SULLIVAN & CROMWELL LLP

# *Dodd-Frank Disruptive Trading Provisions:*

# *CFTC Provides Final Interpretive Guidance*

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# Overview

- Section 747 of Dodd-Frank amended CEA § 4c(a) to add a new section (§ 4c(a)(5)) making it unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that:
  - Violates bids or offers;
  - Demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period ("banging the close"); or
  - 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).

# *Overview*

*(continued)*

- On March 18, 2011, the CFTC issued a Proposed Interpretive Order ("Proposed Order") explaining how it plans to interpret the new disruptive trading prohibitions. The CFTC requested comment on all aspects of the Proposed Order. The Comment Period closed on May 17, 2011.
- More than two years later, on May 16, 2013, the CFTC held an open meeting, during which it considered final interpretive guidance on the disruptive trading provisions. In very brief testimony, Director of Enforcement David Meister answered questions regarding the proposed final guidance.

# *Final Interpretive Guidance*

- The CFTC unanimously approved the final interpretive guidance proposed by the Enforcement Division.
- The final guidance largely adopts the interpretations in the CFTC's Proposed Order.
    - *Section 4c(a)(5)(A)* – ***Per se*** offense to violate bids or offers. No requirement of manipulative intent or other scienter.
    - *Section 4c(a)(5)(B)* – Prohibits ***reckless disregard*** for the orderly execution of transactions during the closing period. Conduct outside the closing period can be a violation.
    - *Section 4c(a)(5)(C)* – Prohibits "spoofing," i.e., an ***intent*** to cancel a bid or offer before execution.

# Final Interpretive Guidance

*(continued)*

- Final guidance first addresses general applicability of CEA Section 4c(a)(5).
  - The CFTC refused to interpret provisions as applying only to platforms that have order book functionality.
  - The CFTC refused to read a manipulative intent requirement into the prohibitions: "The Commission interprets the prohibitions in CEA section 4c(a)(5) to be distinct statutory provisions from the anti-manipulation provisions in section 753 of the Dodd-Frank Act . . . ."
  - Provisions apply to any trading, practices, or conduct on a registered entity, such as a DCM or SEF. They apply not only to swaps, but to futures, options, and activity on any CFTC-registered entity.
  - The CFTC "does not intend to apply CEA section 4c(a)(5)" to **block trades** or **exchange for related positions** transacted in accordance with Commission regulation 1.38.

# *“Violates Bids or Offers”*

- The final guidance adopts the Proposed Order’s substantive interpretation of violating bids or offers: “buying a contract on a registered entity at a price that is **higher than the lowest available offer price** . . . or selling a contract on a registered entity at a price that is **lower than the highest available bid price**.”
- The CFTC interprets Section 4c(a)(5)(A) as a **strict liability** offense: “The Commission declines to interpret CEA section 4c(a)(5)(A) as applying only where a person intends to disrupt fair and equitable trading. The Commission interprets CEA section 4c(a)(5)(A) as a *per se* offense.”

# "Violates Bids or Offers"

*(continued)*

- Despite the interpretation that this is a *per se* offense, the CFTC states in the final guidance that it does not intend to exercise its enforcement discretion against an "individual who, purely by accident, makes a one-off trade in violation of CEA section 4c(a)(5)(A)."
  - Whether an "accidental" violation warrants lenient treatment or violates other provisions of the CEA will depend on the facts and circumstances.
- Final guidance includes other interpretive limitations:
  - Section 4c(a)(5)(A) operates in any trading environment where a person is not using trading algorithms that automatically match the best price for bids and offers.
  - With respect to SEFs, Section 4c(a)(5)(A) applies only when a person is using a SEF's order book. The provision does not apply to other execution methods (e.g., the RFQ system in conjunction with the order book).

# *"Violates Bids or Offers"*

*(continued)*

- Other limitations (*continued*):
  - Section 4c(a)(5)(A) does not apply to non-cleared swap transactions, even if they are transacted on or through a registered entity.
  - Section 4c(5)(A) does not apply to bids or offers on swaps that would be cleared at different clearing houses, because each clearing house may have different cost, risk, and material clearing features.
  - The CFTC will not interpret the statute to prohibit "buying the board," i.e., executing a series of trades to buy all available offers or sell all available bids on an order book in accordance with the rules of the facility.

# *"Disregard for the Orderly Execution of Transactions During the Closing Period"*

- Section 4c(a)(5)(B) applies to any trading, conduct, or practices that demonstrate an intentional or reckless disregard for the orderly execution of transactions during the closing period.
- **Recklessness standard.** Prior to Dodd-Frank, CFTC had to prove specific intent to bang the close. The CFTC now needs only to prove recklessness. Intent is also sufficient, but not necessary, to constitute a violation.
  - The CFTC rejected "extreme recklessness" or "manipulative intent" standard.
  - Accidental or negligent trading practices or conduct will not be a sufficient basis to violate Section 4c(a)(5)(B).
  - The CFTC will use the "well-established" standard of recklessness: 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."
- In determining whether a violation has occurred, the CFTC will evaluate all **facts and circumstances**, including what the person knew or should have known, his or her trading patterns, and the market context.

# *"Disregard for the Orderly Execution of Transactions During the Closing Period"*

*(continued)*

- When is the "**closing period**?"
  - Final guidance defines "closing period" "generally 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."
  - 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.
    - The CFTC interprets a swap as subject to this provision if a DCM or SEF determines that a settlement or pricing period exists for the particular swap.

**BUT . . . .**

# *"Disregard for the Orderly Execution of Transactions During the Closing Period"*

*(continued)*

- The CFTC's policy is that conduct **outside the closing period** may still form the basis of a violation.
- Violations may include not only **executed orders** that disrupt execution during the closing period, but also and **bids/offers** that disrupt fair and equitable trading during the closing period.
- Commission will be guided (but not controlled) by case law applying concepts of orderly securities markets.
- Orderly markets are characterized by, among other things:
  - Rational relationships between consecutive prices;
  - Strong correlation between price changes and volume of trades;
  - Levels of volatility that do not materially reduce liquidity;
  - Accurate relationships between prices of derivatives and the underlying commodity; and
  - Reasonable spreads between contracts for near months and for remote months.

# “Spoofing”

- Section 4c(a)(5)(C), the anti-spoofing provision, covers bid and offer activity on all registered entities, including all regulated futures, options and swap execution activities. **Includes all bids and offers in pre-open periods or during other exchange-controlled trading halts**.
- Final guidance provides four non-exclusive examples of prohibited spoofing:
  - 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; and
  - Submitting or cancelling bids or offers with intent to create artificial price movements upwards or downwards.

# "Spoofing"

*(continued)*

- Market participants must act with **some degree of intent** to cancel a bid or offer before execution. Recklessness or negligence is not enough.
- The CFTC will consider market context, person's trading activity, and all other relevant facts and circumstances. A single cancellation can violate the "spoofing" prohibition—there is no "pattern" requirement.
- Orders, modifications and cancellations will not be considered "spoofing" if submitted as part of a **legitimate, good faith attempt to consummate a trade** (e.g., properly placed stop-loss orders).
- However, partial fill does not automatically exempt activity from being classified as "spoofing."
- David Meister commented at the open meeting that it is not a defense if the order is ultimately executed. The offense is complete at the time the order is placed. This nuance is not in the Final Guidance.

# "Spoofing"

*(continued)*

- Spoofing can occur on any trading platform or venue where a market participant has the ability either to send executable bids and offers to market participants, or transact against resting orders.
- Spoofing prohibition not limited to trading platforms and venues only having order book functionality.
- **Not intended** to cover non-executable market communications, *e.g.*, RFQs and other authorized pre-trade communications.
- Question at open meeting regarding the following practices: strobing; priority positioning (or laddering); front-running. The CFTC's interpretation is not entirely clear how the anti-spoofing provision will affect these practices.

# Q&A

Please use the chat window to send in questions.

If your question is not answered in this session, please email:

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