Comments Sought on Proposed Interpretive Order on Disruptive Practices Due May 17

March 18, 2011

The Commodity Futures Trading Commission's (Commission) Proposed Interpretive Order on Disruptive Practices (Proposed Order) announced during the Commission's February 24, 2011, open meeting was published today in the Federal Register. Parties have until May 17, 2011 to file comments. The Commission contemporaneously issued a Notice of Termination ending the Commission's Advance Notice of Proposed Rulemaking on Antidisruptive Practices Authority.

The Proposed Order is intended to provide guidance to market participants regarding compliance with new section 4c(a)(5) of the Commodity Exchange Act (CEA), which prohibits market participants from (i) violating bids and offers; (ii) demonstrating intentional or reckless disregard for the orderly execution of transactions during the closing period; and (iii) spoofing.

As a threshold matter, the Proposed Order expressly acknowledges that the section 4c(a)(5) prohibitions do not apply to ex-pit and off-exchange transactions, including "block trades or exchanges for related positions ('EFRPs') transacted in accordance with the rules of a designated contract market or [Swap Execution Facility] or bilaterally negotiated swap transactions." (Proposed Order at ¶ 14945)

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

The Commission interprets section 4c(a)(5)(A) as proscribing the practice of buying a contract at a price that is higher than the lowest available offer price or selling a contract at a price that is lower than the highest available bid price. Under the Proposed Order, any such transaction would be a *per se* offense regardless of the trader's intent so long as the trader exercises some control over the selection of bids or offers against which they transact. As such, the prohibition should not apply to trading on an electronic trading system that uses algorithms to automatically match bids and offers, but it will apply to automated trading systems that operate without predetermined matching algorithms.

The Commission clarifies that the prohibition "does not create any sort of best execution standard across multiple trading platforms and markets." (Proposed Order at ¶ 14946) Instead, the Commission explains that "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." (Proposed Order at ¶ 14946)

The Commission also clarifies that section 4c(a)(5)(A) does not prohibit executing a sequence of trades to buy all available bids or offers on a trading platform ("buying the board") in accordance with the rules of the facility.

2. Trading During the Closing Period (Section 4c(a)(5)(B))

Section 4c(a)(5)(B) makes it unlawful for any person to "demonstrate[] intentional or reckless disregard for the orderly execution of transactions during the closing period." Acknowledging the scienter requirement included in section 4c(a)(5)(B), the Commission concludes that accidental, or even negligent, trading conduct and practices will not constitute a violation under this section. (Proposed Order at ¶ 14946)

The Commission interprets the "closing period" to generally include "the period in the contract or trade when the daily settlement price is determined under the rules of that trading facility." (Proposed Order at ¶ 14946) With regard to swaps executed on a Swap Execution Facility, the Commission will apply section 4c(a)(5)(B) to any swap for which a closing period or daily settlement price exists.

Although the Commission states that it interprets the prohibition to include trading, conduct, or practices transpiring during the closing period, it asserts that "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," and it will assess orders and trades in the time periods prior to and during the closing period. (Proposed Order at ¶ 14946)

The Commission provides the following non-exhaustive recitation of the characteristics of an orderly market:

- 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.

(Proposed Order at ¶ 14946)

Finally, noting market participants' familiarity with notions of orderly commodities and securities markets in the context of market manipulation and risk management, the Commission warns participants to assess market conditions and consider the impact of their conduct on the orderly execution of transactions during the closing period.

3. Spoofing (Section 4c(a)(5)(C))

Section 4c(a)(5)(C) prohibits "spoofing," which the statute defines as "bidding or offering with the intent to cancel the bid or offer before execution." The Commission recognizes the specific intent requirement and concludes that a spoofing violation requires "that a person intend to cancel a bid or offer before execution." (Proposed Order at ¶ 14947) The Commission believes recklessness will not result in a violation of section 4c(a)(5)(C), and 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." (Proposed Order at ¶ 14947)

Although the Commission clarifies that the legitimate, good-faith cancellation of partially filled orders would not constitute spoofing, it warns that a partial fill will not automatically exempt activity from being classified as spoofing. The Commission also concludes that spoofing "is not intended to cover non-executable market communications such as requests for quotes and other authorized pre-trade communications."

The Commission clarifies that spoofing includes bids and offers in pre-open periods and during "other exchange-controlled trading halts," and offers the following examples of non-legitimate purposes for placing or cancelling orders:

- To overload the quotation system of a registered entity;
- To delay another person's execution of trades; or
- To create an appearance of false market depth.

(Proposed Order at ¶ 14947)

Finally, the Commission notes that no pattern of activity is required for a section 4c(a)(5)(C) violation; rather, a single instance of trading activity can disrupt fair and equitable trading.

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