MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

December 28, 2010

Via Electronic Submission: http://comments.cftc.gov

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

Re: Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act. RIN No. 3038-AD26.

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] submits the following comments in response to the Commodity Futures Trading Commission's (the "Commission") request for comment in its Advance Notice of Proposed Rulemaking and Request for Comments ("ANPR") on Antidisruptive Practices Authority contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") Section 747.

We appreciate the opportunity to provide comments to the Commission at an early stage of the rulemaking process. MFA and its members unequivocally support the Commission's mission of deterring and preventing price manipulation and other disruptions to market integrity. We look forward to working closely with the Commission to promulgate rules that serve the public interest by preserving the liquidity of the futures and derivatives markets; so that these markets can continue to provide a means of managing price risks, discovering prices and disseminating price information through liquid, fair and financially secure trading practices.[2]

I. Summary

The Commission has asked in its ANPR, among other things, how various statutory terms should be defined. Many of the terms referenced in the ANPR are based on

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, DC, with an office in New York.

[2] *See* 7 U.S.C. § 5(a)

securities law precedent that has limited, if any, relevance to trading activities in the futures or derivatives markets. MFA believes that definitions such as "orderly execution," "violates bids and offers" and "spoofing" require refinement so that their meanings relate to specific and measurable characteristics that can guide market participants in their conduct and in a manner that takes into account futures and derivatives market structures, practices and customs. Since the Commission requested and Congress agreed to provide the enforcement authority in Section 747, we think it is incumbent on the Commission to establish clearly what conduct it was concerned about when it asked for this authority and how it plans to apply the authority.

In summary, MFA submits the following recommendations:

- The Commission should continue its policy of delegating supervisory and disciplinary authority in the area of market disruptions to the exchanges;

- However, if the Commissions promulgates rules, it should adopt rules that define specifically and narrowly the prohibited disruptive trading practices;

- The Commission should interpret and confine Section 747 to well-established legal standards and principles set forth in the *DiPlacido*[3] precedent and in a manner that remains faithful to the plain language of Section 747;

- Violating bids or offers is impermissibly vague and any potential rule should not be actionable in the absence of manipulative intent to influence price;

- Demonstrating an "intentional or reckless disregard for the orderly execution of transactions during the closing period" should be understood to refer to trading activities similar to marking the close and should not be actionable in the absence of manipulative intent or, at the minimum, extreme recklessness;

- "Spoofing" should be narrowly defined and should take into account the distinct market structure, practices and customs of the futures and derivatives markets; and

- The Commission should provide clarity as to the type of conduct that constitutes anti-disruptive practices in the context of algorithmic and high-frequency trading, and any potential rulemaking should be principles-based and not hinder the ability of these traders to continue to add value to the markets.

II. The Commission Should Reinforce the Expanded Responsibilities of the Exchanges to Oversee the Markets to Prevent Disruptive Trading Practices

[3] *DiPlacido* v. *CFTC*, 2009 WL 3326624 (2d Cir. Oct. 16, 2009)

In our opinion, both the traditional supervisory structure in the futures and derivatives markets and the Dodd-Frank Act support delegating to the exchanges responsibility of regulating market disruptions. The Commodity Exchange Act ("CEA") has long recognized the role of the exchanges as the first line of defense in preventing market disruptions. Reflecting a principles-based regulatory approach, the CEA required the exchanges to comply with certain core principles and allowed the exchanges "reasonable discretion in establishing the manner in which [the board of trade] complie[d] with the core principles."[4] Given the constantly evolving nature of the markets and the increased role and importance of technology, MFA believes exchanges are in the best position to monitor and control the risk of market disruptions; and the adoption of prescriptive rules are inherently at odds with effective enforcement in this area. Prior to its amendment by the Dodd-Frank Act, core principle number four required that boards of trade "monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process."[5] Additionally, to aid in enforcement, the CEA required boards of trade to maintain rules and procedures to provide for the recordkeeping of all identifying trade information "for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules. . . ."[6]

Rather than reducing the regulatory and supervisory significance of the boards of trade, the Dodd-Frank Act enhanced the role of the boards of trade. Once required merely to monitor trading, boards of trade now must have:

> the *capacity and responsibility* to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement *practices and procedures*, including—
>
> (A) methods for conducting real-time monitoring of trading; and
>
> (B) comprehensive and accurate trade reconstructions.[7]

Additionally, under the Dodd-Frank Act, Swap Execution Facilities ("SEFs") have monitoring obligations similar to the boards of trades' enhanced provisions.[8]

The decision to increase the role of the boards of trade in preventing market disruptions is a recognition by Congress that the boards of trade have the right experience, capabilities and track records to monitor and discipline markets. The Commission's principles-based guidance should likewise acknowledge and reinforce the exchanges' extensive capabilities and past regulatory experience.

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4 7 U.S.C. § 7(d)(1).

5 7 U.S.C. § 7(d)(4).

6 7 U.S.C. § 7(d)(10).

7 Dodd-Frank Act § 735(b) (emphasis added).

8 Dodd-Frank Act § 733.

We also believe that this approach is appropriate because it will preserve the long-standing distinction between the Commission and the exchanges with respect to disciplinary authority and, in doing so, will reinforce the market regulatory and monitoring roles of each. Market manipulation, in which market participants intentionally interfere in market performance to create personal gains, traditionally has merited federal sanctions. Unlike market manipulations, market disruptions are not used to generate profit illegally at the expense of the market or another individual market participant. Market disruptions, traditionally in the purview of the exchanges, are not events engineered by market participants to earn illegal or unfair profits. We recommend that the Commission focus its enforcement actions to punish and prevent market manipulators and leave to the exchanges primary authority to monitor market disruptions and discipline parties responsible for market disruptions. We are concerned that imposing federal enforcement authority in areas of vague definition and unclear standards of intent will chill legitimate market activity. Boards of trade already have the appropriate tools to monitor, prevent and curb the recurrence of market disruptions and have greater experience and flexibility than federal regulators to adopt and revise standards. We urge that the Commission's regulations preserve the CEA's delegation of disciplinary responsibility in this area.

III. If the Commission Decides to Promulgate Rules, It Should Define Specifically and Narrowly the Prohibited Disruptive Trading Practices.

MFA is concerned that Dodd-Frank Act Section 747 as written is vague and particularly vulnerable to constitutional challenge by market participants. We are concerned that without greater clarity from exchanges, or the Commission, this provision may serve to undermine the Commission's enforcement efforts to deter and prevent price manipulation and will have a chilling effect on legitimate trading practices. Market participants that exercise legitimate trading strategies should not have to operate in an industry where there are potentially onerous regulatory and reputational risks for conduct where no specific or clear guidance is issued as to what is prohibited. "[A] regulation carrying penal sanctions [must] give fair warning of the conduct it prohibits or requires."[9] Traditional concepts of due process preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule.[10] We believe regulators should provide clear guidance under Section 747 before bringing enforcement actions to provide market participants with notice as to what constitutes violative trading activity.

To provide market participants with guidance under Section 747, we believe the Commission should reinforce its delegation of authority to the exchanges in the areas as explained above. Alternatively, if the Commission proceeds towards rulemaking, we believe it should define specifically and narrowly the type of trading activities that are prohibited to provide clear guidance to market participants. We are concerned that if the Commission were to use its authority under Section 747 to charge market participants engaged in routine trading activities after the fact as disruptive, when there is no manipulative intent or effect, it would

[9] *DiPlacido* v. *CFTC*, 2009 WL 3326624, at *1 (2d Cir. Oct. 16, 2009) (citing *Rollins Envtl. Servs. (NJ) Inc.* v. *U.S. EPA*, 937 F.2d 649, 653 n.2 (D.C. Cir. 1991).

[10] *Satellite Broad. Co.* v. *FCC*, 824 F.2d 1, 3 (D.C. Cir. 1987).

severely limit the efficient functioning of the markets and cause more instability to the markets. Without greater guidance under Section 747, enforcement actions could undermine, rather than enhance, the functioning of the markets. Market participants may choose not to enter the market because of the increased and uncertain enforcement risk, thereby harming the liquidity and depth of the markets.

A. If It Promulgates Rules, the Commission Should Clearly Define What Constitutes "Violat[ing] Bids or Offers" and Any Definition Must Require Manipulative Intent.

What constitutes a violation of bids or offers is not at all clear in the context of the futures and derivatives markets. The term "violate bids or offers" has been used in the Commission's enforcement actions involving floor traders, but it has virtually no application to electronic trading where systems buy or sell at the best available quote. Similarly, violations of bids or offers should not apply in the over-the-counter markets or in the execution of block trades. Over-the-counter and block trades often occur at prices inconsistent with contemporary bids and offers, because privately negotiated purchases and sales reflect the positions and unique characteristics of the parties, including the size of their holdings relative to the market and the liquidity of the instruments being traded, among other factors. Moreover, in some thinly traded markets, there are no clear parameters as to what the bid or offer price is at any given time.

If it proceeds to rulemaking, we believe the Commission should look to judicial precedent in order to craft a rule that is specific, narrow and clear enough not only to give market participants notice of what is prohibited, but also clear enough to withstand judicial scrutiny. The Commission should also follow its own past enforcement practices and require that a violation of bids or offers be actionable only if undertaken with manipulative intent to influence prices. Under an arbitrary and capricious standard of review, the Second Circuit upheld the Commission's definition of manipulation, a four-part test which was established in the absence of a statutory definition of "manipulation."[11] The Second Circuit placed emphasis on the fact that the Commission had fulfilled its burden of proof to demonstrate manipulative intent. The Court explained:

> DiPlacido further challenges the Commission's standard on the ground that the elements of the four-part test 'collapse[]' into one-uneconomic trading so that a violation exists wherever bids and offers are violated, and even lawful hedging may constitute manipulation. We are not persuaded. The Commission stated that 'violating bids and offers—*in order to influence prices*' was 'sufficient to show manipulative intent.' Its findings of intent thus

[11] *DiPlacido*, 2009 WL 3326624, at *2 (2d Cir. Oct. 16, 2009). Manipulation cases involving "corners" and "squeezes" produced a framework requiring the Commission establish: "1) That the accused had the ability to influence market prices; 2) that they specifically intended to do so; 3) that artificial prices existed; and 4) that the accused caused the artificial prices." The Commission has also reaffirmed this four-part test in its Notice of Proposed Rulemaking on the Prohibition of Market Manipulation. *See* Prohibition of Market Manipulation, 75 Fed. Reg. 67657, 67660 (Nov. 3, 2010).

> depended not merely on DiPlacido's [violations of] bids and offers, but also on taped conversations signaling manipulative intent …[12]

Thus, the Commission should reaffirm in any potential rulemaking that it intends to interpret Section 747 as a codification of *DiPlacido*'s principles requiring manipulative intent. Without incorporating this manipulative intent, the "violates bids or offers" clause lacks any language of scienter and is therefore unconstitutionally vague. The Supreme Court has long recognized that—

> [T]he constitutionality of a vague statutory standard is closely related to whether that standard incorporates a requirement of *mens rea*. Because 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.'[13]

Without including specific intent in the rule, market participants that do not intend to move the market and are acting in good faith may face substantial enforcement risk given the ambiguity of the provision. This risk may prove too great for market participants seeking to enter the futures and derivatives market and their decision to not enter the markets may ultimately result in decreased liquidity and depth. The Commission will help add clarity to the proposed rule's prohibitions by closely following this firmly established judicial precedent. Market participants are now familiar with the contours of the *DiPlacido* case and *DiPlacido*'s concrete facts will help show how the rule's prohibitions will be applied in practice.

B. The "Intentional or Reckless Disregard for the Orderly Execution of Transactions During the Closing Period" Should Be Clearly Defined and Require Manipulative Intent.

Dodd-Frank Act Section 747 prohibits an "antidisruptive" trade practice, defined as "demonstrating an intentional or reckless disregard for the orderly execution of transactions during the closing period." We are concerned that this clause is impermissibly vague. We believe that any proposed rulemaking should provide guidance on violative conduct and the meaning of "orderly execution".

We believe any proposed rule under this clause should also require manipulative intent, or at the very least an "*extreme* departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or so obvious that the actor must have been aware of it."[14] The "extreme recklessness" standard carries with it the notion that a person is acting willfully to carry out his or her ultimate objective. Even in connection with transactions under the securities laws involving retail

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[12] *DiPlacido*, 2009 WL 3326624, at *3 (2d Cir. Oct. 16, 2009) (citations omitted; emphasis original).

[13] *Colautti* v. *Franklin*, 439 U.S. 379, 395 (1979) (collecting cases that recognize the proposition; citations omitted). *See also DiPlacido*, 2009 WL 3326624, at *2 (citing *Colautti*).

[14] *Sundstrand Corp.* v. *Sun Chem. Corp*., 553 F.2d 1033, 1044 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977) (emphasis added).

unsophisticated investors, courts have imposed a high standard.[15] The same standard should apply here. This is especially crucial because of the unpredictability of the futures markets' ability to absorb any given trade at any given time. Market participants may have executed the same exact trade the day before without any disruptive effect, but given the unpredictable volatility and liquidity profile of the market on another day, the exact same trade may cause a disruption. Market participants simply cannot predict prospectively with certainty that their trades will not be disruptive. Thus, the Commission should only focus on those disruptions that were caused while employing manipulative intent, and leave to the exchanges the responsibility to discipline market participants where there is disruption without manipulative intent.

Finally, MFA stresses that there are many routine and legitimate trading activities that are required to be conducted during the closing period and as such, market participants require more clarity and guidance on the definition of "orderly execution" during the closing period to prevent running afoul of Section 747.

C. "Spoofing" Should Be Narrowly Defined and Should Take Into Account Distinct Market Structures, Practices and Customs of the Futures and Derivatives Markets.

We respectfully request that the Commission give additional guidance as to what the prohibition on "spoofing" entails in the context of the futures and derivatives markets. Section 747 defines spoofing as "bidding or offering with the intent to cancel the bid or offer before execution."[16] The statutory definition is vague and does not offer market participants guidance about what behavior and activities are prohibited. More generally, "spoofing" is not a term that has ever been commonly used in the futures and derivatives markets. Securities markets have their own concept of "spoofing," but its application in the futures and derivatives markets is not at all clear.[17] MFA is of the view that there is simply no commonly understood or accepted meaning among market participants of what the term prohibits.

MFA is concerned that the statutory definition is sufficiently broad to capture many legitimate trading practices in the futures and derivatives markets. The Commission itself recognizes in question eight of the ANPR one of the practices captured by the statutory definition. In futures trading, it is a legitimate practice for an individual to "enter[] an order larger than necessary with the intention to cancel part of the order to ensure that his or her order

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[15] *See Phillips* v. *LCI Int'l, Inc*., 190 F.3d 609, 621 (4th Cir. 1999); *SEC* v. *Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992); *Hollinger* v. *Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (*en banc*); *Ross* v. *Bank South, N.A.*, 885 F.2d 723, 730 n.10 (11th Cir. 1989); *Hackbert* v. *Holmes*, 675 F.2d 1114, 1118 (10th Cir. 1982); *Broad* v. *Rockwell*, 642 F.2d 929, 961 (5th Cir. 1981) (*en banc*); *McLean* v. *Alexander*, 599 F.2d 1190, 1197 (3d. Cir. 1979); *Mansbach* v. *Prescott, Ball, & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *see also Greebel* v. *FTP Software*, 194 F.3d 185, 198 (1st Cir. 1999); *Camp* v. *Dema*, 948 F.2d 455, 461 (8th Cir. 1991).

[16] CEA § 4c(a)(5)(C).

[17] *See, e.g.*, *In re Fishman*, Exchange Act Release No. 40115 (June 24, 1998) (violating Section 10(b) by submitting limit orders to move the public bid or offer quote and then cancelling the orders).

is filled."[18] Similarly, "spoofing" is arguably indistinguishable from the legitimate strategies employed by high-frequency traders that enter and cancel orders at high volumes, but in doing so serve to add liquidity to the markets. The increase in the volume of placed and cancelled orders, made possible by high-frequency trading strategies and technology is a sign of a competitive market that contributes to the price discovery function of markets. Distinguishing this objective behavior from prohibited conduct is not at all easy.

As noted above, the execution of trade practices captured by the term "spoofing" in the futures or derivatives markets do not automatically imply clear manipulative intent. Because order execution is not guaranteed, market participants legitimately compensate against this by entering larger orders than are necessary in order to meet their trading needs. Cancellations of orders also serve other legitimate purposes and do not imply manipulative intent. This, in turn, leads to many practices being labeled as "disruptive" by the plain terms of Section 747. Given this probabilistic component in the futures and derivatives markets, MFA believes that anything short of a requirement of manipulative intent will not properly distinguish legitimate from illegitimate trading practices.

IV. Antidisruptive Practices Authority Is Unclear in the Context of Algorithmic and High-Frequency Trading Entities.

In questions 15-19 of the ANPR, the Commission has asked how various aspects of algorithmic and automated trading systems fit within the antidisruptive practices authority in Section 747. Specifically, the Commission asked whether it should consider promulgating rules to regulate the use of algorithmic or automated trading systems to prevent disruptive trading practices and if so, what kind of rules it should consider. Additionally, the Commission asks whether there should be supervision and monitoring of such trading systems and whether additional rules reasonably necessary to prevent disruptions by these systems should be promulgated by the Commission.

As a general matter, MFA is concerned that the Commission's rulemaking in the context of algorithmic or high-frequency trading will stifle financial innovation. Technology has changed the financial industry for the better. Algorithmic trading strategies and low latency technology have delivered important benefits to the markets, including the dramatic improvement of bid-ask spreads, faster execution speeds, reduced commissions and transaction costs, greater liquidity and increased market depth and increases in efficiency and pricing transparency and reliability.[19] Additionally, technology has enhanced risk management among market participants and the markets generally. For example, the use of pre- and post-trade checks, fat finger controls and other reasonable limitations to trading have added to the stability of the markets. The importance of financial innovation should not be underestimated when considering the substantial competitive advantages that technology has given the American

[18] Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protections Act, 75 Fed. Reg. 67301, 67302 (Nov. 2, 2010).

[19] MFA's comment letter to the SEC on its concept release on Equity Market Structure discusses empirical data on the benefits of technology to the markets and is available at: http://www.managedfunds.org/downloads/MFA%20Mkt%20Structure%20Ltr.5.7.10.pdf.

futures and derivatives markets. We strongly urge the Commission not to proceed down a rulemaking process without having a full understanding of the very serious potential adverse consequences that a vague, indefinite and potentially broad rule might cause.

Rather than implementing prescriptive rules that are inflexible and not suitable to the constantly-evolving nature of technology, we believe the Commission should adopt a principles-based approach. This would afford the Commission flexibility as the industry develops new technological methods of preventing disruptions and renders old methods obsolete. Additionally, we believe any proposed rulemaking should be grounded in empirical data to reduce the potential for any proposed rules to have unintended consequences. Without empirical data, any rule-making could become a vehicle for costly, unintended detrimental consequences and could reverse the global leadership status that the United States has earned. MFA recommends to the Commission that any rule-making should be limited to ensuring: (i) economically efficient execution; (ii) fair competition; and (iii) the availability of information with respect to quotations and transactions.

Finally, MFA respectfully urges that the Commission leverage the resources of the exchanges to its advantage in this area, as was discussed above. Indeed, many of the major exchanges have kept up with the increased technological demands of market participants and have put in place their own infrastructure not only to handle this demand, but also to properly monitor trading and prevent disruptions. We believe the Commission should look to the exchanges to take a leading supervisory role in this effort, as they have historically possessed the expertise, tools and capabilities to prevent market disruptions.

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MFA thanks the Commission for the opportunity to provide comments regarding the proposed roles on its new anti-manipulation authority. MFA is of the view that "[n]otice is said not only to improve the quality of rulemaking through exposure of a proposed rule to comment, but also to provide fairness to interested parties and to enhance judicial review by the development of a record through the commentary process."[20] In that spirit, we look forward to the Commission's final rule.

We would be pleased to discuss questions or comments the Commission or its staff might have regarding any aspects of this letter. Please feel free to contact Jennifer Han or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

[20] *Nat. Black Media Coal.* v. *FCC*, 791 F.2d 1016, 1022 (2d Cir. 1986).

cc: The Hon. Gary Gensler, CFTC Chairman
The Hon. Michael Dunn, CFTC Commissioner
The Hon. Bart Chilton, CFTC Commissioner
The Hon. Jill E. Sommers, CFTC Commissioner
The Hon. Scott D. O'Malia, CFTC Commissioner