FIA Webinar: CME Group Rule 575

Disruptive Practices Prohibited

CME Group Market Regulation Department

September 11, 2014

CME Group

Rule 575 Disruptive Practices Prohibited

Providing clarity to the marketplace of conduct prohibited in CME Group's markets.

CME Group Webinar Participants:

Tom LaSala – Managing Director, Chief Regulatory Officer

Steven Schwartz – Executive Director, Global Head of Enforcement

Andrew Vrabel – Executive Director, Global Head of Investigations

Webinar Agenda

1. Historical perspective of disciplinary actions brought in “disruptive trading” cases

2. Origin of Rule 575

3. Discussion of key aspects of Rule 575 and its associated MRAN

4. Questions & Answers

Rule 575 Disruptive Practices Prohibited

DISCLAIMER:

Rule 575 is currently pending Commission review. Absent a stay of the certification of the rule, it is expected to become effective September 15, 2014. Any amendments to the rule prior to its effective date could result in a delay of the rule's effective date.

A Historical Perspective of Disruptive Trading Actions

The enumerated practices in CFTC rule 38.152 "Abusive Trading Practices Prohibited," which includes the prohibition against disruptive trading practices under the Act, "are commonly prohibited within the industry and are typically already prohibited in DCM rulebooks."

Core Principles and Other Requirements for Designated Contract Markets, 77 FR 36612-01 (June 19, 2012)

Existing Exchange Rules

432. GENERAL OFFENSES

It shall be an offense:

B. 1. to engage in fraud or bad faith; 2. to engage in conduct or proceedings inconsistent with just and equitable principles of trade;

H. to engage in, or attempt to engage in, the manipulation of prices of Exchange futures or options contracts; to corner or squeeze, or attempt to corner or squeeze, the underlying cash market; or to purchase or sell, or offer to purchase or sell Exchange futures or options contracts, or any underlying commodities or securities, for the purpose of upsetting the equilibrium of the market or creating a condition in which prices do not or will not reflect fair market values;

Q. to commit an act which is detrimental to the interest or welfare of the Exchange or to engage in any conduct which tends to impair the dignity or good name of the Exchange;

T. to engage in dishonorable or uncommercial conduct;

W. for any party to fail to diligently supervise its employees and agents in the conduct of their business relating to the Exchange;

Disciplinary actions for disruptive trading activity date as far back as 2002:

FINDINGS:	Waters misled other market participants when he entered E-Mini Standard & Poor's 500 Stock Price Index® futures buy orders for an excessively large quantity, and subsequently canceled the majority of those orders. Further, the Panel found that, if executed, a position of that size may have posed an excessive risk to Waters and his qualifying firm. The Panel found that in so doing, Waters committed two violations of CME Rule 433.b, both minor offenses.
PENALTY:	In accordance with the settlement offer, the Panel fined Waters $10,000 for placing misleading bids and $10,000 for exposing his qualifying firm to an excessive risk.
EFFECTIVE DATE:	October 28, 2002

Recent Disruptive Trading Disciplinary Actions

SPOOFING EXAMPLES:

1. CBOT/CME/NYMEX/COMEX 11-8581-BC
   $800,000 fine; $1.3 million disgorgement; and 6 month suspension

2. CBOT 0-7960-BC
   $140,000 fine and $5,000 disgorgement

3. CME 10-7599-BC
   $155,000 fine and 2 month suspension/membership ban

4. CBOT 12-8931-BC
   $65,000 fine and 12 month suspension

ALGORITHM EXAMPLES:

1. NYMEX 10-7565-BC / CME 09-06562-BC -- $850,000 fine
   ATS malfunction causing price and volume aberrations

2. NYMEX 11-08535-BC -- $150,000 fine
   ATS malfunction resulting in volume aberrations and improper cross-trades

3. NYMEX 11-08420-BC -- $250,000 fine
   ATS left running unattended when it should have been turned off causing disruptive price movements

4. CME 10-06741-BC -- $150,000 fine
   ATS malfunction caused volume aberrations and significant self-matches

5. COMEX 13-9340-BC -- $90,000 fine
   Auto-spreader streamed price modifications and looping behavior thereby compromising the audit trail

Recent Disruptive Trading Disciplinary Actions

In the last 3 years, the CME Group exchanges have brought >40 disciplinary actions under the general provisions of Rule 432 for conduct that was of the nature of spoofing, misleading, or intentionally/recklessly disruptive.

Origin of Rule 575

Section 747 of the Dodd-Frank Act added subparagraph (5) to Section 4c(a) of the Commodity Exchange Act, which provides:

(5) DISRUPTIVE PRACTICES – 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).

CME Group

Craig S. Donohue
Chief Executive Officer

VIA ELECTRONIC MAIL

January 3, 2011

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
secretary@cftc.gov

Re: Advanced Notice of Proposed Rulemaking on Disruptive Trading Practices – RIN #: 3038-AD26

Dear Mr. Stawick:

In order to effectively implement Section 747, the Commission must first promulgate rules that give market participants appropriate notice of the specific trading practices which run afoul of Section 747.

. . .

It is imperative that the Commission provide additional clarity regarding what conduct is proscribed by paragraphs 5(A-C) in Section 747.

. . .

Rule 575 Disruptive Practices Prohibited

Providing the marketplace notice of prohibited conduct in CME Group's markets through:

- Rule 575
- 22 Comprehensive Questions & Answers
- Non-Exhaustive List of Examples

Rule 575 Disruptive Practices Prohibited

Introductory Paragraph

All orders must be entered for the purpose of executing bona fide transactions. Additionally, all non-actionable messages must be entered in good faith for legitimate purposes.

. . .

Rule 575 Disruptive Practices Prohibited

Sub-part A:

No person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution;

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Sub-part B:

No Person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to mislead other market participants;

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Sub-part C:

No Person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to overload, delay, or disrupt the systems of the Exchange or other market participants;

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Sub-part D:

No person shall enter or cause to be entered an actionable or non-actionable message with intent to disrupt, or with reckless disregard for the adverse impact on, the orderly conduct of trading or the fair execution of transactions.

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Concluding Paragraph

To the extent applicable, the provisions of this Rule apply to open outcry trading as well as electronic trading activity. Further, the provisions of this Rule apply to all market states, including the pre-opening period, the closing period and all trading sessions.

Questions & Answers

- Lists factors that may be considered in assessing whether a violation has been committed
- Addresses key terms and definitions within the rule
- Identifies certain bona fide practices
- Identifies certain non-bona fide practices

Questions & Answers

Factors that Market Regulation may consider in assessing a potential violation of Rule 575:

- **Market conditions**
- **Subject's pattern of activity:**
  - **Historical trading behavior;**
  - **Order entry & cancellation activity, including order duration;**
  - **Queue position;**
  - **Size of the orders relative to market conditions;**
  - **Ability to manage risk associated with orders**
- **Subject's activity in related markets**
- **Effect on other market participants**
- **Other circumstantial evidence demonstrating intent**

Questions & Answers

Factors demonstrating whether an act was done with the prohibited intent or reckless disregard of the consequences:

- Proof of intent is not limited to instances in which a market participant admits its state of mind.
- Where the conduct was such that it more likely than not was intended to produce a prohibited disruptive consequence without justification, intent may be found.
- Claims of ignorance, or lack of knowledge, are not acceptable defenses to intentional or reckless conduct.
- Recklessness has been commonly 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." *See* Drexel Burnham Lambert, Inc. v. CFTC*,* 850 F.2d 742, 748 (D.C. Cir. 1988).

Questions & Answers

The Q&A articulates Rule 575.D.'s prohibition related to intentional/reckless conduct that affects the "orderly conduct of trading or the fair execution of transactions."

- Evaluated in the context of the specific instrument, market conditions, and other circumstances present at the time in question.
- Some factors that may be considered include:
  - relationship between consecutive prices;
  - correlation between price changes and the volume of trades;
  - levels of volatility that do not dramatically reduce liquidity;
  - relationships between the price of a derivative and the underlying; and
  - reasonable spreads between near months and deferred.

Questions & Answers

Other important concepts from the Q&A:

- Market participants should be cognizant of the market characteristics of the products they trade and ensure that their order entry activity does not result in market disruptions.

- Momentum ignition practices may be deemed to violate Rule 575 if the momentum igniting orders were intended to be canceled before execution, or if the orders were intended to mislead others, or if it is determined the intent was to disrupt the orderly conduct of trading or the fair execution of transactions, if the conduct was reckless, or if the conduct distorted the integrity of the determination of settlement prices.

- Aggressively turning the market after an order cancelation (described as “flipping”) may be considered disruptive to the orderly conduct of trading or the fair execution of transactions.

Final Overview

- Disruptive practices, such as those detailed in proposed Rule 575, have always been prohibited by the CME Group exchanges, and have been prosecuted under the general provisions of Rule 432.
- Proposed Rule 575 provides specific guidance on certain practices that are prohibited and how the CME Group exchanges will assess whether a market participant has violated Rule 575.
- Disruptive practices occurring prior to the effective date of Rule 575 will continue to be subject to Rule 432.
- Any practices not specifically covered by Rule 575 occurring after the effective date will continue to be subject to other exchange rules, including Rule 432.

Questions?

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