

COMMODITY FUTURES TRADING COMMISSION

RIN 3038-AD96

Antidisruptive Practices Authority

AGENCY: Commodity Futures Trading Commission.

ACTION: Interpretive guidance and policy statement.

SUMMARY: The Commodity Futures Trading Commission (the “Commission” or “CFTC”) is issuing this interpretive guidance and policy statement (“interpretive statement”) to provide guidance on section 747 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which prohibits certain disruptive trading, practices, or conduct as set forth in new section 4c(a)(5) of the Commodity Exchange Act (the “CEA”). This interpretive statement will provide market participants and the public with guidance on the scope and application of the statutory prohibitions set forth in CEA section 4c(a)(5).

DATES: This interpretive statement will become effective [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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## 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 Consumer Protection Act (“Dodd-Frank Act”).<sup>1</sup> Title VII of the Dodd-Frank Act<sup>2</sup> amended the Commodity Exchange Act (“CEA”)<sup>3</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 doing, among other things, the following: 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 (“Prohibited Transactions”) 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

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<sup>1</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>2</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>3</sup> 7 U.S.C. 1 et seq.

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) of the CEA by granting the Commission authority under new section 4c(a)(6) of the CEA to promulgate such “rules and regulations as, in the judgment of the Commission, are reasonably necessary to prohibit the trading practices” enumerated therein “and any other trading practice that is disruptive of fair and equitable trading.”<sup>4</sup>

The Commission is issuing this interpretive guidance and policy statement (“interpretive statement”) to provide market participants and the public with guidance on the manner in which it intends to apply the statutory prohibitions set forth in section 4c(a)(5) of the CEA. The public has the ability to present facts and circumstances that would inform the application of these policies.

## **II. Proposed Interpretive Order**

On March 18, 2011, the Commission issued a proposed interpretive order (“Proposed Order”) providing proposed interpretive guidance on the three new statutory provisions of section 4c(a)(5) of the CEA.<sup>5</sup> In the Proposed Order, the Commission stated that CEA section 4c(a)(5) applied to trading, practices, or conduct on registered

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<sup>4</sup> 7 U.S.C. 4(a)(6). At this time, the Commission is only providing interpretive guidance on the disruptive trading, practices, or conduct discussed herein. The Commission does not foreclose subsequent promulgation of rules and regulations pursuant to CEA section 4c(a)(6). The Commission also notes that new CEA section 4c(a)(5) is self-effectuating.

<sup>5</sup> 76 FR 14943 (Mar. 18, 2011). On November 2, 2010, the Commission issued an Advance Notice of Proposed Rulemaking (the “ANPR”) asking for public comment on section 747 of the Dodd-Frank Act. 75 FR 67301 (Nov. 2, 2010). The ANPR formed the basis for a roundtable held on December 2, 2010, by Commission staff in Washington, D.C. The Commission subsequently terminated the ANPR on March 18, 2011. 76 FR 14826 (Mar. 18, 2011).

entities, including designated contract markets (“DCMs”) and swap execution facilities (“SEFs”).<sup>6</sup> The Proposed Order also provided that CEA section 4c(a)(5) would not apply to block trades, bilaterally negotiated swap transactions, or exchanges for related positions (“EFRPs”) transacted in accordance with the rules of a DCM or SEF.<sup>7</sup>

With respect to CEA section 4c(a)(5)(A)’s prohibition on violating bids and offers, the Proposed Order stated that a person is prohibited from buying a contract at a price that is higher than the lowest available offer price and/or from selling a contract at a price that is lower than the highest available bid price.<sup>8</sup> Such conduct, regardless of intent, disrupts the foundation of fair and equitable trading. The Commission further proposed that CEA section 4c(a)(5)(A) was a *per se* offense where the Commission would not be required to show that a person violating bids or offers did so with any intent to disrupt fair and equitable trading.<sup>9</sup>

In the Proposed Order, the Commission also stated that CEA section 4c(a)(5)(A) is applicable in any trading environment where a person exercises some control over the selection of bids and offers against which they transact, including when using an automated trading system that operates without pre-determined matching algorithms.<sup>10</sup> The Commission further explained that CEA 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 using an order matching

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<sup>6</sup> 76 FR at 14945. The Commission also stated that a trade does not become subject to CEA section 4c(a)(5) because it is reported to a swap data repository, even though such swap data repository is a registered entity.

<sup>7</sup> Id. at 14946.

<sup>8</sup> Id.

<sup>9</sup> Id.

<sup>10</sup> Id.

algorithm.<sup>11</sup> The Commission also proposed that CEA section 4c(a)(5)(A) would not apply where an individual is executing a sequence of trades to buy all available bids or sell to all available offers on an order book in accordance with the rules of the facility on which the trades were executed.<sup>12</sup>

In regard to CEA section 4c(a)(5)(B), the provision for orderly execution during the closing period, the Commission interpreted the provisions as requiring that a market participant must at least act recklessly to violate CEA section 4c(a)(5)(B).<sup>13</sup> The Proposed Order stated that accidental, or even negligent trading, is not a sufficient basis for the Commission to claim a violation has occurred under CEA section 4c(a)(5)(B). The Proposed Order also generally defined the closing period as the period in the contract or trade when the settlement price is determined under the rules of that registered entity.<sup>14</sup>

The Proposed Order also explained that while CEA section 4c(a)(5)(B) encompasses any trading, practices, or conduct inside the closing period that affects the orderly execution of transactions during the closing period, disruptive conduct outside the closing period may also form the basis for investigations of potential CEA section 4c(a)(5)(B) violations.<sup>15</sup> Section 4c(a)(5)(B) violations may also include executed orders, as well as bids and offers submitted by market participants for the purpose of disrupting fair and equitable trading.<sup>16</sup>

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<sup>11</sup> Id.

<sup>12</sup> Id.

<sup>13</sup> Id.

<sup>14</sup> Id.

<sup>15</sup> Id.

<sup>16</sup> Id.

When determining whether a person violated CEA section 4c(a)(5)(B), the Commission proposed to evaluate the facts and circumstances as of the time the person engaged in the trading, practices, or conduct.<sup>17</sup> The Commission proposed to use existing concepts of orderliness when assessing whether trades were executed, or orders were submitted, in an orderly fashion in the time periods prior to and during the closing period.<sup>18</sup> The Proposed Order also expressed that market participants should assess market conditions and consider how their trading practices and conduct would affect the orderly execution of transactions during the closing period.<sup>19</sup>

With respect to CEA section 4c(a)(5)(C), the Proposed Order stated that a market participant must act with some degree of intent to violate the “spoofing” provision.<sup>20</sup> Reckless trading, practices, or conduct would not violate CEA section 4c(a)(5)(C); instead, a person must intend to cancel a bid or offer before execution.<sup>21</sup> Additionally, orders, modifications, or cancellations would not be considered “spoofing” if they were submitted as part of a legitimate, good-faith attempt to consummate a trade.<sup>22</sup> While the Proposed Order did not exempt partial fills from CEA section 4c(a)(5)(C), legitimate, good-faith cancellations of partially filled orders would not violate CEA section 4c(a)(5)(C).<sup>23</sup> Similar to the Commission’s proposed approach to CEA section

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<sup>17</sup> Id.

<sup>18</sup> Id.

<sup>19</sup> Id.

<sup>20</sup> Id.

<sup>21</sup> Id.

<sup>22</sup> Id.

<sup>23</sup> Id.

4c(a)(5)(B), the Commission proposed to evaluate the facts and circumstances when distinguishing between legitimate trading and “spoofing” behavior.<sup>24</sup>

Under the Proposed Order, CEA section 4c(a)(5)(C) covers bid and offer activity on all registered entities, including all bids and offers in pre-open periods or during exchange-controlled trading halts. The Proposed Order also provided three non-exclusive examples of “spoofing” behavior.<sup>25</sup> The Commission further proposed that CEA section 4c(a)(5)(C) does not cover non-executable market communications such as requests for quotes and other authorized pre-trade communications.<sup>26</sup> Finally, the Commission proposed that a violation of CEA section 4c(a)(5)(C) does not require a pattern of activity, even a single instance of trading activity can be disruptive of fair and equitable trading.<sup>27</sup>

The Commission requested comment on all aspects of the Proposed Order, with the comment period ending on May 17, 2011. In response to the Proposed Order, the Commission received 16 comments from industry members, trade associations, exchanges, and other members of the public.<sup>28</sup> In drafting this interpretive statement, the Commission also considered the ANPR and December 2, 2010 roundtable comments, as

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<sup>24</sup> Id.

<sup>25</sup> The Proposed Order described “spoofing” to include the following: (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. 76 FR at 14946.

<sup>26</sup> 76 FR at 14946.

<sup>27</sup> Id.

<sup>28</sup> Appendix 3 contains the list of commenters that responded to the Proposed Order. The comment letters may be accessed through <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=893>.

well as comments related to section 747 of the Dodd-Frank Act that were filed in response to the SEF notice of proposed rulemaking (the “SEF NPRM”).<sup>29</sup>

### **III. Comments on the Proposed Order**

#### **A. General Applicability of CEA Section 4c(a)(5)**

##### **1. Comments**

In response to the Proposed Order, several commenters requested additional guidance and suggested that additional clarity was needed regarding how the Commission would interpret and apply new CEA section 4c(a)(5).<sup>30</sup> Some commenters supported the statutory requirement in new CEA section 4c(a)(5) to prohibit the enumerated trading practices and prevent the disruption of fair and equitable trading.<sup>31</sup> Other commenters noted that the Commission should recognize the complementary role of the exchanges and continue relying on the exchanges’ self-regulatory organization (“SRO”) authority to identify and pursue trading practices that are manipulative or detrimental to the exchange’s markets.<sup>32</sup> Commenters also requested that CEA section 4c(a)(5) violations be limited to those trading platforms on DCMs or SEFs that have

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<sup>29</sup> 76 FR 1214 (Jan. 7, 2011).

<sup>30</sup> See, e.g., FIA at 2 (“The Proposed Order does not go far enough in offering guidance to market participants.”); ICE at 2 (“Additional clarity is required with respect to the Commission’s interpretation and guidance regarding paragraphs (A) through (C) of Section 747.”).

<sup>31</sup> See, e.g., ISDA at 2 (“ISDA supports the Commission’s effort to facilitate fair and equitable trading on registered entities by issuing guidance as to the parameters of the three statutory disruptive practices found in Subsection 5.”); ICE at 2 (“ICE continues to support the Commission’s efforts to promote open and competitive markets while improving the ability to deter improper trading practices that are disruptive to legitimate trading and orderly markets.”); Barnard at 2 (“I welcome and support your proposed interpretive order. It brings clarity to the antidisruptive practices authority, and strikes the right balance between rules- and principles-based regulation.”).

<sup>32</sup> See, e.g., ICE at 5 (“ICE respectfully suggests that the Commission continue to rely on exchange SRO authority to identify and pursue trading practices that are determined to be manipulative or detrimental to the exchange’s markets, including practices that are the character of spoofing.”); FIA at 7 (“The Associations believe that any rulemaking under 747 must reinforce the distinct yet complementary roles of the Commission and the exchanges.”); and CMC at 2 (“SROs and the Commission historically have served distinct but largely complementary roles.”).

order book functionality.<sup>33</sup> Lastly, some commenters requested that the Commission incorporate a manipulative intent requirement into its new antidisruptive practices authority to ensure that the prohibitions in CEA section 4c(a)(5) do not capture legitimate trading practices that may be indistinguishable from the proposed prohibited conduct.<sup>34</sup>

## 2. Commission Guidance

The Commission recognizes commenters' requests for additional guidance on CEA section 4c(a)(5) and is issuing this interpretive statement to clarify how the Commission interprets and intends to apply the three statutory provisions of CEA section 4c(a)(5). With respect to the role of exchanges in ensuring fair and equitable markets, the Commission agrees with commenters that exchanges serve an important role in preventing the disruptive practices prohibited in CEA section 4c(a)(5) and ensuring fair and equitable trading in CFTC-regulated markets.

The Commission declines the request by commenters to interpret CEA section 4c(a)(5) as applying to only those trading platforms or venues that have order book functionality. In accordance with the statutory language of CEA section 4c(a)(5), the Commission interprets CEA section 4c(a)(5) to apply to *any* trading, practices or conduct on a registered entity<sup>35</sup> such as a DCM or SEF.<sup>36</sup> Depending on the particular facts and

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<sup>33</sup> See, e.g., ISDA at 2 (“Subsection 5, though stated to apply to all “registered entities” – that is...swap execution facilities (“SEFs”) and designated contract markets (“DCMs”) – should be clearly limited at the outset only to those order-book trading facilities within the Commission’s proposed regulation, 17 CFR § 37.9(a)(1)(i)(C), for the definition of “order book.””).

<sup>34</sup> See, e.g., FIA at 5 (“Unfortunately, the antidisruptive practices authority captures many legitimate trading practices which, without a manipulative intent requirement, are objectively indistinguishable from the proposed prohibited conduct.”).

<sup>35</sup> 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

circumstances, CEA section 4c(a)(5) violations may also occur on trading platforms or venues that are distinct from order books, even if such platforms or venues may have similar functionality.

The Commission also declines commenters' requests to read a manipulative intent requirement into the CEA section 4c(a)(5) prohibitions. The Commission interprets the prohibitions in CEA section 4c(a)(5) provisions to be distinct statutory provisions from the anti-manipulation provisions in section 753 of the Dodd-Frank Act; the Commission does not interpret the CEA section 4c(a)(5) violations as including any manipulative intent requirement. Including such a manipulative intent requirement is contrary to the statutory language.

The Commission does not intend to apply CEA section 4c(a)(5) to either block trades or exchanges for related positions ("EFRPs") that are transacted in accordance with Commission regulation 1.38.

In addition to these general comments on CEA section 4c(a)(5), commenters provided comments on the three new statutory provisions, which are discussed in the following sections.

## **B. Violating Bids and Offers**

### **1. Comments to the Proposed Interpretive Order**

Commenters requested that the Commission modify its interpretation that a CEA section 4c(a)(5)(A) violation is a *per se* offense and incorporate a requirement that a

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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).

<sup>36</sup> The Commission confirms that a trade does not become subject to CEA section 4c(a)(5) solely because it is reported on a swap data repository, even though a swap data repository is a registered entity.

person must intend to disrupt fair and equitable trading.<sup>37</sup> Commenters noted that the Commission’s interpretation that the violation of bids or offers is a *per se* offense conflicts with exchange rules.<sup>38</sup> Other commenters requested that the Commission adopt either a “specific” intent or “extreme recklessness” standard for CEA section 4c(a)(5)(A).<sup>39</sup> Commenters to the Proposed Order also requested guidance on how CEA section 4c(a)(5)(A) would apply to the trading of swaps on SEFs.<sup>40</sup> In particular, commenters stated that end-users should have discretion when choosing a counterparty and also requested clarification on whether market participants may consider additional non-price factors when trading on a SEF.<sup>41</sup> Commenters also requested guidance on whether CEA section 4c(a)(5)(A)’s prohibition applies to bids and offers on non-cleared swaps.<sup>42</sup> Commenters also stated that swaps with different clearing destinations should not be deemed comparable for the purposes of CEA section 4c(a)(5)(A).<sup>43</sup>

Commenters further asked whether CEA section 4c(a)(5)(A) requires market participants to transact at the best price across a particular SEF’s different trading

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<sup>37</sup> See, e.g., Working Group at 3 (“The Working Group strongly recommends that the Commission interpret new CEA Section 4c(a)(5)(A) as requiring an intent to disrupt the market.”).

<sup>38</sup> See, e.g., CME at 4 (“Contrary to the Commission’s assertion, this broad construction is not consistent with exchange rules, which only proscribe market participants’ intentional violation of bids and offers.”).

<sup>39</sup> See, e.g., CMC at 3 (“The Commission should clarify that only intentional or extremely reckless action to violate transparent bids or offers contravenes this prohibition.”).

<sup>40</sup> See, e.g., FIA at 4 (“The Associations recommend that the Commission provide further clarification. One example is the application to swap execution facilities (‘SEFs’)”); BF at 14 (“We further recommend that the CFTC confirm that transactions executed other than on a SEF’s central order book will not be deemed to “violate bids or offers” for purposes of CEA Section 4c(a)(5)(A), regardless of their price level.”).

<sup>41</sup> See, e.g., Coalition at 4 (“An interpretation that precludes end-users from exercising discretion in its counterparty selection could force end-users to make sub-optimal decisions when determining the most suitable swap counterparty on a given transaction.”).

<sup>42</sup> See, e.g., MarketAxess at 3 (“The final order should make clear that the CFTC’s interpretation of new CEA § 4c(a)(5)(A) does not apply to uncleared swaps.”).

<sup>43</sup> See, e.g., Consolidated Banks at 14 (“Nor should swaps with different bilateral counterparties or clearing destinations be deemed comparable to each other for such purposes.”).

systems or platforms, such as the SEF's order book and request-for-quote system. Commenters also asked for clarification on how CEA section 4c(a)(5)(A) applies to request-for-quote systems on SEFs and whether request-for-quotes ("RFQs") must interact with the SEF's order book or centralized electronic screen.<sup>44</sup> One commenter stated that the Proposed Order would effectively impose a "trade through" requirement on market participants executing swap transactions across a particular SEF's trading systems or platforms.<sup>45</sup> Commenters further requested that the Commission confirm that the final order would not create a best execution requirement across multiple SEFs.<sup>46</sup>

A commenter also agreed with the statement in the Proposed Order that CEA section 4c(a)(5)(A) should not apply where an individual is "buying the board" and executing a sequence of trades to buy all available bids or sell to all available offers on the order book in accordance with the rules of the facility executing the trades.<sup>47</sup>

## 2. Commission Guidance

The Commission declines requests 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. Congress did not

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<sup>44</sup> See, e.g., MarketAxess at 3 ("We ask that the Commission confirm in its final Interpretive Order that a person would not violate bids or offers by buying or selling a contract on a SEF's Request for Quote System when that contract is available to buy or sell at a 'better' price through another permitted execution method offered by that SEF such as an Order Book or a centralized electronic screen.").

<sup>45</sup> See, e.g., GFI at 2 ("GFI believes that the Proposed Interpretation would effectively impose a trade-through rule on SEFs that utilize trading methods that are not strictly automated, and that such a requirement is neither required by the Dodd-Frank Act nor furthers the purposes of the CEA.").

<sup>46</sup> See, e.g., Working Group at 3 ("The Working Group supports the Commission's statement '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' and strongly recommends that such interpretation of new CEA Section 4c(a)(5)(A) be adopted in any final interpretive order.").

<sup>47</sup> See CME at 3 ("We also concur with the Commission's determination that this section does not apply where an individual is "buying the board.").

include an intent requirement in CEA section 4c(a)(5)(A) as it did in both CEA sections 4c(a)(5)(B) and 4c(a)(5)(C). Therefore, the Commission does not interpret CEA section 4c(a)(5)(A) as requiring the Commission to show that a person acted with *scienter* in violating bids and offers (e.g., that a person acted with either the intent to disrupt fair and equitable trading or with the intent to violate bids and offers). Unlike certain exchange rules that prohibit the intentional violation of bids and offers, the statutory language of CEA section 4c(a)(5)(A) does not contain a similar intent requirement.<sup>48</sup> While the Commission's determination of whether to bring an enforcement action depends on facts and circumstances, the Commission does not, for example, intend to exercise its discretion to bring an enforcement action against an individual who, purely by accident, makes a one-off trade in violation of CEA section 4c(a)(5)(A). Whether such an accidental violation gives rise to some other violation of the CEA or Commission regulations depends, again, on the facts and circumstances of the particular situation.

As a general matter, the Commission interprets CEA section 4c(a)(5)(A) as operating in any trading environment where a person is not utilizing trading algorithms that automatically match the best price for bids and offers. With respect to SEFs, the Commission interprets CEA section 4c(a)(5)(A) as being applicable only when a person is using a SEF's "order book," and not when a person uses a SEF's other execution methods (such as the RFQ system in conjunction with the order book). The Commission recognizes that market participants may consider a number of factors in addition to price when trading or executing less liquid swaps, which are more likely to be traded on a SEF's RFQ system or a different execution method. However, as SEFs and the swaps

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<sup>48</sup> See, e.g., New York Mercantile Exchange Rule 514.A.3; Minneapolis Grain Exchange Rule 731.00.

markets evolve, the Commission may revisit these issues in the future. The Commission agrees with commenters that parties trading non-cleared swaps may take into consideration factors other than price, such as counterparty risk, when determining how to best execute their trades.<sup>49</sup> Therefore, the Commission interprets CEA section 4c(a)(5)(A) as not applying to non-cleared swap transactions, even if they are transacted on or through a registered entity. In such swap transactions, the credit considerations of the counterparties are important components of choosing which bid or offer to accept.

The Commission also agrees with commenters that parties may take into account clearing considerations, such as the use of a particular clearing house, when trading cleared swaps on certain platforms on a SEF or on a DCM.<sup>50</sup> The Commission interprets CEA section 4c(a)(5)(A)'s prohibition as not applying 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.<sup>51</sup> For example, the choice of a clearing house may affect a party's net and gross outstanding exposures, which may result in differing capital and cost of financing effects. Additionally, the pricing of swaps may also incorporate other potential considerations such as the available credit capacity at the clearing member or clearing house, margining arrangements, or post-trade market risk.

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<sup>49</sup> See, e.g., Coalition at 3 (“To understand the impact of applying section 4c(a)(5)(A) to non-cleared transactions executed off-facility, we have to understand how corporate treasurers have a fiduciary duty to optimize numerous factors – not solely the transaction price of a particular derivative – in achieving ‘best execution’”).

<sup>50</sup> As stated previously, the Commission interprets new CEA section 4c(a)(5)(A) as applying to any cleared swap traded on a SEF's order book, regardless of whether such cleared swap is subject to the mandatory trade execution requirement of new CEA section 2(h).

<sup>51</sup> See, e.g., GFI at 2 (“Because market participants that execute transactions on a SEF may clear their transactions at different clearinghouses, they must have the flexibility to take factors other than price into account when executing transactions on a SEF.”).

Therefore, the Commission interprets CEA section 4(c)(a)(5)(A) as prohibiting a person from buying a contract on a registered entity at a price that is higher than the lowest available price offered for such contract or selling a contract on a registered entity at a price that is lower than the highest available price bid for such contract subject to the situations described above. Such conduct, regardless of intent, disrupts fair and equitable trading by damaging the price discovery function of CFTC-regulated markets. By adopting a policy that market participants cannot execute trades at prices that do not accurately reflect the best price for such contracts, this interpretive statement furthers the CEA's purpose of ensuring the integrity of the price discovery process by helping ensure that the prices disseminated to market users and the public reflect bona fide prices that accurately reflect the normal forces of supply and demand.

The Commission further recognizes that at any particular time the best price in one trading environment such as a particular SEF may differ from the best price in a different trading environment such as a second, distinct SEF. Accordingly, the Commission does not interpret CEA section 4c(a)(5)(A) as creating any sort of best execution standard across multiple registered entities, including SEFs or DCMs; rather, the Commission interprets a person's obligation to not violate bids or offers as applying only to the specific registered entity being utilized at a particular time.<sup>52</sup>

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<sup>52</sup> A person's obligation to not violate bids or offers is confined to the particular SEF or DCM he is utilizing at a particular time and does not extend across multiple SEFs or DCMs or between different trading systems or platforms within a particular SEF or DCM, such as between a pit and any electronic trading platform within a DCM or a SEF's "order book" and RFQ system in conjunction with the order book. However, as the swaps and SEF markets evolve, the Commission may revisit these issues in other Commission regulations. For example, the Commission may consider whether a person's obligation to not violate bids or offers when trading swaps should extend across multiple SEFs or DCMs or across a particular SEF's different trading systems or platforms, including whether the CEA section 4c(a)(5)(A) prohibition should apply to the scenario where market participants can access multiple SEFs through one trading platform.

The Commission does not interpret CEA section 4c(a)(5)(A) as applying where an individual is executing a sequence of trades to buy all available offers or sell to all available bids on an order book in accordance with the rules of the facility on which the trades were executed. Similar to the treatment of block trades and EFRPs described above, the Commission expects that “buying the board” transactions, absent other facts and circumstances, would not violate CEA section 4c(a)(5) or disrupt fair and equitable trading.

**C. Disregard for the Orderly Execution of Transactions during the Closing Period**

**1. Comments to the Proposed Interpretive Order**

Commenters supported the Commission’s proposed guidance that accidental or negligent conduct does not constitute a violation of new CEA section 4c(a)(5)(B).<sup>53</sup> With respect to the *scienter* required for a CEA section 4c(a)(5)(B) violation, commenters requested that the Commission require, at a minimum, a *scienter* of “extreme recklessness.”<sup>54</sup> Commenters also stated that manipulative intent should be required to violate CEA section 4(c)(a)(5)(B) and that these prohibitions should be limited to manipulative conduct such as “banging” or “marking the close.”<sup>55</sup>

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<sup>53</sup> See, e.g., CME at 4 (“We commend the Commission for clarifying that, consistent with the plain language of Section 747, accidental or negligent conduct does not constitute a violation of subsection (B).”).

<sup>54</sup> See id. (“We believe that the Commission should provide in its final order that a violation of subsection (B) requires a showing of scienter – that is, that the person acted knowingly, intentionally, or with extreme recklessness to commit the prohibited conduct.”).

<sup>55</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 Section 4c(a)(5)(B)... Additionally, the Commission should clarify that manipulative intent is required to violate Section 4c(a)(5)(B)”).

Commenters requested that the Commission provide additional clarity regarding the meaning of the term “closing period” as used in CEA section 4c(a)(5)(B).<sup>56</sup>

Commenters expressed the view that, unlike futures, certain swaps, such as physical products that are priced using indices, do not have defined closing periods.<sup>57</sup> Some commenters disagreed with the Commission’s view that the prohibition on disorderly execution of transactions should extend to conduct occurring outside the closing period.<sup>58</sup>

Commenters also requested that the Commission further clarify the term “orderly execution” as set forth in section CEA section 4c(a)(5)(B).<sup>59</sup> Commenters stated that the Commission should not engage in *post hoc* evaluations as to what types of trading, conduct, or practices violate CEA section 4c(a)(5)(B).<sup>60</sup> Commenters also claimed that having the Commission rely on concepts of orderliness as developed in securities law

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<sup>56</sup> See, e.g., BGA at 3 (“BGA is concerned that the Commission has not provided sufficient clarity around the terms ‘orderly execution,’ ‘disruptive conduct,’ or ‘closing period.’”); CME at 5 (“We understand that the Commission cannot precisely define the parameters of ‘orderly execution’ and whether certain executions during the closing period are ‘orderly’ must necessarily be inferred from the totality of the facts and circumstances. Indeed, we noted in our comment letter in response to the ANPR that ‘orderly execution’ can be evaluated only in the context of the specific instrument, market conditions, and participant circumstances at the time in question.”).

<sup>57</sup> See *id.* (“It appears that the Commission is changing the definition of ‘closing period’ relating to physical products that are pricing using indices or benchmarks. These products do not have defined closing periods; therefore, it is inappropriate to apply a ‘closing period’ concept to them.”).

<sup>58</sup> See, e.g., CME at 6 (“It is unclear how trading practices or conduct outside of the ‘closing period’ would demonstrate intentional or reckless disregard for the orderly execution of transactions during the closing period.”).

<sup>59</sup> See, e.g., BGA at 3 (“BGA is concerned that the Commission has not provided sufficient clarity around the terms ‘orderly execution,’ ‘disruptive conduct,’ or ‘closing period.’”); CME at 5 (“We understand that the Commission cannot precisely define the parameters of ‘orderly execution’ and whether certain executions during the closing period are ‘orderly’ must necessarily be inferred from the totality of the facts and circumstances. Indeed, we noted in our comment letter in response to the ANPR that ‘orderly execution’ can be evaluated only in the context of the specific instrument, market conditions, and participant circumstances at the time in question.”).

<sup>60</sup> See, e.g., MFA at 4 (“The definition of the term ‘orderly’ is not only vague, but also subjective and would allow for post hoc judgments as to what constitutes violative, disruptive conduct.”); FIA at 5 (“Market participants should not fear that their trading activity may be the subject of a post hoc analysis which labels a trade or a series of trades “disruptive.””).

precedent was problematic because of the significant differences between the securities and CFTC-regulated markets.<sup>61</sup> Commenters further stated that requiring market participants to assess market conditions before trading conflicts with the Commission's assertion that CEA section 4c(a)(5)(B) will not capture legitimate trading behavior.<sup>62</sup> Commenters also noted that in today's highly automated trading environments, it is impractical for market participants to assess market conditions prior to the entry of each order.<sup>63</sup>

## 2. Commission Guidance

The Commission interprets Congress's inclusion of a *scienter* requirement in CEA section 4c(a)(5)(B) as meaning that accidental, or even negligent, trading, practices, or conduct will not be a sufficient basis for the Commission to claim a violation under CEA section 4c(a)(5)(B). The Commission interprets CEA section 4c(a)(5)(B) as requiring a market participant to at least act recklessly to violate CEA section 4c(a)(5)(B).<sup>64</sup> The Commission declines to interpret CEA section 4c(a)(5)(B) to include

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<sup>61</sup> See, e.g., CME at 6-7 (“In light of these and other significant differences that exist in their respective market and regulatory structures, as well as the fundamental purposes of the markets, we caution the Commission against importing securities-based concepts to the derivatives markets.”).

<sup>62</sup> See *id.* (Requiring participants to assess market conditions and consider how their trading may affect orderly execution during the closing period is “at odds with the Commission’s assertion that this section ‘will not capture legitimate trading behavior and is not a trade for those who act in good faith.’”).

<sup>63</sup> See, e.g., CME at 4 (“Given today’s highly automated environment and the millisecond speed with which liquidity can be sourced, consumed and withdrawn, it is impractical to require such analysis prior to the entry of each order, much less presume that market participants can always accurately assess market conditions or divine market impact, particularly during the closing period which is often the most volatile period of the day and a period in which certainty of execution may be a more material consideration than price.”).

<sup>64</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

either an extreme recklessness standard or a manipulative intent requirement because this modification would alter the *scienter* standard mandated by the statute, which prohibits conduct that demonstrates “intentional or reckless disregard for the orderly execution of transactions during the closing period.”<sup>65</sup> Recklessness is a well-established *scienter* standard, which has consistently been 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.”<sup>66</sup> Consistent with long-standing precedent under commodities and securities law, the Commission intends to apply this commonly-known definition of recklessness to CEA section 4c(a)(5)(B). A person with manipulative intent, such as one attempting to “bang” or “mark the close” may also intend to disrupt the orderly execution of transactions during the closing period, but the finding of a manipulative intent is not a prerequisite for a finding of a violation of CEA section 4c(a)(5)(B).

The Commission interprets the prohibition in CEA section 4c(a)(5)(B) to apply to any trading, conduct, or practices occurring within the closing period that demonstrates an intentional or reckless disregard for the orderly execution of transactions during the

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“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>65</sup> 7 U.S.C. 4c(a)(5)(B).

<sup>66</sup> Drexel Burnham Lambert Inc. at 748; see also Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1977) (holding that recklessness under SEC Rule 10b-5 means “an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it”) (internal quotation marks and citation omitted); SEC v. Platforms Wireless Int’l Corp., 617 F.3d 1072, 1093-94 (9th Cir. 2010) (“*scienter* [under SEC Rule 10b-5] requires either deliberate recklessness or conscious recklessness, and [ ] it includes a subjective inquiry turning on the defendant’s actual state of mind”) (internal quotation marks and citations omitted). See also, the final rules issued by the Commission on July 14, 2011 (Prohibition on the Employment, or Attempted Employment, of Manipulation and Deceptive Devices and Prohibition on Price Manipulation), 76 FR, July 14, 2011.

closing period. The Commission interprets the closing period to be defined 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. 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). With respect to swaps, the Commission interprets a swap as being subject to the provisions of section 4c(a)(5)(B) if a DCM or SEF determines that a settlement or pricing period exists for that particular swap.<sup>67</sup> Additionally, the Commission's policy is that conduct outside the closing period may also disrupt the orderly execution of transactions during the closing period and may thus form the basis of a violation under CEA section 4c(a)(5)(B) and any other applicable CEA sections. For example, a CEA section 4c(a)(5)(B) violation may occur when a market participant accumulates a large position in a product or contract 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, or a similar product's, defined closing period.

The Commission interprets CEA section 4c(a)(5)(B) violations as including not only executed orders by market participants that disrupt the orderly execution of transactions during the closing period, but also any bids and offers submitted by market participants that disrupt the orderly execution of transactions during the closing period.

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<sup>67</sup> The Commission disagrees with commenters that physical products priced using indices or benchmarks do not have defined closing periods. For physical products priced using indices, price reporting agencies may use the transaction prices during a certain window of time to calculate price indexes. Market participants have the same ability to disrupt trading during these windows of time as they do during the closing periods as defined by the DCM or SEF.

For example, bids and offers submitted by a person, even if they are not executed against by other market participants, may disrupt orderly trading in the closing period by sending false signals to the marketplace that consequently affect the trading behavior of market participants in the closing period. As such, bids and offers submitted by a person who intends to cancel the bid or offer before execution may have violations of both CEA section 4c(a)(5)(B), a disruption of orderly trading in the closing period, and CEA section 4c(a)(5)(C), “spoofing.”

Similar to other scienter-based violations of the CEA, the Commission intends to consider all of the relevant facts and circumstances when determining whether a person violated CEA section 4c(a)(5)(B). The Commission recognizes that an evaluation of “orderly execution” should be based on the totality of the facts and circumstances as of the time the person engaged in the relevant trading, practices, or conduct—i.e., the Commission intends to consider what the person knew or should have known, and the information available at the time he or she was engaging in the conduct at issue. For example, a CEA section 4c(a)(5)(B) violation would not occur simply because a person’s execution of orders during the closing period had a substantial effect on a contract’s settlement price; rather, such person’s conduct must also demonstrate an intentional or reckless disregard for the orderly execution of transactions during the closing period.

While the Commission recognizes there are differences between securities markets and CFTC-regulated markets, fundamental concepts of how an orderly market should function are similar in both markets. In light of the differences between these two markets, the Commission will be guided, but not controlled, by the substantial body of judicial precedent applying the concepts of orderly markets established by the courts with

respect to the securities markets. To this end, the Commission's policy is that 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 dramatically 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>68</sup> For example, trading in a manner that intentionally or recklessly causes the price relationships between the price of a derivative and the underlying commodity to diverge, or cause spreads between contracts for near months and for remote months to diverge could constitute a violation of the statute.

Finally, the Commission recommends 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. Market participants should assess market conditions before placing a bid or offer, or executing an order, because this will help prevent market participants from engaging in trading, practices, or conduct that disrupts fair and equitable trading in CFTC-regulated markets.

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<sup>68</sup> While the role of market specialists is unique to the securities markets as of this time, the economic concepts applicable to orderly markets in securities markets may help guide the Commission when analyzing orderly trading in CFTC-regulated markets.

## D. “Spoofing”

### 1. Comments to the Proposed Interpretive Order

Commenters requested additional Commission guidance on the definition of “spoofing” as set forth in CEA section 4c(a)(5)(C).<sup>69</sup> Commenters stated that any violations should not capture legitimate trading behavior. For example, to differentiate “spoofing” from legitimate trading behavior, commenters state that any person violating CEA section 4c(a)(5)(C) must also intend to mislead market participants and to exploit that deception for the spoofing entity’s benefit.<sup>70</sup> Commenters further requested that if a bid or offer has the risk of being hit or lifted by the market, for any period of time, such trading activity should be exempt from being classified as a “spoofing” violation.<sup>71</sup> Commenters expressed a similar view that partial fills should also be exempt from the definition of “spoofing.”<sup>72</sup> Lastly, one commenter stated CEA section 4c(a)(5)(C) violations should only be applicable to order-book facilities.<sup>73</sup>

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<sup>69</sup> See, e.g., ICE at 4 (“The Commission should provide additional guidance as to what specific types of improper trading practices or activity would be broadly characterized as being spoofing and ‘of the character of’ spoofing.”).

<sup>70</sup> See, e.g., CMC at 4 (“The distinguishing characteristic between ‘spoofing’ that should be covered by Section 747(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 for the spoofing entity’s benefit.*”).

<sup>71</sup> See, e.g., BGA at 4 (“BGA recommends the Commission clarify that, if a bid or offer has the risk of being hit or lifted by the market, for any period of time, this activity be deemed legitimate conduct and not be deemed ‘spoofing.’”).

<sup>72</sup> See, e.g., FIA at 6 (“Traders engage in legitimate trading practices that are unintentionally captured by Section 747’s definition of ‘spoofing.’ For example, traders may enter larger than necessary orders to ensure their hedging or delivery needs are met and, once met, they may then cancel part of the original order.”).

<sup>73</sup> See, e.g., ISDA at 4 (“The entire Proposed Guidance discussion of spoofing is in exchange terminology and facially applicable only in an exchange environment. Again, we believe this is, if applicable at all, applicable at this time only to Order-Book facilities.”).

## 2. Commission Guidance

The Commission interprets a CEA section 4c(a)(5)(C) violation as requiring a market participant to act with some degree of intent, or *scienter*, beyond recklessness to engage in the “spoofing” trading practices prohibited by CEA section 4c(a)(5)(C). Because CEA section 4c(a)(5)(C) requires that a person intend to cancel a bid or offer before execution, the Commission does not interpret reckless trading, practices, or conduct as constituting a “spoofing” violation.<sup>74</sup> Additionally, the Commission interprets that a spoofing violation will not occur when the person’s intent when cancelling a bid or offer before execution was to cancel such bid or offer as part of a legitimate, good-faith attempt to consummate a trade. Thus, the Commission interprets the statute to mean that a legitimate, good-faith cancellation or modification of orders (e.g., partially filled orders or properly placed stop-loss orders) would not violate section CEA 4c(a)(5)(C). However, the Commission does not interpret a partial fill as automatically exempt from being classified as “spoofing” and violating CEA section 4c(a)(5)(C).

When distinguishing between legitimate trading (such as trading involving partial executions) and “spoofing,” the Commission intends to 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 and not attempt to consummate a legitimate trade, regardless of whether such bid or offer was subsequently partially filled, that conduct may violate CEA section 4c(a)(5)(C).

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<sup>74</sup> Similar to violations under CEA section 4c(a)(5)(B), the Commission does not interpret CEA section 4c(a)(5)(C) as reaching accidental or negligent trading, practices, or conduct.

The Commission interprets and intends to apply CEA section 4c(a)(5)(C) as covering bid and offer activity on all products traded on all registered entities, including DCMs and SEFs. The Commission further interprets CEA section 4c(a)(5)(C) to include all bids and offers in pre-open periods or during other exchange-controlled trading halts. As noted earlier, the Commission does not interpret CEA section 4c(a)(5)(C) as restricting “spoofing” violations to trading platforms and venues only having order book functionality. “Spoofing” may possibly occur on any trading platform or venue where a market participant has the ability to either (a) send executable bids and offers to market participants or (b) transact against resting orders.

The Commission provides four non-exclusive examples of possible situations for when market participants are engaged in “spoofing” behavior,<sup>75</sup> including: (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, (iii) submitting or cancelling multiple bids or offers to create an appearance of false market depth, and (iv) submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards. The Commission also does not intend to apply the “spoofing” provision as covering market communications such as authorized pre-trade communications.

As with other intent-based violations, the Commission intends to distinguish 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. The Commission does not interpret a CEA section 4c(a)(5)(C) violation as requiring a

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<sup>75</sup> See 76 FR at 14947.

pattern of activity; the Commission interprets CEA section 4c(a)(5)(C) such that even a single instance of trading activity can violate CEA section 4c(a)(5)(C), provided that the activity is conducted with the prohibited intent.

Issued in Washington, DC, on May 20, 2013, by the Commission.

Christopher J. Kirkpatrick,

Deputy Secretary of the Commission.

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

**Appendix 1 – Commission Voting Summary**

On this matter, Chairman Gensler and Commissioners Sommers, Chilton, O’Malia, and Wetjen voted in the affirmative. No Commissioners voted in the negative.

**Appendix 2 – Statement of Chairman Gary Gensler**

I support the Interpretive Guidance and Policy Statement regarding disruptive practices on swap execution facilities and designated contract markets. As part of market reform, Congress expressly prohibited certain trading practices that were deemed disruptive of fair and equitable trading on CFTC-registered entities, such as swap execution facilities and designated contract markets.

These provisions are important because it is a core mission of the CFTC to protect the markets against abusive and disruptive practices, particularly those that impede critical price discovery functions.

The Interpretive Guidance and Policy Statement provides additional guidance to market participants regarding the scope of conduct and trading practices that would violate the law. For instance, the Commission interprets this provision, section 747 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, to apply to any trading, practices or conduct on registered SEFs or DCMs.

The guidance addresses the comments the Commission received in response to the proposal, including a roundtable.

### **Appendix 3 – Parties Submitting Comment Letters in Response to Disruptive Trading Practices Proposed Interpretive Order**

Banking Firms Consolidated (“BF”)

Better Markets (“BM”)

BG Americas & Global LNG (“BGA”)

Chris Barnard

Coalition for Derivatives End Users (“Coalition”)

CME Group (“CME”)

Commodity Markets Council (“CMC”)

Futures Industry Association/Securities Industry and Financial Markets Association (“FIA”)

GFI Group, Inc. (“GFI”)

Hampton Technology Resources (“HTR”)

InterContinentalExchange (“ICE”)

International Swaps and Derivatives Association (“ISDA”)

Managed Funds Association (“MFA”)

MarketAxess

Minneapolis Grain Exchange (“MGE”)

Working Group of Commercial Energy Firms (“Working Group”)