

**CFTC SEEKS COMMENTS ON TRADING PRACTICES**

The Dodd-Frank Act<sup>1</sup> gave the Commodity Futures Trading Commission authority to prohibit certain trading practices deemed to disrupt fair and orderly markets.<sup>2</sup> Specifically, on a market subject to the jurisdiction of the CFTC, it will be a violation of the Commodity Exchange Act for any person to engage in any trading, practice or conduct 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).<sup>3</sup> The CFTC issued an advance notice of proposed rulemaking (“ANPR”)<sup>4</sup> and held a roundtable discussion with interested parties to solicit comment prior to promulgating rules to implement the new prohibitions. The ANPR asks 19 specific questions, which are reproduced below. The resolution of some of these questions could have significant effects on various market participants beyond traders. For example, the ANPR asks whether executing brokers should bear any responsibility for disruptive trading practices of their customers. In addition, in a statement accompanying the ANPR, CFTC Chairman Gensler said that he is particularly interested in algorithmic trading.

During the December 2, 2010 roundtable, several participants expressed concern about the vagueness of the new statutory provisions and the ambiguity of the standards articulated in them. They noted the difficulty of determining whether a bid or offer is violated in the over-the-counter context. They also noted that long-established trading practices could be viewed as disorderly in hindsight and that orders may be placed with a legitimate expectation of being canceled. Participants said that there is no commonly accepted definition of the term “spoofing” in the futures markets. Participants urged the CFTC to work with and rely on the exchanges to monitor and identify inappropriate activity on their markets. Most participants also suggested that

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No 111-203, 124 Stat. 1376 (2010) (“Dodd-Frank Act”).

<sup>2</sup> See § 4c(a) of the Commodity Exchange Act (“CEA”), as amended by § 747 of the Dodd-Frank Act.

<sup>3</sup> CEA, as amended by Dodd-Frank, § 4c(a)(5). This section becomes effective July 16, 2011.

<sup>4</sup> Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 FR 67301 (Nov. 2, 2010). In addition, on November 3, 2010, the Securities and Exchange Commission voted unanimously to adopt a rule to prevent certain disruptive practices by requiring securities brokers and dealers to have risk management controls and supervisory procedures in place before providing their customers with access to the markets. The rule effectively eliminates “unfiltered” or “naked” customer access to exchanges and alternative trading systems. On the same day, the SEC also proposed a rule intended to prevent fraud, manipulation, and deception in connection with the offer, purchase or sale of any security-based swap, the exercise of any right or performance of any obligation under a security-based swap, or the avoidance of such exercise or performance. Comments to the SEC’s proposed rule are due by December 23, 2010. See Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, 75 FR 68560 (Nov. 8, 2010).

executing brokers likely would not have sufficient information about the purpose of their customers' trades to be in a position to effectively monitor for disruptive orders. In terms of algorithmic trading, participants noted the difficulty in determining whether and how a particular algorithm might be harmful to the markets. Participants also cautioned against establishing rules that would stifle innovation or otherwise chill conduct, resulting in less liquidity in the markets.

Comments to the ANPR are due by January 3, 2011.

In the ANPR, the CFTC asks:

1. Should the CFTC provide additional guidance as to the nature of the conduct that is prohibited?
2. How should the prohibition against violating bids and offers be applied in the context of electronic trading platforms with pre-determined order-matching algorithms that preclude a trader from executing an order against a quote other than the best one available? In particular, should the provision apply to "buying the board" in an illiquid market?<sup>5</sup>
3. How should the CFTC distinguish between orderly and disorderly trading as articulated in the prohibition against conduct that demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period? What factors should a fact-finder consider in this inquiry?
4. How should "orderly execution" be defined? How should "closing period" be defined? Should the definition of closing period include:
  - a. Daily settlement periods?
  - b. Some period prior to contract expiration?
  - c. Trading periods used to establish indices or pricing references?
5. Should the CFTC recognize that a trading practice or conduct outside of the closing period is actionable so long as it "demonstrates intentional or reckless disregard for the execution of transactions during the closing period?"
6. Should the prohibition against conduct that demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period extend to order activity as well as consummated transactions?

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<sup>5</sup> The ANPR describes the practice of "buying the board" as when a trader, in a sufficiently illiquid market, enters an order for a large quantity at a price that is so far beyond the best available resting quote that the order executes against all resting quotes. In doing so, the trader would establish a new artificial best bid or offer that does not reflect market forces. See *In re Henner*, 30 Agric. Dec. 1151, 1155 (1971) (defendant "bought the board" – accepted all outstanding offers – and then bid for a single contract well in excess of the previously prevailing price. He was sanctioned for manipulating the price of egg futures; the fact that he paid more than necessary for shell egg futures was the basis for finding an artificial price).

7. Should executing brokers have an obligation to ensure that customer trades are not disruptive trade practices? If so, in what circumstances? What pre-trade risk checks should executing brokers have in place to ensure customers using their automated trading systems, execution systems or access to their trading platforms do not engage in disruptive trade practices?
8. How should the CFTC distinguish “spoofing” from legitimate trading activity where an individual enters an order larger than necessary with the intention to cancel part of the order to ensure that his or her order is filled?
9. Should the CFTC separately specify and prohibit the following practices as distinct from “spoofing” or should these practices be considered a form of “spoofing” that is prohibited:
  - a. submitting or canceling bids or offers to overload the quotation system of a registered entity, or delay another person’s execution of trades?
  - b. submitting or canceling multiple bids or offers to cause a material price movement?
  - c. submitting or canceling multiple bids or offers to create an appearance of market depth that is false?
10. Does partial fill of an order or series of orders necessarily exempt that activity from being defined as “spoofing”?
11. Are there ways to more clearly distinguish the practice of “spoofing” from the submission, modification, and cancellation of orders that may occur in the normal course of business?
12. Should the CFTC specify an additional disruptive trading practice concerning the disorderly execution of particularly large orders during periods other than the closing period? If so, at what size should this provision become effective and how should the CFTC distinguish between orderly and disorderly trading?
13. Should the CFTC specify and prohibit other additional practices as disruptive of fair and equitable trading?
14. Should the CFTC articulate specific duties of supervision relating to the prohibited trading practices (as well as any other trading practice that the CFTC determines to be disruptive of fair and equitable trading) to supplement the general duty to supervise contained in CFTC Regulation 166.3? To which entities should these duties of supervision apply?
15. Should the CFTC consider promulgating rules to regulate the use of algorithmic or automated trading systems to prevent disruptive trading practices? If so, what kinds of rules should the CFTC consider?

16. Should the CFTC consider promulgating rules to regulate the design of algorithmic or automated trading systems to prevent disruptive trading practices? If so, what kinds of rules should the CFTC consider?
17. Should the CFTC consider promulgating rules to regulate the supervision and monitoring of algorithmic or automated trading systems to prevent disruptive trading practices? If so, what kinds of rules should the CFTC consider?
18. Should the CFTC promulgate additional rules specifically applicable to the use of algorithmic trading methodologies and programs that are reasonably necessary to prevent algorithmic trading systems from disrupting fair and equitable markets? If so, what kinds of rules should the CFTC consider?
19. Should algorithmic traders be held accountable if they disrupt fair and equitable trading? If so, how?

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