFTC's final guidance, any trade executed on, or subject to, the rules of a registered entity (such as a DCM or SEF) is governed by Section 4c(a)(5). The CFTC further clarified that, although SDRs are registered entities, Section 4c(a)(5) would not apply to SDRs. Therefore, transactions executed off-exchange do not become subject to the anti-disruptive practices authority as a result of being reported to an SDR.
- **No General Manipulative Intent Requirement** - The CFTC took the view that including a manipulative intent requirement in the anti-disruptive practices authority was contrary to the statutory language of the Dodd-Frank Act, which has a separately codified set of provisions for the CFTC's anti-manipulation authority. [\[5\]](#)
- **Applicability to Block Trades and Exchanges for Related Positions** - the CFTC clarified that the anti-disruptive practices authority will not apply to either block trades or exchanges for related positions, provided that they are transacted in accordance with Commission Regulation 1.38.

Violating Bids and Offers - Section 4c(a)(5)(A)

- **No Intent Requirement** - According to the CFTC, the prohibition on violating bids and offers is a per se offense. Therefore, the CFTC need not show that a market participant acted with scienter in violating bids or offers. The CFTC, however, clarified that it does not intend to exercise its anti-disruptive authority against accidental one-off violations of the prohibition against violating bids and offers.
- **Algorithmic Trading** - The CFTC confirmed that the prohibition against violating bids and offers does not apply in a trading environment where a person is utilizing trading algorithms that automatically match the best price for bids and offers.
- **Swaps Trading** - The CFTC interpreted Section 4c(a)(5)(A) as applying only to cleared swaps activity executed on an SEF's or DCM's "order book" to address concerns that the prohibition may capture trading activity by market participants considering a number of factors beyond price when trading or executing less liquid swaps (such as credit risk posed by the parties). Therefore, non-cleared swaps activity is not covered by the prohibition, irrespective of whether it is transacted on or through a registered entity such as an SEF. Additionally, the CFTC interpreted the prohibition as not applying to swaps that would be cleared at different clearing houses, as parties may validly consider the cost, credit risk, and material clearing features of different clearing houses when taking into consideration bid/ask prices.
- **No Best Execution Standard** - The CFTC declined to interpret Section 4c(a)(5)(A) as creating a best-execution standard across multiple registered entities, as it would require market participants to search across all registered facilities to ensure they are compliant with the requirement of bidding or offering at the best price on a particular instrument. Therefore, a market participant's obligation to not violate bids or offers applies only to the specific registered entity being utilized at the time.

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

- Intent – The CFTC clarified that the standard of intent required for a Section 4c(a)(5)(B) violation is recklessness. The Final Interpretive Guidance defines recklessness 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.” [\[6\]](#)
- Defining “Closing Period” - The Commission adopted the definition of “closing period” as “the period in the contract or trade when the settlement price is determined under the rules of a trading facility” such as a DCM or SEF. [\[7\]](#) The Commission adopted the policy that conduct outside the closing period may constitute a violation of Section 4c(a)(5)(B), citing the example of a trader accumulating a large position in a product in the period immediately preceding the closing period with the intent (or reckless disregard) to disrupt the orderly execution of transactions during that product’s closing period.
- Clarifying Market Disruption –The Commission stressed its intent to consider the “totality of facts and circumstances” that surround a potential violation of Section 4c(a)(5)(B), placing particular emphasis on the knowledge or information known or available to individuals engaged in the relevant trading, practices, or conduct.
- Defining “Orderly Execution” – In determining whether trading, practices or conduct disrupt the orderly execution of transactions during the closing period, the Commission stated that it will be guided by the definition of an “orderly market” as developed through judicial precedent. The Final Interpretive Guidance cited factors such as a “rational relationship between consecutive prices,” reasonable spreads between contracts,” “levels of volatility that do not dramatically reduce liquidity,” and accurate relationships between the price of a derivative and the underlying as characteristics of an orderly market. [\[8\]](#)
- Disruptive Bids and Offers – The Commission affirmed that, in addition to executed orders, bids and offers submitted by market participants that disrupt the orderly execution of transactions during the closing period constitute a Section 4c(a)(5)(B) violation.

Spoofing - Section 4c(a)(5)(C)

- Intent – The Commission reaffirmed that a person must intend to cancel a bid or offer prior to execution to violate this section. Therefore, reckless trading, practices, or conduct would not constitute a “spoofing” violation. The Commission noted that legitimate cancellations or modifications of orders – such as partially filled orders or properly placed stop-loss orders – would not violate Section 4c(a)(5)(C), although partial fills may be subject to scrutiny as “spoofing” behavior.
- Preventing Capture of Legitimate Trading - In distinguishing legitimate trading from “spoofing”, the Commission stated that it intends to evaluate the market context, pattern of trading activity, and surrounding facts and circumstances of trading activity. The Commission provided four non-exclusive examples of situations in which market participants are engaged in “spoofing” behavior:
 - Submitting or cancelling bids or offers to overload the quotation system of a registered entity.
 - Submitting or cancelling bids or offers to delay another person’s execution of trades.
 - Submitting or cancelling multiple bids or offers to create an appearance of false

market depth.

- Submitting or cancelling bids or offers with intent to create artificial price movements upwards or downwards. [9]

Sarah A. Bessin
Senior Counsel

endnotes

[1] Final Interpretive Guidance and Policy Statement, Antidisruptive Practices Authority, available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister051613d.pdf> ("Final Interpretive Guidance").

[2] Proposed Interpretive Order, Antidisruptive Practices Authority, 76 FR 14943 (Mar. 18, 2011).

[3] Section 1a(40) of the CEA defines "registered entity" as "(A) a board of trade designated as a contract market under section 5; (B) a derivatives clearing organization registered under section 5b; (C) a board of trade designated as a contract market under section 5f; (D) a swap execution facility registered under section 5h; (E) a swap data repository registered under section 21; and (F) with respect to a contract that the Commission determines is a significant price discovery contract, any electronic trading facility on which the contract is executed or traded." 7 U.S.C. 1a(40).

[4] 7 U.S.C. 4c(a)(5)(A)-(C).

[5] See Section 753 of the Dodd-Frank Act.

[6] Final Interpretive Guidance at 19 (citing *Drexel Burnham Lambert, Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1988)).

[7] *Id.* at 20. The Final Interpretive Guidance cites examples of the closing period as 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).

[8] *Id.* at 22.

[9] *Id.* at 25.