THE DODD-FRANK ACT’S PROHIBITION OF DISRUPTIVE TRADING PRACTICES

The Dodd-Frank Act has amended the Commodity Exchange Act to prohibit conduct that “violates bids or offers,” disrupts the “orderly execution” of trading during the closing period, or is “of the character of spoofing.” The authors point out that these offenses are largely undefined, resulting in putative trading violations of uncertain scope.

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A potentially significant, though less-publicized, provision in the Dodd-Frank Act1 is the prohibition of certain so-called “disruptive” trading practices. Specifically, section 747 of the Act amends section 4c(a) of the Commodity Exchange Act (“CEA”) – which already prohibited “wash sales” and “fictitious sales” – by adding three prohibited transactions deemed “disruptive of fair and equitable trading.” The amendments to CEA section 4c(a) became effective on July 16, 2011.2

Although the Dodd-Frank Act also authorized the Commodity Futures Trading Commission (“CFTC”) to promulgate any rules it believes are necessary to prohibit the specified transactions in amended CEA section 4c(a), no implementing rules were required for the prohibitions to become effective, and the CFTC has not proposed any rules. Rather, the CFTC has issued a Proposed Interpretive Order to explain how it plans to interpret the new prohibitions in section 4c(a).3 A final interpretive order has not been released, but the Proposed Interpretive Order is effective until superseded by a subsequent order.

As explained below, the boundaries of amended section 4c(a) of the CEA remain largely undefined. The CFTC’s Proposed Interpretive Order highlights some of the concerns, but leaves many of them unresolved. As a result, firms and individuals trading commodity futures, options, and swaps must attempt to predict how the CFTC and its staff will apply the text of section 4c(a) to a wide variety of conduct. This article identifies some of the open issues created by amended section 4c(a) and explains the risks that may flow from these uncertainties.

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AMENDED TEXT OF SECTION 4C(A) OF THE CEA

As amended by section 747 of the Dodd-Frank Act, section 4c(a) of the CEA (entitled “Prohibited Transactions”) now includes the following subsection:

(5) Disruptive practices. – It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that –

(A) violates bids or offers;

(B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or

(C) is 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).

HOW FAR DOES CEA SECTION 4C(A) REACH?

As support for the CEA’s broad prohibition of manipulation, the Court of Appeals for the Eighth Circuit famously observed that the “methods and techniques of manipulation are limited only by the ingenuity of man.” 4 In other words, the argument against prohibiting particular types of manipulation is that clever participants might find a way around those definitions. The flip side of this argument is that a broad-brushed prohibition might not provide sufficient notice as to what types of conduct are in fact prohibited – rendering the statute unconstitutional as applied to certain activity. 5 Amended section 4c(a) reflects this tension. As explained below, each of the three types of prohibited transactions added to section 4c(a) presents unique risks for industry participants, in large part because neither the Dodd-Frank Act nor the Proposed Interpretive Order clearly identifies the types of activities that traders should avoid.

CEA 4c(a)(5)(A) Creates Strict Liability for Violating Bids or Offers.

The prohibition on violating bids or offers in section 4c(a)(5)(A) stands apart from the other new prohibitions, in that it appears to create a strict liability offense. Whereas the offenses identified in sections 4c(a)(5)(B) and (C) specify a level of intent necessary to prove a violation, section 4c(a)(5)(A) includes no reference to a particular state of mind. The CFTC takes the same reading of the statute, and plans to interpret the prohibition under section 4c(a)(5)(A) as creating a “per se offense” – i.e., one where no proof of intent is required. 6 Thus, traders who violate bids or offers may be liable under this subsection regardless of whether

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200 (1966) (“Vague laws in any area suffer a constitutional infirmity.”). With respect to amended section 4c(a), civil litigation is much more likely than criminal prosecution. Although the government theoretically could bring criminal charges for violations of section 4c(a) under section 9(a)(5) of the CEA, it would need to prove that the defendant’s conduct was “willful” – i.e., that the defendant violated section 4c(a)(5) with knowledge that its conduct was unlawful. Safeco Ins. Co. of America v. Burr, 551 U.S. 47, 57 n.9 (2007) (holding that criminal willfulness requires proof that the defendant “acted with knowledge that his conduct was unlawful” (quoting Bryan v. United States, 524 U.S. 184, 193 (1998))). This is a difficult standard to meet. Therefore, the most likely enforcement of section 4c(a)(5) will be through CFTC civil enforcement actions seeking injunctive relief and civil monetary penalties. In addition, private litigants may sue for violations of the subsection, provided they have suffered damages and can satisfy the remaining requirements for bringing a private cause of action under the CEA. 7 U.S.C. § 25(a)(1).

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4 Cargill, Inc. v. Hardin, 452 F. 2d 1154, 1163 (8th Cir. 1971).

5 See, e.g., United States v. Radley, 659 F. Supp. 2d 803, 816 (S.D. Tex. 2009) (dismissing criminal manipulation charges because the “uncertain[]” definition of manipulation as applied to the defendant’s conduct was “the very thing that the constitutional vagueness doctrine is meant to protect against”), aff’d, 632 F.3d 177 (5th Cir. 2011). Although Radley was a criminal case, the constitutional “vagueness” doctrine also applies in civil litigation. See Ashton v. Kentucky, 384 U.S. 195, 7 U.S.C. § 25(a)(1).

6 Proposed Interpretive Order, supra note 3, at 14,946.
they do so intentionally or negligently (or even through no fault of their own).

In addition, the statute does not define what it means to “violate bids or offers.” The CFTC plans to interpret this phrase as prohibiting a person from “buying a contract at a price that is higher than the lowest available offer price and/or selling a contract at a price that is lower than the highest available bid price.” Based on this interpretation, firms that bid above the prevailing offer or offer below the prevailing bid – even for legitimate reasons – could find themselves accused of violating the CEA if another trader accepts their bid or offer.

In an effort to clarify its interpretation, the CFTC’s Proposed Interpretive Order sets forth several additional guidelines. First, the CFTC does not intend for the prohibition to create a “best execution standard across multiple trading platforms and markets” (some of which may have different bid-ask spreads for the same contracts). Second, the CFTC will not interpret the statute to preclude a trader’s efforts to “buy the board” – i.e., to execute a sequence of trades to buy all available bids or offers. Finally, though the prohibition in section 4c(a)(5)(A) is not limited to floor trading, the CFTC takes the position that section 4c(a)(5)(A) only applies when a trader has control over the bids or offers he selects. Thus, trades made on an electronic trading platform that use automated order-matching software should not give rise to liability under this section to the extent that such software precludes parties from buying higher or selling lower than prevailing market prices.

Notwithstanding these clarifications, the primary issue still remains – namely, that the inadvertent violation of bids or offers gives rise to the same type of liability under section 4a(c) as does a trader’s deliberate efforts to violate bids or offers. Until the CFTC issues a final version of its interpretive order, traders should exercise caution in placing bids and offers so as not to inadvertently purchase at prices above the lowest offer or sell at prices below the highest bid.

**CEA Section 4c(a)(5)(B) Does Not Identify What Type of Conduct Disrupts the “Orderly Execution” of Trading during the Close**

For several reasons, the second type of “disruptive practice” identified in subsection five – conduct demonstrating “intentional or reckless disregard for the orderly execution of transactions during the closing period” – raises a deeper concern for market participants than does the prohibition on violating bids and offers. First, the prohibition of this second type of trading practice will prompt regulators to scrutinize more closely the activities of anyone who trades during the closing period. The closing period, of course, is one of the most actively traded periods during the trading day, and this concentration can lead to greater movements in price. Thus, perhaps more than usual, traders who execute trades during a volatile closing period may be asked to respond to regulatory inquiries.

Second, the current statutory language provides little guidance as to what type of conduct is prohibited, because the phrase “orderly execution” is not defined. The CFTC’s Proposed Interpretive Order attempts to address this concern by identifying the “parameters” that exist in an orderly market, including “a rational relationship between consecutive prices, a strong correlation between price changes and the volume of trades, levels of volatility that do not materially reduce liquidity, accurate relationships between the price of a derivative and the underlying,” and “reasonable spreads between contracts for near months and for remote months.” However, none of these parameters appear logically to relate to a specific type of conduct. If anything, the Proposed Interpretive Order expands the universe of potentially violative trading activity by interpreting the prohibition in section 4c(a)(5)(B) as covering the submission of bids and offers in addition to the execution of orders, as well as entangling trading activity outside of the closing period. Indeed, a

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7 Id. at 14,945-46.


9 Proposed Interpretive Order, supra note 3, at 14,946.

10 Id. The concept of “control” may prove elusive. If a developer programs an algorithm that is not susceptible to change or modulation by a trader, does control exist?

11 Prepared Answering Testimony and Exhibits of Prof. S. Craig Pirrong, In re Energy Transfer Partners, L.P., et al., Docket No. IN06-3-002, before the Federal Energy Regulatory Commission, at p. 70 (Mar. 31, 2009) (noting that “trading activity in financial markets tends to occur disproportionately in abbreviated periods during the trading day (e.g., the open and the close)”).

12 Proposed Interpretive Order, supra note 3, at 14,946.

13 Id.
footnote in the Proposed Interpretive Order states that the closing period can include cash market transactions in physical commodity markets in contracts where the transactions are used to establish a settlement price for a futures contract or swap.\textsuperscript{14}

One reading of the statute is that Congress intended this subsection to prevent conduct more commonly known as “marking the close,” where a person trades a large number of contracts in the last few minutes of the trading day in order to artificially benefit a related position.\textsuperscript{15} Even so, however, marking the close is often difficult to distinguish from legitimate trading activity due to the volume of trading that already takes place during the closing period. Thus, absent further clarification, market participants will be left with little guidance as to what they may and may not do during the closing period. This is particularly concerning given that subsection (5)(B) will enable the CFTC to prove a violation without proving that the defendant acted with specific intent—mere recklessness will suffice—\textsuperscript{16} as it had to do in marking-the-close cases brought prior to the Dodd-Frank Act.\textsuperscript{17}

Considered together, these issues threaten to create serious regulatory risks for anyone who trades aggressively during a closing period.

\textsuperscript{14} Id. at 14,946 n.42.


\textsuperscript{16} See Proposed Interpretive Order, supra note 3, at 1,946. While specific intent to manipulate generally requires proof that the defendant acted for the specific purpose of creating prices that do not reflect legitimate forces of supply and demand, the CFTC defines “recklessness” 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.” Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices, 76 Fed. Reg. 41,398, 41,404 (July 14, 2011) (quoting Drexel Burnham Lambert Inc. v. U.S. Commodity Futures Trading Comm’n, 850 F.2d 742, 748 (D.C. Cir. 1988)). The CFTC does not provide any specific examples of the type of trading behavior that would be captured by the “reckless” standard, but it states that proof of knowledge is not required and that it will apply a “facts and circumstances” test to each case it brings. Proposed Interpretive Order, supra note 3, at 1,946.


**Section 4c(a)(5)(C) Presents Serious Risks for High-Frequency and Algorithmic Traders.**

The final “disruptive practice” identified in new Subsection 5 pertains to so-called “spoofing.” Based on the definition of “spoofing” in section 4c(a)(5)(C)—“bidding or offering with the intent to cancel the bid or offer before execution”—it would appear that a violation would depend on proof that a defendant entered an order with the intent to cancel it before it was filled. In other words, the CFTC may need to prove that the defendant intended for its order not to be filled. According to the CFTC, the fact that an order was filled is irrelevant; the trader who submitted the order can still be found to have violated this subsection.\textsuperscript{18} Absent contemporaneous evidence reflecting the defendant’s intent—e.g., e-mails, instant messages, phone recordings, etc.—the CFTC will need to prove intent using circumstantial evidence. Such evidence could include the number and pattern of orders submitted, the length of time orders remained active before being cancelled, the nature of the trading methodology, and the viability of the order in the first place (i.e., whether the price of the order was close the market price at the time of submission).

The CFTC’s Proposed Interpretive Order also offers several examples of wrongful intent in the spoofing context. In particular, the CFTC suggests that a trader could violate subsection (5)(C) by submitting or cancelling bids or offers in order to (1) “overload the quotation system of a registered entity”; (2) “delay another person’s execution of trades”; or (3) “create an appearance of false market depth.”\textsuperscript{19} Traders should be able to structure their order entry practices in order to reduce the risk that wrongful intent will be found under these standards.

Nevertheless, the Dodd-Frank Act’s blanket prohibition on spoofing, which includes conduct that is only “of the character” of spoofing, should raise particular concern for firms that engage in electronic and algorithmic trading. Empirical evidence suggests that so-called high-frequency traders cancel “at least 90 percent of their orders,”\textsuperscript{20} suggesting that these firms

\textsuperscript{18} Proposed Interpretive Order, supra note 3, at 1,947.

\textsuperscript{19} Id.

may become a convenient target for the CFTC in enforcing this prohibition. CFTC Commissioner Bart Chilton has reinforced this notion by referring to high-frequency traders as “cheetahs,” a loaded label which suggests both that these traders are “preying” upon less sophisticated market participants, and that they are somehow evading the law – i.e., “cheating.” Because the CFTC takes the position that the submission of a single bid or offer with intent to cancel is enough to constitute a violation of subsection (5)(C), high-frequency and algorithmic trading firms will need to be extremely diligent in their compliance efforts.

CONCLUSION

David Meister, the director of the CFTC’s Division of Enforcement, refers to the Dodd-Frank Act as having given the agency a “bigger arsenal of weapons.” The new anti-disruptive trading authority in CEA section 4c(a) is a big part of this new “arsenal.” As amended, this section allows the CFTC to move against market participants for the largely undefined offenses of “violating bids and offers” (regardless of any wrongful intent by the defendant), spoofing, or conduct that is “of the character” of spoofing, and “reckless disregard for the orderly execution of transactions during the closing period.” The only real certainty with respect to these offenses is that their scope is uncertain. It remains to be seen how broadly the CFTC will exercise its new authority over these so-called disruptive trading practices.


22 Proposed Interpretive Order, at 14,947.