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DISRUPTIVE TRADING AND THE SEARCH FOR WRONGFUL INTENT

The new prohibitions of disruptive trading in the Commodity Exchange Act and in rules promulgated by the leading commodity exchanges require proof of scienter but, notably, no proof of actual market impact. If it is the "thought" that counts in this developing area of law, how will the scienter analysis proceed? The authors answer this question and others using available guidance provided by the regulators and recent enforcement cases — both civil and criminal.

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Given the label of "disruptive trading," one might expect that the new prohibitions in the Commodity Exchange Act (CEA) and the new rules at the leading commodity exchanges would require proof of actual market impact. They do not. Instead, they turn almost entirely on the trader's intent, *i.e.*, whether or not he acted with the requisite *scienter*. Under the CEA, for example, it is now unlawful to engage in trading that (1) "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)" or (2) "demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period."[1]

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[1] 7 U.S.C. § 6c(a)(5). Section 4c(a)(5) of the CEA, as amended, also prohibits trading that "violates bids or offers." 7 U.S.C. § 6c(a)(5)(A). However, there can be no violation of this section when a person trades in a market "utilizing trading algorithms that automatically match the best price for bids and offers." Antidisruptive Practices Authority, 78 *Fed. Reg.* 31,890, 31,893

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The Chicago Mercantile Exchange (CME) and the Intercontinental Exchange (ICE) have each adopted a disruptive trading rule to prohibit these same activities and others that the exchange views as "disruptive" — regardless of their impact on the market.[2]

Although evidence of market impact may bolster the *scienter* case against a particular trader, it is not clear how much weight, if any, regulators — either the Commodity Futures Trading Commission (CFTC) or exchanges — will give to evidence showing a *lack* of market impact. Whether this approach is good policy is beyond the scope of this article. Without question, however, it further distinguishes the new disruptive trading offenses from traditional market manipulation, in which causing an artificial price is an element of proof and thus a fertile ground for attack by the defense.[3] Although prior manipulation cases sometimes involved disruptive trading activities, disruptive trading is now itself unlawful in a more expansive way than ever before, regardless of any impact on prices in the market.

To date, the CFTC and the exchanges have brought only a handful of cases charging violations of the new disruptive trading prohibitions. But civil enforcement is just the tip of the iceberg. In the last 10 months alone, federal prosecutors in Chicago have twice brought criminal charges for alleged spoofing on CME markets.[4] More investigations are in progress, and additional

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(May 28, 2013) [hereinafter CFTC Interpretive Guidance]. Given that most exchanges use electronic order-matching systems, it would appear that Section 4c(a)(5)(A) is limited to open-outcry trading and does not apply in electronically traded markets. CME officials have expressed this same view. *See* Tom LaSala, Steven Schwartz & Andrew Vrabel, Remarks During "FIA Webinar: CME Group Rule 575" (Sept. 11, 2014) (presentation *available at http://www.automatedtrader.net/Files/z/FIA_CME_Rule_575.pdf*, last accessed June 24, 2015). For this reason, and because neither CME nor ICE incorporated the prohibition against violating bids or offers into its new disruptive trading rule, this article does not discuss the prohibition further.

[2] CME Rule 575 (effective Sept. 15, 2014) and ICE Rule 4.02(l) (effective Jan. 14, 2015) (set forth in full in the attached "Appendix A"). CME, as referenced herein, includes all four exchanges within the CME Group: the Chicago Mercantile Exchange Inc., the Board of Trade of the City of Chicago, Inc. (CBOT), the New York Mercantile Exchange, Inc. (NYMEX), and the Commodity Exchange, Inc. (COMEX). Before CME and ICE adopted their respective disruptive trading rules, the CBOE Futures Exchange (CFE) adopted its own "disruptive practices" rule, Rule 620. CBOE Futures Exchange, LLC Rulebook at 203 (revised as of May 26, 2015), *available at* http://cfe.cboe.com/publish/CFERuleBook/CFERuleBook.pdf (last accessed June 24, 2015). The text of CFE Rule 620 mirrors the text of Section 4c(a)(5) of the CEA. On July 16, 2015, CFE proposed to amend its Rule 620 (effective July 30, 2015) to add a new paragraph (b) to the Rule that sets forth particular types of order entry and trading practices that CFE considers to be abusive to the orderly conduct of trading or the fair execution of transactions. The proposed amendment also adds a "Policy and Procedure XVIII" to CFE's rulebook to provide further guidance on the disruptive trading practices prohibited under Rule 620. *See* CFE Rule Certification Submission Number CFE-2015-020 (July 16, 2015), *available at* http://www.cftc.gov/filings/orgrules/rule071615cfedcm001.pdf (last visited July 27, 2015). CFE's proposed rule amendment

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mirrors the text of the CME's Rule 575 (discussed *infra passim*), and CFE has included many of the same factors and examples previously identified by CME. Thus, this article does not further discuss CFE Rule 620.

[3] *See, e.g., In re Amaranth Nat. Gas Commodities Litig.*, 730 F.3d 170, 173 (2d Cir. 2013) ("[A] court will find manipulation where "(1) Defendants possessed an ability to influence market prices; (2) an artificial price existed; (3) Defendants caused the artificial prices; and (4) Defendants specifically intended to cause the artificial price." (emphasis added) (quoting *Hershey v. Energy Transfer Partners, L.P.*, 610 F.3d 239, 247 (5th Cir. 2010)).

[4] Criminal Complaint and Affidavit, *United States v. Sarao*, No. 15-cr-75 (N.D. Ill. Feb. 11, 2015), *available at* http://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/21/sarao_criminal_complaint.pdf (last accessed June 24, 2015); Indictment, *United States v. Coscia*, No. 14-cr-551 (N.D. Ill. Oct. 1, 2014), *available at* http://www.justice.gov/usao/iln/pr/chicago/2014/pr1002_01a.pdf (last accessed June 24, 2015).

prosecutions — both civil and criminal — are sure to come. Using prior cases and the CFTC's and the exchanges' respective interpretive guidance for the new disruptive trading prohibitions, this article suggests both the types of trading activities market participants should avoid and how the *scienter* analysis may proceed in new disruptive trading cases.

CONDUCT THAT MAY TRIGGER A DISRUPTIVE TRADING INVESTIGATION

As noted above, there are two principal categories of conduct that the CEA now prohibits as "disruptive": (1) spoofing, or trading that is of the character of spoofing and (2) trading that demonstrates reckless disregard for orderly executions during the closing period. CME and ICE have addressed both types of conduct in their new disruptive trading rules. The CFTC and the exchanges are likely to charge this conduct as "disruptive" when the circumstantial evidence supports an inference of *scienter*, regardless of whether the conduct at issue caused any observable impact on the market.

Trading that is, or is of the Character of, "Spoofing"

Under Section 4c(a)(5)(C) of the CEA, it is unlawful to engage in any trading, practice, or conduct that "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)." Significantly, the statute itself defines the offense in terms of intent, not whether the trading affected the market. The level of *scienter* required is "beyond recklessness."[5]

The CFTC's Interpretive Guidance identifies four types of practices that may constitute spoofing or conduct that "is of the character of" spoofing: "(i) [s]ubmitting 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 cancelling bids or offers with intent to create artificial price movements upwards or downwards."[6] None of the examples requires the market participant to have actually *achieved* the alleged purpose of these practices; proof of trading with that purpose alone is sufficient to violate Section 4c(a)(5)(C).

CME and ICE incorporated not only the CEA's definition of spoofing into their own disruptive trading rules, but also these four specific practices identified in the CFTC's Interpretive Guidance. CME Rules 575(B) and (C), for example, prohibit the entry of orders "with intent to mislead other market participants" or "to overload, delay, or disrupt the systems of the Exchange or other market participants," respectively. Likewise, ICE Rules 4.02(l)(1)(B) and (C) prohibit the entry of orders with "intent to overload, delay, or disrupt the systems of the Exchange or other market participants," or to "mislead other market participants." The exchanges' rules, like the examples set forth in the CFTC's Interpretive Guidance, require proof of intent, but not market impact. In addition, they also suggest that the intent to *modify* orders "to avoid execution" will violate the rule. Although the CEA makes no reference to order modifications as falling within the ban on spoofing, one could infer from the Commission's Interpretive Guidance that it, too, interprets the prohibition of conduct that is "of the character" of spoofing to include improper modifications. In particular, the Commission's Interpretive Guidance clarifies that it does not view the statute to prohibit the *legitimate* "modification of orders," suggesting *illegitimate* modifications are prohibited.[7]

Notwithstanding the CEA's definition of spoofing, the scope of that definition and its application to conduct in the derivatives industry — including the outer boundaries of conduct that is "of the character of . . . spoofing"[8] — has generated disagreement within the industry. It is not possible to identify every example of an activity that may trigger spoofing charges, but the exchanges' rules guidance, recent spoofing cases, and CFTC's and CME's prior enforcement actions together suggest a range of trading activities that may give rise to a spoofing investigation.

In addition to the four practices that the CFTC suggested in its Interpretive Guidance could constitute spoofing — and that both ICE and CME incorporated into their disruptive trading rules — CME's guidance identifies specific additional examples of conduct that CME believes may violate one or more provisions of Rule 575. All of CME's examples describe conduct that CME likely would prosecute under the portions of Rule

[5] CFTC Interpretive Guidance, *supra* note 1, at 31,896.

[6] *Id.* (noting that these examples represent a "non-exclusive" list).

[7] *Id.*

[8] *See, e.g.*, Transcript from CFTC Staff Roundtable on Disruptive Trading Practices, at 64, 111, 171, and 176–77 (Dec. 2, 2010), *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission24_120210-transcri.pdf (last accessed June 24, 2015).

575 related to spoofing (575(A)–(C)). Although some of the examples describe trading activity that could have an actual impact on markets, it is important to remember that CME believes the strategies alone will violate its rule, without requiring proof of market impact:

1) entering large orders to create the false appearance of market activity in order to achieve fills on smaller orders at advantageous prices on the opposite side of the market, and then cancelling the large orders after the smaller orders are filled;

2) placing — and then cancelling — numerous orders on the opposite side of the market for the purpose of inducing market participants to trade with resting orders;

3) entering orders in one market (Market A) solely to learn how algorithmic trading systems in an economically related market (Market B) will react, and then using this knowledge to profit in Market B from "momentum ignition" orders placed in Market A (*i.e.*, orders that "ignite" algorithmic trading systems and create price momentum — up or down — in Market B);

4) placing large orders in the pre-open period to increase or decrease the Indicative Opening Price and encourage other participants to join at the entered price levels, only to cancel the orders at the last minute, leaving the other participants exposed when the market opens;

5) entering orders at increasing (or decreasing) price levels in the pre-open period to ascertain market depth and hidden liquidity at particular price levels, and then cancelling the orders before the market opens;

6) entering numerous orders for the purpose of creating "information arbitrage" (a trading advantage created by overloading competitors' trading systems with excess market data) or "latencies" in information distribution (slowing the orderly flow and function of the market by overloading exchange systems); and

7) trading with all resting orders on one side of the market to become the first resting order in the queue, thereby convincing others to join at that price level, and then entering a large order on the other side of the market (knowing that the exchange's system will prevent wash trades).[9]

The circumstances surrounding CME's issuance of its final guidance permit speculation that the Commission may consider these same strategies to also violate Section 4c(a)(5)(C) of the CEA. In particular, two weeks after issuing its initial guidance on Rule 575, CME issued revised guidance that identified changes it made "[s]ubsequent to discussions with" the CFTC. Notably, however, CME did not make any changes to the above examples after its discussions with the Commission. This fact supports speculation that the CFTC approved of CME's examples — and perhaps even that it may treat the same conduct as violating Section 4c(a)(5)(C) of the CEA.

The United States Department of Justice (DOJ) has raised the stakes even further. In October 2014, prosecutors in Chicago obtained an indictment in the first criminal case based on alleged spoofing activity. The indictment alleges that the defendant, Michael Coscia (owner of the trading firm Panther Energy Trading LLC) had engaged in spoofing on CME and on ICE Futures Europe in violation of Section 4c(a)(5)(C) of the CEA. In particular, DOJ claimed that Coscia had "entered large-volume orders that he intended to immediately cancel before they could be filled by other traders," in order to create false impressions in the market that would allow him to offset additional trades at better prices before quickly cancelling the large-volume orders.[10] Prosecutors made similar allegations in a criminal complaint and supporting affidavit filed in April 2015 against London resident Navinder Sarao, accusing him of "placing multiple large-volume orders on the CME at different price points" in order to "induce other market participants to react to his deceptive market information" so that he could execute other orders profitably.[11] Sarao, it is alleged, constantly modified his large-volume orders to eliminate the risk that the orders would be executed.[12] Both cases involve conduct similar to that described in CME's Rule 575 Guidance.

[9] CME Group Market Regulation Advisory Notice No. RA1405-5R — Disruptive Practices Prohibited, at 10-12 (Sept. 15, 2014) [hereinafter CME Rule 575 Guidance], *available at* http://www.cmegroup.com/rulebook/files/ra1405-5r.pdf (last accessed June 24, 2015).

[10] *Coscia* Indictment, *supra* note 4, at ¶ 3.

[11] *Sarao* Criminal Complaint and Affidavit, *supra* note 4, at ¶ 14.

[12] *Id.*

The CFTC's enforcement actions are also instructive in determining how regulators may define the offense. In April 2015, at the same time as the indictment and in likely coordination with criminal authorities, the CFTC filed a complaint against Navinder Sarao alleging manipulation, attempted manipulation, disruptive trading, and use of a manipulative device (identified as the spoofing activity supporting the disruptive trading charge) in connection with a futures contract. Among other things, the CFTC alleged that Sarao had used a layering algorithm to "place, modify, and cancel orders in cycles lasting less than six minutes" and had the ability to, and did, "create large Order Book imbalances between the sell and buy side" — which in turn had the ability to affect the market price.[13] The CFTC's complaint demonstrates that, despite the new prohibition of spoofing, the Commission may still prosecute spoofing-like activity as manipulation where it believes that the defendant's conduct reflects both an intent to cancel an order before execution *and* an intent to create artificial prices in the market.

Similar to its complaint against Sarao, the CFTC in May 2015 filed a federal lawsuit against two United Arab Emirates residents, Heet Khara and Nasim Salim, for alleged spoofing violations under Section 4c(a)(5)(C). More specifically, the CFTC alleged that Khara entered "several orders on one side of the market ('layered orders') while also having one or more smaller orders on the opposition side of the market," and that he "cancel[led] the layered orders" as soon as the smaller orders were executed.[14] The CFTC also alleged that Khara and Salim coordinated their trading in separate accounts to engage in this same type of trading activity.[15]

Foreshadowing the later criminal case against Coscia, the Commission found in an administrative settlement in July 2013, in the first CFTC case brought under amended Section 4c(a)(5)(C), that Coscia and Panther had engaged in spoofing over a four-month period using an algorithm designed to place bids and offers, and then cancel them before execution. The Commission found that the respondents had used the algorithm to generate interest on one side of the market with strategically placed orders to achieve a profitable execution on a resting order on the other side, and then to quickly cancel any remaining orders before they could be executed.[16] In all of these cases, the Commission's allegations regarding the defendant's intent formed the primary basis for the alleged violations.

Prior to these cases, the CFTC had prosecuted pre-Dodd-Frank conduct that it might now address under Section 4c(a)(5)(C), but it did so under separate and different provisions of the CEA. When the CFTC believed it had evidence of manipulative intent, as in its action against Eric Moncada, it charged the conduct as manipulation. The consent order in *Moncada* found that the trader had attempted to manipulate prices by placing and immediately cancelling numerous large-lot orders at, or near, the best bid or best offer price, without the intent to have them filled but instead to move prices artificially, and that he then tried to profit from these price movements by placing small-lot orders on the other side of the large-lot orders.[17]

In contrast to the charges in *Moncada* brought as manipulation, the CFTC settled two other enforcement actions involving similar conduct under sections of the CEA prohibiting conduct that (1) causes non-bona fide prices to be reported and (2) causes false, misleading, or knowingly inaccurate reports to be delivered. The CFTC alleged that the respondents in those cases (Gelber Group, LLC and Bunge Capital Markets, Inc., respectively) had entered orders in the pre-open period to gauge market depth at different prices levels, and then cancelled the orders before the market opened and the orders could be executed.[18] Perhaps not coincidentally, both the pre- and post-Dodd-Frank conduct prosecuted in these CFTC cases is similar to some of the examples described in CME's guidance and to the factors identified by both CME and ICE in their rules' guidance,

[13] Complaint at ¶¶ 50-52, *CFTC v. Nav Sarao Futures Limited PLC and Navinder Singh Sarao*, No. 15-cv-3398, 2015 WL 1843321 (N.D. Ill. April 17, 2015).

[14] Complaint at ¶ 18, *CFTC v. Khara*, No. 15-cv-3497, 2015 WL 2066257 (S.D.N.Y. May 5, 2015).

[15] *Id.* at ¶¶ 27-28.

[16] *In the Matter of Panther Energy Trading LLC and Michael J. Coscia*, CFTC Docket No. 13-26, 2013 WL 3817473, at *1–3 (CFTC July 22, 2013).

[17] Consent Order, Docket No. 80, *CFTC v. Moncada*, Case No. 1:12-cv-8791 (S.D.N.Y. Oct. 1, 2014); *see also In the Matter of Ecoval Dairy Trade, Inc.*, CFTC Docket No. 11-16, at 2–3 (CFTC July 19, 2011) (finding, by administrative settlement, that respondent attempted to manipulate futures settlement prices by engaging in a scheme that included bidding and then quickly cancelling bids without the intent to have the bids filled).

[18] *In the Matter of Gelber Group, LLC*, CFTC Docket No. 13-15, 2013 WL 525839 (CFTC Feb. 8, 2013); *In the Matter of Bunge Global Markets, Inc.*, CFTC Docket No. 11-10, 2011 WL 1099346 (CFTC Mar. 22, 2011).

making it more likely that the CFTC and the exchanges will prosecute such conduct under Section 4c(a)(5)(C) and their new disruptive trading rules, respectively.

Although CME has not yet announced the resolution of any cases under Rule 575, like the CFTC, it too had previously charged conduct similar to that which is now prohibited under Rule 575(A)–(C) (the spoofing sections). In fact, CME estimated in September 2014 that it had brought more than 40 disciplinary actions in the past three years for conduct "that was of the nature of spoofing, misleading, or intentionally/recklessly disruptive."[19] A review of these actions suggests that CME, with perhaps more frequency than the CFTC, will bring cases for disruptive trading whenever it believes that a market participant has entered an order for *any* purpose other than to execute a legitimate trade and cancelled the order before execution. A few examples include:

- *In the Matter of Shlomi Salant*,[20] involving a trader who allegedly entered a small order on one side of the market and multiple large-lot orders on the other side to "create the appearance of an imbalance in buy/sell pressure," and then "canceled the large orders" when the small order was executed;

- *In the Matter of Robert Leeds*,[21] involving a trader who, with "an order resting on the buy (sell) side of the market," allegedly entered "a large order, often at the top of the book, on the sell (buy) side of the market causing other market participants to trade with his resting buy (sell) order," and then cancelled the large order as soon as "trading ceased on his buy (sell) order";

- *In the Matter of Igor Oystacher*,[22] involving a trader who allegedly entered "iceberg" orders (large orders with only a small portion made visible to the market, so as not to impact the market price as the order is filled) on one side, layered in orders on the other side, and cancelled those orders as soon as trading ceased on the iceberg orders;

- *In the Matter of Hard Eight Futures LLC*,[23] involving a firm that allegedly entered large orders without the intent to trade, but instead to obtain "fills on much smaller liquidating orders already resting on the other side of the order book," or to "encourage[e] a market movement" so that the firm would "receive better fills when entering aggressive, liquidating orders"; and

- *In the Matter of Joseph Lalich*,[24] involving a trader who entered futures orders on Globex during the pre-open session allegedly not "in good faith for the purpose of executing bona fide transactions," and whose orders and subsequent cancellations "caused fluctuations" in the Indicative Opening Price.

ICE also has prosecuted conduct that likely falls within the category of spoofing. In June 2015, it announced the settlement of charges against a trader who "engag[ed] in a pattern of trading activity where he would enter buy or sell orders on one side of the market at different price levels and subsequently cancel such orders in close time proximity to trades [he] executed on the opposite side of the market." Although ICE also found that the trader's conduct "may have disrupted the marketplace" (despite resulting "in no financial gain" to the trader),[25] that finding was likely superfluous, in that ICE's Rule 4.02(l) does not require proof of market impact.

CME and ICE brought these types of actions pursuant to their broad authority under CME Rule 432 and ICE Rule 404, respectively, to prohibit conduct either "inconsistent with just and equitable principles of trade" or "detrimental to the interest or welfare of the Exchange."[26] However, they are likely to bring them in

[19] CME Group Market Regulation Department, *FIA Webinar: CME Group Rule 575*, at 10 (Sept. 11, 2014), *available at* http://www.automatedtrader.net/Files/z/FIA_CME_Rule_575.pdf (last accessed June 24, 2015).

[20] CBOT 12-8860-BC (Jan. 22, 2015).

[21] NYMEX 12-8886-BC (Jan. 20, 2015).

[22] COMEX 11-08380-BC (Nov. 28, 2014).

[23] CBOT 10-7960-BC (Apr. 4, 2014).

[24] CBOT 11-8430-BC (Mar. 18, 2013).

[25] *In the Matter of Igor Oystacher*, ICE Case Number 2013-009 (June 5, 2015). The respondent in this case had previously settled a disciplinary matter at CME involving similar conduct and similar spoofing-like charges. *See* note 22, *supra*.

[26] CME Rule 432 prohibits, among other things, "bad faith" conduct (432.B.1), conduct "inconsistent with just and equitable principles of trade" (432.B.2), "dishonest conduct" (432.C), conduct "substantially detrimental to the interests or welfare of the Exchange" (432.Q), and "dishonorable or uncommercial conduct" (432.T). Similarly, ICE Rule 404 prohibits the failure to conform to ICE's rules or procedures, conduct "inconsistent with just and equitable principles of trade," and "conduct detrimental to the best interests of the Exchange."

the future under Rule 575 and Rule 4.02(l), respectively, and perhaps under the more general misconduct rules as well.[27]

Trading that Causes or Contributes to "Disorderly Executions"

Section 4c(a)(5)(B) of the CEA makes it unlawful to engage in any trading, practice, or conduct that "demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period." CME's and ICE's disruptive trading rules adopt this prohibition and, like the CEA, focus on intent. Like spoofing, there is no requirement in either CME's or ICE's rules that the participant's conduct actually cause disorderly executions or some other type of market impact.

CME's and ICE's disruptive trading rules also expand upon the prohibition in Section 4c(a)(5)(B) of the CEA in one material respect. Whereas Section 4c(a)(5)(B) of the CEA is limited to conduct impacting orderly executions "during the closing period," neither CME's nor ICE's rule limits the prohibition to conduct affecting the closing period; on the contrary, the rules have no time restrictions. CME Rule 575(D) provides that no person shall enter orders "with intent to disrupt, or with reckless disregard for the adverse impact on, the orderly conduct of trading or the fair execution of transactions." The rule does not specify a time period during which "disorderly" trading or "unfair" executions could lead to a possible rule violation. Subsections (C) and (D) of ICE Rule 4.02(l) likewise prohibit the entry of orders with "intent to disrupt" or with "reckless disregard for the adverse impact" on the market at any time. Thus, while the CFTC may bring charges for conduct that reflects intentional or reckless disregard for the impact on orderly executions *only* during the closing period, the exchanges may prosecute conduct reflecting intentional or reckless disregard for orderly executions at any time during the trading day. Both the exchanges and the CFTC, however, need only show wrongful intent; actual market impact is not required.

The exchanges' respective rules guidance and prior enforcement activity, as well as the CFTC's prior enforcement activity, together identify conduct that regulators may prosecute in the future under this category of disruptive trading. The Commission's Interpretive Guidance is less helpful in this respect. In particular, although it discusses factors present in "orderly markets" — such as a correlation between price changes and trading volumes, relatively low volatility, and reasonable price spreads between contract months — it identifies only a few generic examples of conduct that the CFTC views as prohibited by Section 4c(a)(5)(B) of the CEA. These include (1) accumulating a large position with the intent to disrupt, or with reckless disregard for the likelihood of disrupting, the orderly execution of transactions during the close and (2) like spoofing, submitting bids or offers with intent to cancel them before execution to the extent such "false signals" disrupt orderly trading during the close.[28] Both examples turn on the market participant's intent. But neither example translates easily into clear boundaries for real-world trading strategies or activities that market participants must avoid.

In contrast to the limited number of examples identified in the CFTC's Interpretive Guidance, CME's rule guidance identifies a non-exhaustive list of specific examples of conduct that it has determined may violate Rule 575. At least two of CME's examples likely would be prosecuted under Rule 575(D), which addresses trading carried out with intentional or reckless disregard for the impact on orderly executions. They are (1) the entry of orders in one market for the purpose of discovering how a related market will react in order to enter and profit from "momentum ignition" orders[29] if such conduct causes a "disruption to the orderly execution of transactions" and (2) the entry of orders "for the purpose of creating latencies in the market or in information dissemination . . . for the purpose of disrupting the orderly functioning of the market."[30]

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[27] CME's guidance, in addition to identifying conduct that may violate Rule 575's spoofing prohibitions, also clarifies that several common practices do *not* constitute a violation of Rule 575(A)-(C) in the absence of evidence that they were done for disruptive purposes. Such practices include using stop orders to protect a position, making two-sided markets, entering iceberg orders (unless the orders are used as part of a larger disruptive scheme, as alleged in CME's disciplinary action against *Oystacher*), and entering orders at various price levels in order to gain queue position (even if many are later cancelled). CME Rule 575 Guidance, *supra* note 9, at 6 (FAQ #s 7-10). ICE's guidance similarly approves of all of these practices — except for the use of stop orders, which it omits without explanation. ICE Futures U.S., Disruptive Trading Practices FAQs, at 3 (FAQ #s 7-9) (Jan. 2015) [hereinafter ICE Rule 4.02(l) Guidance], *available at* https://www.theice.com/publicdocs/futures_us/Futures_US_Disruptive_Practice_FAQ.pdf (last accessed June 24, 2015).

[28] CFTC Interpretive Guidance, *supra* note 1, at 31,895-96.

[29] *See* explanation of such orders at text accompanying note 9, *supra*.

[30] CME Rule 575 Guidance, *supra* note 9, at 11-12.

Both examples, like the rule itself, depend on a showing of *scienter*. But CME's guidance also suggests that the fact alone that an order is large may give rise to a violation of Rule 575(D) if its "entry results in disorderliness in the markets" or "distorts the integrity of the settlement prices."[31] Courts have criticized attempts to punish large traders simply for trading in large quantities,[32] and CME presumably will require some evidence beyond mere size alone before bringing charges under Rule 575(D). Nonetheless, the significance of size in the exchange's analysis should create concern for market participants who trade in large sizes.

The CFTC has not advised whether it will treat CME's examples as violations of the CEA. Nevertheless, the fact that the CFTC did not make changes to CME's examples after its review, as noted above, supports speculation that the CFTC approved of CME's examples — and perhaps even that it may treat the same conduct as violating Section 4c(a)(5)(B) of the CEA.

Prior CFTC and exchange-level enforcement actions — brought under pre-Dodd-Frank Act authority — also suggest conduct that the regulators may now deem a violation of either Section 4c(a)(5)(B) of the CEA or the exchanges' disruptive trading rules. Here, too, the CFTC's and the exchanges' treatment of the intent element is instructive. Examples of prior CFTC cases include:

- *CFTC v. Wilson*,[33] in which the CFTC alleges that a proprietary trading firm amassed a large, long position in a futures contract and then strategically placed (and later cancelled before execution) bids at increasingly higher prices in the closing period to allegedly influence the settlement price and thereby drive up the value of the firm's positions;

- *In the Matter of Christopher Louis Pia*,[34] in which the CFTC found (in an order settling the matter) that the portfolio manager for a hedge fund had "engaged in a trading practice known as 'banging the close'" — namely, causing large market-on-close orders to be executed in the last 10 seconds of the closing period in two relatively illiquid futures contracts in an attempt to push settlement prices upward; and

- *CFTC v. Amaranth Advisors, LLC*,[35] alleging that a now-defunct hedge fund had manipulated natural gas futures prices by selling an excessive number of futures contracts during the closing period with the intent of lowering the settlement price — because it knew that a lower settlement price would benefit the hedge fund's even larger short position in natural gas swaps.

These cases, though admittedly only a snippet of prior CFTC case law, charged conduct with two principal characteristics — size and intent. These same characteristics likely will be the focus of CFTC disruptive trading cases involving disorderly executions going forward, in that the CFTC has suggested that the size of a market participant's positions and trades relative to the market could serve as circumstantial evidence of *scienter*.

The CME also has prosecuted several matters involving similar conduct. For example:

- *In the Matter of Alan Kleinstein*,[36] in which CME found as part of a settlement that a floor trader "facilitated his customer's manipulation of the settlement prices" in the markets for two related futures contracts by executing a large number of trades (including wash trades) for the customer that produced "artificially high fill prices during the two minute close"; and

- *In the Matter of Jeffrey Schondorf*,[37] in which a Business Conduct Committee panel at CME (NYMEX) found after a full hearing that the respondent had created fictitious volume and fictitious trades in several products and had executed wash trades to benefit his existing positions, which together caused an impact on settlement prices.

The conduct at issue in both of these cases — charged under CME Rule 432, the general "bad conduct" rule — involved trading during the closing period, and the violations were premised upon evidence of price impact.

[31] *Id.* at 7.

[32] *See, e.g.*, *United States v. Radley*, 659 F. Supp. 2d 803, 806–09 (S.D. Tex. 2009) ("Large market participants . . . are market participants nonetheless. Their individual supply and demand are part of the aggregate, and it is axiomatic that their actions will affect the price of a commodity.").

[33] 27 F. Supp. 3d 517 (S.D.N.Y. June 26, 2014).

[34] CFTC Docket No. 11-17, 2011 WL 3228315 (July 25, 2011).

[35] 554 F. Supp. 2d 523 (S.D.N.Y. 2008).

[36] NYMEX 10-7443-BC (June 16, 2014).

[37] NYMEX 11-8059-BC (Mar. 14, 2014).

Such evidence will no longer be necessary in future disruptive trading cases under Rule 575.

Runaway Algorithms

The exchanges also may use their new rules to prosecute market participants' failure to prevent or fix software glitches and malfunctions in their electronic trading systems, even when such failure is unintentional. In contrast to the exchanges' focus on *scienter* for the new disruptive trading violations, they appear to have adopted a near strict-liability test for runaway algorithms such that the respondent's mental state is irrelevant. CME's and ICE's cases in this area have involved price and volume aberrations, wash trades, inaccurate disclosure of prices to the market, and excessive order and cancel messages, all apparently resulting from what may be called "runaway algorithms."[38]

Although there is no obvious reason why CME or ICE would bring these cases under the new disruptive trading rules rather than the broad rules previously used, ICE has already done so. In the first reported case under new Rule 4.02(l), *In the Matter of Trevor Gile trading as Liger Investments, Inc.*,[39] ICE found that the respondent firm had violated Rule 4.02(l)(2) (prohibiting the entry of orders "other than in good faith for the purpose of executing *bona fide* [t]ransactions") because the firm's "automated trading system . . . malfunctioned, due to an undetected software bug, and caused numerous order messages to be entered in the Henry LD1 Fixed Price ICE Lot Futures Market not made in good faith for the purpose of executing bona fide transactions." CME's disruptive trading rule contains similar language to the language on which ICE relied in the *Liger Investments* case. It provides that "[a]ll orders must be entered for the purpose of executing bona fide transactions," and that "all non-actionable messages" (*e.g.*, requests for quotes) "must be entered in good faith for legitimate purposes." Thus, it appears market participants should expect going forward that the exchanges may charge algorithm malfunctions as disruptive trading violations, regardless of whether the participant acted with any wrongful intent.

PROVING (OR DISPROVING) THE SCIENTER ELEMENT

As demonstrated through the discussion of prior disruptive trading cases, *scienter* is a critical element of CEA Sections 4c(a)(5)(B)-(C) and (runaway algorithms aside) the new disruptive trading rules at CME and ICE. Indeed, similar to the requirements for establishing the traditional offense of attempted manipulation under the CEA,[40] a violation of CEA Sections 4c(a)(5)(B)-(C), CME Rule 575(A)-(D) or ICE Rule 4.02(l)(1) requires only an overt act — *e.g.*, the entry of an order — combined with the requisite level of *scienter*.[41] Thus, the difference between unlawful and lawful conduct in the majority of cases will necessarily be the Commission's or the exchanges' ability (or inability) to prove the necessary *scienter*.

The exchanges' rules guidance is helpful in predicting how the exchanges — and perhaps the CFTC — may approach the *scienter* analysis. In particular, CME and ICE each set forth a non-exclusive list of 17 factors that the exchange plans to consider in assessing whether CME Rule 575 or ICE Rule 4.02(l) have been violated. (A complete list of the 17 factors is set forth in the attached "Appendix B.") Many of the factors could provide circumstantial evidence that a market participant intended to disrupt or was reckless regarding the adverse impact on the orderly conduct of trading, or entered orders with the intent to cancel them before execution. For example, the exchanges may consider the market participant's historical pattern of activity and may be more likely to infer a wrongful intent when the participant's conduct diverges significantly from historical trading patterns. Similarly, the exchanges may consider the size, number, and the price of the market participant's orders relative to market conditions or the

[38] *See, e.g., In the Matter of Port 22 LLC*, CME 13-9649-BC (Feb. 27, 2015); *In the Matter of Traditum Group LLC*, CME 1108613-BC (Dec. 19, 2014); *In the Matter of Tower Research Capital Investments LLC*, CBOT 11-8056-BC (Sept. 22, 2014); *In the Matter of Credit Suisse Securities (USA) LLC*, ICE 2011-048 (July 24, 2014); *In the Matter of Neil Brookes*, NYMEX 10-7565-BC (Dec. 23, 2011).

[39] ICE 2013-159 (Mar. 27, 2015).

[40] *Wilson*, 27 F. Supp. 3d at 531-32 ("To state a claim for attempted manipulation, the CFTC must allege (1) an intent to affect market prices and (2) an overt act in furtherance thereof.").

[41] The CFTC and the exchanges agree that "recklessness" is sufficient to establish the disruptive trading offenses other than spoofing. They interpret "recklessness" to encompass 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." *See* CFTC Interpretive Guidance, *supra* note 1, at 31,895 (quoting *Drexel Burnham Lambert, Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1988)); *accord* CME Rule 575 Guidance, *supra* note 9, at 8; ICE Rule 4.02(l) Guidance, *supra* note 27, at 4.

market participant's position.[42] Thus, a trader who trades in massive sizes relative to the market, at prices near the top of the market, and only during the two-minute closing period, may have difficulty convincing the exchange that the trading was not reckless in relation to price impact or other disruptions during the closing period.

Although the new disruptive trading rules focus on intent rather than actual market impact, evidence that trades affected the market can be expected to enhance the level and number of charges regulators bring against traders. Regulators may even attempt to rely on this evidence (*e.g.*, price changes that arguably result from the participant's conduct) to explain the participant's motivation behind a continued series of transactions or modifications to an existing trading strategy, or to infer an intent to manipulate the market.

In the absence of contemporaneous evidence of intent (for example, e-mails and phone recordings), CME and ICE likely will focus on some or all of these factors to fill the gap. In fact, in many of CME's pre-Rule 575 cases, its notices of disciplinary action explained that the exchange had relied on several factors in determining that the respondent entered the orders without the intent to trade (or, in the parlance of Rule 575, with intent to "cancel the order before execution"). These factors included, among others, the exposure time of cancelled orders, the frequency of the respondent's cancellations, and the imbalance created through the orders between the volume on the bid and offer — many of the same factors listed in CME's Rule 575 guidance.[43]

Here, too, the fact that CME made only one minor modification to its list of factors (adding the "number of orders" as a relevant factor) after discussions with the CFTC allows speculation that the Commission also may consider the same factors in its disruptive trading investigations.

The Commission has traditionally relied on circumstantial evidence of *scienter* in the cases involving conduct it has already prosecuted, or likely will prosecute, as spoofing. In *Panther*, for example, the Commission supported its finding of intent by focusing on the respondents' bids and offers, which it noted were entered and cancelled "over a very short time frame," and on the fact that respondent used the algorithm in question "hundreds of times in an individual futures contract in a single day."[44] Likewise, in *Moncada*, the consent order distinguished the size, duration, and volume of the defendant's orders from the rest of the market, and noted that he had not used order types that would increase the likelihood of executions — all of which allegedly supported his wrongful intent.[45] More recently, the CFTC attempted to establish the requisite *scienter* in its spoofing complaint against Heet Khara and Nasim Salim by describing in detail the sequence of trades and the short time period for which the cancelled orders were exposed to the market.[46] Similarly, in the *Sarao* case, the CFTC's allegations of intent focused on the extent of Sarao's trading activity as compared to the overall market activity.[47] Criminal prosecutors, too, have relied on similar circumstantial evidence. In the criminal complaint and supporting affidavit against Sarao, for example, the Government alleged, as evidence of Sarao's intent, that he repeatedly placed and cancelled shortly thereafter multiple orders of between 200 and 900 lots — as compared to an alleged average market order of only seven lots.[48]

Similarly, the Commission's prior cases involving conduct similar to that now seemingly prohibited under CEA Section 4c(a)(5)(B) highlight many of these same factors as evidence of the market participants' alleged *scienter*. In *Wilson*, for example, a case involving alleged disorderly trading during the closing period, the district court held in denying a motion to dismiss that allegations that the defendants were aware of their "impact on prices and nonetheless persisted in [the alleged] practice" supported the existence of their

[42] CME Rule 575 Guidance, *supra* note 9, at 4; ICE Rule 4.02(l) Guidance, *supra* note 27, at 3.

[43] *Compare Leeds*, NYMEX 12-8886-BC *and Oystacher*, COMEX 11-08380-BC, *with* CME Rule 575 Guidance, *supra* note 9, at 4.

[44] *In the Matter of Panther Energy Trading LLC and Michael J. Coscia*, CFTC Docket No. 13-26, 2013 WL 3817473, at *1–3 (CFTC July 22, 2013).

[45] Consent Order, Docket No. 80, *CFTC v. Moncada*, Case No. 1:12-cv-8791 (S.D.N.Y. Oct. 1, 2014).

[46] Complaint at ¶¶ 17-32, *CFTC v. Khara*, No. 15-cv-3497, 2015 WL 2066257 (S.D.N.Y. May 5, 2015). The Commission's Interpretive Guidance also discusses these factors generally, noting that "the market context" and the respondent's "pattern of trading activity (including fill characteristics)" could produce potentially relevant facts and circumstances in a spoofing investigation. CFTC Interpretive Guidance, *supra* note 1, at 31,896.

[47] Complaint at ¶¶ 47-57, 62-71, *CFTC v. Nav Sarao Futures Limited PLC and Navinder Singh Sarao*, No. 15-cv-3398, 2015 WL 1843321 (N.D. Ill. April 17, 2015).

[48] *Sarao* Criminal Complaint and Affidavit, *supra* note 4, at ¶ 17.

alleged intent to manipulate.[49] Similarly, the CFTC's settlement order in *Pia* found *scienter* where the respondent's orders "were relatively large orders" in "relatively illiquid" markets and the respondent had instructed his broker to "wait[] until the last 10 seconds of the closing periods" before entering the trades.[50]

In addition to the factors identified by CME and ICE, regulators also may search for circumstantial evidence of *scienter* in the electronic source code associated with automated trading programs. Depending on the manner in which the code is written, regulators may infer that the coder's intent — and hence, the firm's or trader's intent — was to engage in conduct prohibited by CEA Sections 4c(a)(5)(B)-(C), CME Rule 575(A)-(D) or ICE Rule 4.02(l)(1). As trading strategies become more automated, regulators are increasingly likely to request trading source code as part of their disruptive trading investigations. Market participants who utilize automated strategies should consider implementing training for any employees responsible for writing (or modifying) source code to ensure that the code cannot be misinterpreted to convey a wrongful intent.

Because proof of market impact is not required in the new disruptive trading rules, defense counsel should closely scrutinize the available evidence related to all of the factors identified by CME and ICE. Although certain factors may support an inference of *scienter* in a particular case, others may offer stronger support to rebut the alleged wrongful intent in the same case. For example, CME might open a disruptive trading investigation where a trader has entered and cancelled a large volume of orders in a short period of time on both sides of the market, but a full review of the trader's activity in related markets (one of the factors identified by CME and ICE) may show that the trader was reacting to events occurring in other markets as part of a larger strategy. The fact that CME and ICE identified this factor and others could make it difficult for them to ignore the factors if they end up supporting the market participant's claimed intent.

At the end of the day, the best defense to disruptive trading charges may be to demonstrate that the market participant's intent was to further a legitimate purpose. The Commission's Interpretive Guidance, for example, clarifies that, with respect to spoofing, a "legitimate, good-faith cancellation or modification of orders (for example, partially filled orders or properly placed stop-loss orders) would not violate [Section 4c(a)(5)(C)]."[51] Likewise, according to CME's rules guidance, even if a client routinely modifies or cancels orders prior to execution, so long as the modification or cancellation occurs "due to a perceived change in circumstances," CME will not charge a violation of Rule 575(A).[52] ICE's Rule 4.02(l) guidance contains this same clarification.[53] In other words, the Commission and the two exchanges recognize that there are a multitude of legitimate reasons to cancel an order before execution, which may include changing market conditions or executions by other market participants. There also may be legitimate reasons to engage in conduct that could be viewed as causing disorderly executions in the market. This heightened focus on intent suggests a new best practice — *i.e.*, to document the purpose of a particular trading strategy to later combat a charge if one is brought in the future. This may be difficult to implement, but the benefits are clear: the market participant can later rely on his legitimate motive as contemporaneously documented, thus making it difficult for a regulator to establish the requisite *scienter* to support a disruptive trading violation.

CONCLUSION

As a result of the Commission's Interpretive Guidance for disruptive trading and the rules guidance issued by CME and ICE, respectively, market participants are now better informed about what may qualify as "disruptive trading." Insofar as the new prohibitions of disruptive trading turn largely on the market participant's state of mind, the exchanges' guidance is useful, in that it identifies the types of circumstantial evidence on which regulators may rely in attempting to prove the requisite *scienter*. Market participants should be able to use the exchanges' guidance to strengthen existing compliance and training programs. But they should also continue to ask their traders the most basic question: what were you thinking? In an increasingly regulated trading world involving risks of regulatory, civil, and even criminal liability, this question will not be rhetorical; the answer matters. ■

[49] *Wilson*, 27 F. Supp. 3d at 533.

[50] *Pia*, 2011 WL 3228315 at *2.

[51] CFTC Interpretive Guidance, *supra* note 1, at 31,896.

[52] CME Rule 575 Guidance, *supra* note 9, at 5 (FAQ #4).

[53] ICE Rule 4.02(l) Guidance, *supra* note 27, at 3 (FAQ # 4).

APPENDIX A

CME Rule 575

All orders must be entered for the purpose of executing bona fide transactions. Additionally, all non-actionable messages must be entered in good faith for legitimate purposes.

(1) No person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution;

(2) No person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to mislead other market participants;

(3) No person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to overload, delay, or disrupt the systems of the Exchange or other market participants; and

(4) No person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to disrupt, or with reckless disregard for the adverse impact on, the orderly conduct of trading or the fair execution of transactions.

To the Extent applicable, the provisions of this Rule apply to open-outcry trading, as well as electronic trading activity. Further, the provisions of the Rule apply to market states, including the pre-opening period, the closing period, and all trading sessions.

ICE Rule 4.02(l)

In connection with the placement of any order or execution of any Transaction, it shall be a violation of the Rules for any Person to:

(l) Engage in any other manipulative or disruptive trading practices prohibited by the Act or by the Commission pursuant to Commission regulation, including, but not limited to:

(A) Entering an order or market message, or cause an order or market message to be entered, with:

i. The intent to cancel the order before execution or modify the order to avoid execution;

ii. The intent to overload, delay, or disrupt the systems of the Exchange or other market participants;

iii. The intent to disrupt the orderly conduct of trading, the fair execution of transactions, or mislead other market participants, or

iv. Reckless disregard for the adverse impact of the order or market message.

(2) Knowingly entering any bid or offer for the purpose of making a market price which does not reflect the true state of the market, or knowingly entering, or causing to be entered, bids or offers other than in good faith for the purpose of executing *bona fide* Transactions.

APPENDIX B

Factors CME and ICE may consider in assessing potential violations of CME Rule 575 and ICE Rule 4.02(l):

- whether the market participant's intent was to induce others to trade when they otherwise would not;
- whether the market participant's intent was to affect a price rather than to change his position;
- whether the market participant's intent was to create misleading market conditions;
- market conditions in the impacted market(s) and related markets;
- the effect on other market participants;
- the market participant's historical pattern of activity;
- the market participant's order entry and cancellation activity;
- the size of the order(s) relative to market conditions at the time the order(s) was placed;
- the size of the order(s) relative to the market participant's position and/or capitalization;
- the ability of the market participant to manage the risk associated with the order(s) if fully executed;
- the duration for which the order(s) is exposed to the market;
- the duration between, and frequency of, non-actionable messages;
- the queue position or priority of the order in the order book;
- the prices of preceding and succeeding bids, offers, and trades;
- the change in the best offer price, best bid price, last sale price, or Indicative Opening Price (or some other price) that results from the entry of the order; and
- the market participant's activity in related markets.