May 17, 2011

Commodity Futures Trading Commission
c/o David A. Stawick, Secretary
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Antidisruptive Practices Authority Proposed Interpretive Order

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] and the Securities Industry and Financial Markets Association ("SIFMA,"[2] and together with FIA, the "Associations") submit these comments in response to the Proposed Interpretive Order on Antidisruptive Practices Authority (the "Proposed Order")[3] issued by the Commodity Futures Trading Commission (the "Commission"). The Proposed Order seeks to provide interpretive guidance to the three statutory disruptive practices prohibited by Section 747 of the

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[1] The Futures Industry Association is the leading trade organization for the futures, options and OTC cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world's largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearinghouses, our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions.

FIA's core constituency consists of futures commission merchants, and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA's regular members, who act as the majority clearing members of the U.S. exchanges, handle more than 90% of the customer funds held for trading on U.S. futures exchanges. For more information, visit www.futuresindustry.org.

[2] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[3] Antidisruptive Practices Authority, Proposed Interpretive Order, 76 Fed. Reg. 14,943 (Mar. 18, 2011).

Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") which amends Commodity Exchange Act (as amended, "CEA") Section 4c(a)(5). The Associations appreciate the opportunity to comment on the Commission's Proposed Order.

I. Summary

The Commission has requested comments on all aspects of its Proposed Order, published March 18, 2011 in the Federal Register. The Proposed Order acknowledges many of the comments made in response to the Commission's earlier Advance Notice of Proposed Rulemaking and Request for Comments ("ANPR"),[4] and makes some of the changes recommended in the comments by refining the definitions of key terms such as "violates bids or offers," "orderly" and "closing period," and "spoofing," and adding *scienter* requirements for Sections 4c(a)(5)(B) and 4c(a)(5)(C). The Commission also made several important clarifications insofar as it limited the scope of certain provisions.

However, the Proposed Order does not go far enough in offering guidance to market participants. The Proposed Order is still unclear as to what constitutes proscribed, violative conduct. In light of the Proposed Order, and in furtherance of our ongoing commitment to the Commission's goals, we now offer the following recommendations:

- The Commission should identify specific problems that would necessitate additional enforcement authority to prosecute disruptive trading practices.
- The statute is impermissibly vague and unenforceable. The Commission should further refine definitions of key terms and clarify their meaning so as to sufficiently guide the conduct of market participants.
- The Commission should affirm that any rules or orders apply only to the three categories enumerated in Section 747.
- The Commission should further clarify its authority in the context of algorithmic and high-frequency trading entities.
- Any rules or final orders should reinforce the existing distinct and complementary roles of the Commission and the exchanges.
- The Commission must clarify that CEA Section 4c(a)(7) ("Use of Swaps to Defraud") will only be violated if a party violates a pre-existing duty.
- Executing brokers must be given safe harbor from customer liability and from the Commission's authority in certain circumstances.

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[4] FIA submitted a comment letter in response to the Commission's ANPR. Letter from John M. Damgard, President, Futures Industry Association, to David A. Stawick, Secretary, Commodity Futures Trading Commission (Dec. 23, 2010) (available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26795&SearchText=) [hereinafter FIA Comment Letter].

II. The Commission Should Identify the Specific Enforcement Gaps Which Should Be Subject to the Antidisruptive Practices Authority.

The Commission should identify the specific problems the new antidisruptive practices authority seeks to address. FIA previously requested the Commission identify such problems in light of the fact that the language of Section 747 came from the Commission itself.[5] However, the Commission has yet to identify any specific problems or concerns where its pre-Dodd-Frank authority was lacking. Indeed, the Commission has yet to provide a clear definition of what "disruptive practice" means. By identifying the enforcement gap the Commission seeks to cover with this new authority, the Commission will better allow market participants to conform their conduct.

The Associations believe that absent identification of specific characteristics, problems or concerns, the Commission should urge Congress to repeal the new authority. It is inadvisable to allow statutory language to remain codified in law without a clear understanding of what behavior it seeks to prohibit. Market participants that are subject to the new authority will lack adequate notice of the law. Without a clear understanding of the current gap in enforcement authority, or of the types of practices which the regulation is meant to address, the plain language of Section 747 will chill legitimate trading activity and market participation.

III. Section 747 Is Impermissibly Vague and Unenforceable.

As expressed in our Comment Letter, Section 747, as written, is extremely vague and vulnerable to constitutional challenge.[6] "[A] regulation carrying penal sanctions [must] give fair warning of the conduct it prohibits or requires."[7] Despite the improvements made in the Proposed Order, definitions such as "violates bids or offers," "orderly" and "closing period," and "spoofing" require further refinement and clarification. Additionally, the Commission should make clear that manipulative intent is required to breach these prohibitions.

A. Violates Bids or Offers

The Associations commend the Commission on the steps it took in its Proposed Order to refine the phrase "violates bids or offers." Specifically, the Commission has excluded from this provision block trades, certain exchange of futures for related positions transactions ("EFRPs"), bilaterally negotiated swap transactions, transactions undertaken in environments where electronic trading systems with algorithms

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5 FIA Comment Letter, *supra* note 4, at 3.

6 *Id*.

7 *DiPlacido* v. *CFTC*, 2009 WL 3326624, at *1 (2d Cir. Oct. 16, 2009). *See also Satellite Broad. Co.* v. *FCC*, 824 F.2d 1, 3 (D.C. Cir. 1987) ("Traditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule.").

automatically match the best bid and offer, and instances where an individual is "buying the board."

The Associations recommend that the Commission provide further clarification. One example is the application to swap execution facilities ("SEFs"). Certainly, permitted transactions on SEFs, and particularly those that are not required to be cleared, are like bilaterally negotiated swap transactions and should be excluded. Because the Commission has received numerous comments on the proposed SEFs request-for-quote systems ("RFQs"), we are not in a position to comment on the applicability of the bids and offers violation rule to RFQs. We only point out that to the extent that RFQs for more complex or structured products permit the requester to choose from among submitted RFQs on a basis other than price (e.g., subjective factors based on its own hedging or other needs), it would be concerned about being second guessed in its determination of the best bid or best offer. We suggest that the scope of the applicability of the anti-disruptive regime to SEFs and RFQs in particular be reopened for comment once the Commission has finalized the SEFs and RFQs rules.

Additionally, the provision has no intent standard and the Commission has stated that it interprets violations as *per se* offenses.[8] The Associations respectfully submit that by failing to require manipulative intent, the Commission is compounding the issue of vagueness. The Associations reiterate the Supreme Court's statement that a lack of *mens rea* in an already vague standard is a sign of unconstitutionality. "[T]he constitutionality of a vague statutory standard is closely related to whether that standard incorporates a requirement of *mens rea*. Because of the absence of a scienter requirement in the provision [in question], the statute is little more than 'a trap for those who act in good faith.'"[9]

A *per se* offense should be objectively recognizable and not be subject to any ambiguity or misinterpretation. Unfortunately, the antidisruptive practices authority captures many legitimate trading practices which, without a manipulative intent requirement, are objectively indistinguishable from the proposed prohibited conduct. The use of RFQs, for example, is perfectly legitimate and RFQs serve as part of the price discovery process, one of the foundational purposes for futures and derivatives markets. As long as these are not used with manipulative intent, they must remain unambiguously valid. As another example, trading firms frequently submit bids and offers in the same product traded on both the floor and via an electronic trading venue. It may be that the last price on the floor is different from the price displayed on the screen. A trader who calls a floor broker to execute a Treasury trade, for example, could be outside the bid/offer displayed on the screen for the same Treasury contract. In fact, in the floor environment, it would be nearly impossible to determine that a trader is violating the

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[8] Proposed Order, *supra* note 3, at 14,946.

[9] *Colautti* v. *Franklin*, 439 U.S. 379, 395 (1979) (citations omitted); *see also DiPlacido* v. *CFTC*, No. 08-5559-ag, 2009 WL 3326624 at *2 (citing *Colautti*).

bid/offer. To avoid encompassing legitimate market conduct, the Commission must require manipulative intent to violate this section.

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." The Associations urge the Commission to further clarify the definition of "violates bids or offers" and to apply a manipulative intent requirement to Section 4c(a)(5)(A).

B. Orderly Execution of Transactions During the Closing Period

Although the Proposed Order provides some guidance with respect to the terms "orderly" and "closing period," the terms still are impermissibly vague. As FIA previously stated, 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).[10] Beyond these, the Commission still must identify other practices encompassed by this section.

The definition of the term "orderly" is vague, and would allow for *post hoc* judgments as to what constitutes disruptive conduct. Without a clearer definition, market participants will be unable to evaluate their conduct. The term "closing period" is also vague insofar as it applies to conduct inside closing periods varying in duration, conduct occurring outside closing periods, swaps executed on a SEF if a closing period or daily settlement price exists for a particular swap, and to cash market pricing.

Additionally, the Commission should clarify that manipulative intent is necessary to violate Section 4c(a)(5)(B). Any particular trade has the potential to be disruptive given unpredictable market conditions, and the Commission should not engage in *post hoc* judgments of disruptive practices without a finding of manipulative intent.[11]

As with the previous section, the vagueness in this section increases the risk that legitimate conduct will be subject to arbitrary enforcement. There is greater liquidity during closing periods than occurs during the trading day, and as a result, prices during closing periods more efficiently reflect market fundamentals like tighter bid-ask spreads. Therefore, traders looking to execute a large bid or to offset a position will likely wait until the closing period to execute their trades. For example, a trader may enter into a large volume trade with a firm client at the settlement price and be the buyer at that price. The trader may then look to hedge out the risk by trading the opposite position during the closing period. If during the close the trader begins to fall behind, he may begin to offer at a more aggressive price to ensure that he gets out of the position within the closing period. As another example, traders regularly have cash-settled swaps or options that settle against the exchange closing price. Often these orders are exceptionally large relative to the volume trading during the close. If there is not sufficient TAS liquidity,

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[10] FIA Comment Letter, *supra* note 4, at 5.

[11] *See* FIA Comment Letter, *supra* note 4, at 5.

simply executing hedges for these expiring trades could appear to be a violation of this provision, when actually, traders are simply flattening risk. Without clear guidance as to the meaning of "orderly" and "closing period," and without a stricter intent requirement, the risk of engaging in this sort of legitimate activity in unpredictable markets will be too great. Traders will be deterred from executing trades during the closing period, thereby creating or exacerbating illiquidity and volatility contrary to the Commission's objectives.

C. Spoofing

"Spoofing" is not a term that is commonly used and understood in the context of futures and derivatives markets. Although the Commission attempted in the Proposed Order to clarify the term's meaning, this key term is still impermissibly vague. Moreover, while "spoofing" has been used to describe trading practices in the securities markets,[12] the Commission should not mechanically import interpretation of this term from one context to another. The Securities and Exchange Commission's (the "SEC") interpretation of "spoofing" practices has not been subject to judicial scrutiny, and as such, the Commission owes no interpretive deference to another regulatory agency. Even if one were to accept the SEC's definition of "spoofing," it is unclear how such an interpretation would apply in the futures and derivatives markets, markets that operate on different assumptions and serve very different purposes.

In addition, the Associations believe the Commission must interpret the provision to require manipulative intent to avoid encompassing legitimate conduct. 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. As another example, a trading firm may take a position in one market based on the activity in another market. In a scenario where the systems trading these two markets are linked—even though the individual order activity on each market may not appear to be linked—a change in activity in one market may automatically trigger the system in the other market to cancel trades. As yet another example, a trader may enter a limit order in a particular instrument and may cancel the order based on price changes in a related instrument or a change in the bid/offer ratio. Finally, when executing large spot orders for clients, many traders stay on the phone and, based on factors unrelated to actual market price (e.g., inventory numbers and economic reports), constantly adjust the levels that they want to transact. Therefore, traders must also adjust futures orders accordingly. This conduct could be perceived as "spoofing," but, in reality, it is simply an example of traders trying to follow instructions in order to execute client business. These are bona fide orders which are merely *subject* to cancellation or modification. Such a distinction is not captured by the statute or the Proposed Order.

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[12] *See* FIA Comment Letter, *supra* note 4, at 6.

The examples above represent a sample of legitimate orders entered in good faith that may, at first glance, be construed as "spoofing" because intent is nearly impossible to prove simply by looking at order flow in a single market, let alone many markets. The Associations believe that such strategies and activities are legitimate, and indeed crucial, to efficient and liquid futures and derivatives markets, but without a manipulative intent requirement for this section, they would constitute prohibited conduct.

IV. The Commission Should Affirm That Any Rules or Orders Apply Only to the Three Categories Enumerated in Section 747.

The Proposed Order does not reflect any intent to expand enforcement pursuant to CEA Section 4c(a)(6) to cover disruptive practices not embraced by the three enumerated categories. The Associations applaud the Commission's recognition that Section 747 should not encompass additional practices and urge the Commission to affirm this understanding in any final interpretive order.

V. The Commission Should Further Clarify Its Authority in the Context of Algorithmic and Automated Trading.

Algorithmic trading strategies and low latency technology provide important benefits to the markets, including but not limited to, improvement in bid-ask spreads, faster execution speeds, reduced commissions and transaction costs, greater liquidity, increased market depth and efficiency, and pricing transparency and reliability. Market participants who use these tools are already subject to supervision under conduct and marketplace rules. Separate regulatory mandates that are broadly or vaguely defined would serve only to deter legitimate trading activity and lead to wider spreads. Although the Associations were gratified that the Commission excluded "buying the board" from its new authority, we urge the Commission to adopt a principles-based approach to enforcement of disruptive practices so as not to impede legitimate market activity and stifle financial innovation. At a minimum, the Commission must go further than it has and clearly define the conduct prohibited under Section 747 so that firms can program their systems to avoid such activities.

VI. Any Final Order or Rules Should Reinforce the Separate and Complementary Roles of the Commission and the Exchanges.

As stated in the FIA Comment Letter, the Associations believe that any rulemaking under Section 747 must reinforce the distinct yet complementary roles of the Commission and the exchanges.[13] To do so, the Commission should issue principles-based guidance that adheres to core principle number four, as amended by Dodd-Frank Section 735. Core principle number four, as amended, mandates that the boards of trade "have the capacity and responsibility" to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.[14] In keeping with the traditional

[13] *See* FIA Comment Letter, *supra* note 4, at 7.

[14] Dodd-Frank § 735(b).

roles of the Commission and the exchanges, and the roles as outlined in Dodd-Frank, the Commission should maintain its focus on market manipulation, leaving the exchanges the authority to monitor and regulate market disruptions. If the Commission broadens its focus to include disruption, however, it should rely on the tools it already possesses for prosecuting disruptive conduct, including CEA Sections 4c(a)(1), 4c(a)(2)(B), 6(c)(1) and 9(a)(2). For example, in *In the Matter of Bunge Global Markets, Inc.*, the Commission settled charges against Bunge Global Markets, Inc., including violating CEA Section 9(a)(2) which prohibits manipulation and attempted manipulation, for conduct that is essentially what the Commission now characterizes in its Proposed Order as "spoofing."[15] *Bunge* is a clear example of why the Commission has no need to exercise this new enforcement authority and should remain focused on its existing role and tools.

VII. The Commission Must Clarify That CEA Section 4c(a)(7) Will Only Be Violated If a Party Violates a Pre-existing Duty.

The Proposed Order is silent on Section 4c(a)(7). The Associations urge the Commission to affirm that Section 4c(a)(7) will not impose any additional duties of disclosure, inquiry or diligence. Futures and derivatives market participants have not traditionally been subject to the types of duties imposed by new Section 4c(a)(7) and, without such affirmation, market participants will face increased compliance and operational costs and uncertainty with respect to legitimate market activity. As stated in the FIA Comment Letter, Section 4c(a)(7) should only be violated if a party breaches a pre-existing duty arising under a contract, by operation of common law or under some other non-CEA source.[16]

VIII. Executing Brokers Must Be Given Safe Harbor.

The Proposed Order is silent on the issue of liability for executing brokers. The Associations urge the Commission to affirm that executing brokers are deemed to have satisfied their responsibilities regarding the Commission's Section 747 authority if they design appropriate structural safeguards to ensure that their clients have appropriate checks against entering orders likely to lead to market disruptions. Moreover, executing brokers that conform to principle-based guidelines should be afforded safe harbor protection from customer liability when they choose not to execute a customer trade and from Commission enforcement actions when, despite good faith and the exercise of reasonable controls, a market disruption occurs.

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[15] *In the Matter of Bunge Global Markets, Inc.*, CFTC Docket No. 11-10, 2011 WL 1099346 (C.F.T.C. Mar. 22, 2011).

[16] FIA Comment Letter, *supra* note 4, at 8-9.

The Associations thank the Commission for the opportunity to provide the above comments regarding the Commission's antidisruptive practices authority. Additionally, we would be pleased to meet with the Commission to discuss our concerns.

Respectfully yours,

John M. Damgard
President
Futures Industry Association

Kenneth E. Bentsen, Jr.
Executive Vice President, Public Policy and Advocacy
Securities Industry and Financial Markets Association

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott D. O'Malia, Commissioner
Robert Pease, Counsel to the Director of Enforcement
Steven E. Seitz, Attorney, Office of the General Counsel
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