Freddie Mac
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January 3, 2011

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

Re: Notice of Proposed Rulemaking: Prohibition of Market Manipulation; RIN 3038-AD27

Dear Secretary Stawick:

Freddie Mac is pleased to submit these comments in response to the Notice of Proposed Rulemaking published by the Commodity Futures Trading Commission ("CFTC" or "Commission") on November 3, 2010 (the "Proposal").[1] The Proposal is designed to implement the new anti-manipulation authority in Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") which expands and codifies the authority of the Commission, under Section 6(c) of the Commodity Exchange Act ("CEA"), to prohibit manipulation and fraud in connection with swap transactions in contravention of rules promulgated by the Commission by July 21, 2011.

Freddie Mac was chartered by Congress in 1970 with a public mission to stabilize the nation's residential mortgage markets and expand opportunities for homeownership and affordable rental housing. Our statutory mission is to provide liquidity, stability and affordability to the U.S. housing market. Freddie Mac currently operates under the direction of the Federal Housing Finance Agency as our Conservator.

Summary

Freddie Mac strongly supports the Commission's rulemaking efforts to reduce fraud and manipulation in the swap markets. We believe the Commission, as the new principal regulator for interest rate swaps and certain other derivatives, can enhance stability and oversight to this market for the benefit of customers, such as Freddie Mac. Toward this end, Freddie Mac recommends that the Commission strengthen the protection of customers by clarifying that Section 6(c) of the CEA, as amended by Section 753 of the Dodd-Frank Act, and implemented by proposed new Part 180, expressly prohibits "front running" and similar misuse of customer information by swap dealers as a form of market manipulation. As used in this letter, in the context of swaps, "front running" refers to the practice by swap dealers of trading for their own accounts on the basis of information gained through orders received from clients, or by providing such confidential information about customer orders to third parties, who then trade on the information. As used herein, "similar practices" refers to the misuse of information about customer orders for the benefit of the market professional or other preferred customers.

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[1] 75 Fed. Reg. 67657.

Although the Commission separately intends to prohibit front running under its proposed business conduct rules,[2] we believe the Commission should make clear that front running also is a form of fraud-based manipulation under proposed new Part 180. By doing so, the Commission could improve the certainty of the applicability of this important provision in the courts and clarify the ability of private litigants to enforce this protection against fraudulent and manipulative practices, as discussed below.

Prohibiting Front Running as a Form of Market Manipulation or Fraud

A principal purpose of the CEA, and in particular, the anti-fraud and anti-manipulation provisions thereunder, is the protection of market integrity. The Commission expressly recognizes this purpose in the Proposal, when it states that Section 6(c)(1) of the CEA should be given "a broad, remedial reading, embracing the use or employment, or attempted use or employment, of any manipulative or deceptive contrivance for the purpose of impairing, obstructing, or defeating the integrity of the markets subject to the jurisdiction of the Commission."[3]

Front running in the futures markets occurs when an intermediary "intentionally buys or sells for his or her own account while holding an executable customer order, thus taking the same side of the market as his or her customer with the result that the trade cleared for the intermediary's personal account is at a better price than the trade that filled the customer's order."[4] Such conduct violates the fundamental duty of an intermediary to seek the best possible price for a customer order, because it allows the intermediary to obtain better prices for itself than for its customer. Indeed, as the Seventh Circuit has recognized, trading ahead of customer orders "serves no social function at all" because it allows a broker to obtain a profit from information that comes to him solely in his capacity as a broker.[5] Such harm is also why the Commission has consistently found front running to constitute fraud or deceit in violation of the anti-fraud provisions of the CEA.[6]

Front running in the swaps markets deprives customers of the best rates or prices for swap transactions, defrauds customers through improper use of information obtained from the customer by a market professional through its status and position as a market intermediary,

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[2] *See* CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80638, 80642, 80658 (Dec. 22, 2010).

[3] 75 Fed. Reg. at 67659.

[4] *In the Matter of Rousso*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,133, at 45,309 (CFTC Aug. 20, 1997).

[5] *United States v. Dial*, 757 F.2d 163, 166 (7th Cir. 1985) (holding that a futures broker personally trading ahead of his customers committed fraud "in a classic sense" by causing customers to lose additional profits they would have made except for the improper execution of their orders).

[6] *See, e.g.*, *In the Matter of DiFrancesco, et al.*, [2002-2003 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶29,285, at 54,596 (CFTC Jan. 31, 2003) (trading ahead of customers' orders violates CEA Section 4b(a), the statute's general anti-fraud provision); *In the Matter of Coppola*., [2002-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶28,624, at 52,363-64 (CFTC Aug. 16, 2001) (finding that a floor broker "fraudulently executed trades" in gold options "by trading ahead of customer orders" in violation of CEA Section 4c(b) and CFTC Rule 33.10, which prohibit fraud in options trading).

erodes confidence in the marketplace, and artificially moves prices and rates in the marketplace for derivatives such as interest rate swaps. If permitted to occur on a broad scale, front running in the swaps market will cause market participants to lose confidence and eventually to withdraw from the swaps market.[7]

Section 6(c)(1) of the CEA is patterned after Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") which is primarily implemented through Securities and Exchange Commission ("SEC") Rule 10b-5.[8] In the Proposal, the Commission states that the proposed rules under Section 6(c) of the CEA will embody a broad reading of the statute, "[c]onsistent with judicial interpretations of the scope of SEC Rule 10b-5."[9] In this regard, we note that, in addition to providing for substantial monetary penalties (including treble damages) for violation of the provision, Section 753 includes an express private right of action, both of which further serve to deter manipulative practices.

Although the SEC has long viewed front running to be a violation of Rule 10b-5 under the Exchange Act,[10] and legal scholars agree[11], some courts have rejected the view that such

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[7] Cleared "over-the-counter" derivatives may be particularly susceptible to front running. Unlike non-cleared trades in which the original parties are bound at the time of execution, trades destined for clearing must be submitted to and accepted by a clearing firm. The time delay and multiple parties involved in completing a cleared transaction present opportunities for front running. While normal market making activities to hedge the economic risks of positioning customer trades should be permissible, to the extent market intermediaries use customer trade information or order flow for their own benefit to move the market to the detriment of the customer, such front running activities should be impermissible as a matter of law under CEA Section 6(c). Although each case is facts and circumstances dependent, indicia of market manipulation may include execution of trades by market intermediaries with information about a customer's transaction where the intermediary's trades bear no relation in size or risk to the customer's trades, or where transactions are executed by intermediaries with information about a particular customer's orders that did not execute a transaction with the relevant customer.

[8] 15 U.S.C. 78j(b); 17 C.F.R. 240.10b–5.

[9] Proposal, 75 Fed. Reg. at 67659.

[10] *See, e.g.*, Exchange Act Release No. 14156 (Nov. 9, 1977) (relating to CBOE rulemaking, and noting that "front-running . . . may violate provisions of the [Exchange] Act."). *See, e.g.*, Division of Investment Management, United States Securities and Exchange Commission, Personal Investment Activities of Investment Company Personnel (Sept. 1994) at 8–9 (explicitly stating that front running would violate Exchange Act Rule 10b-5), *available at* http://www.sec.gov/news/studies/icper.txt. The report also took the view that front running by investment company personnel would violate provisions of the Securities Act of 1933, as amended, and the Investment Company Act of 1940, as amended. For a further discussion of the development of the SEC and SRO positions on front-running, see Jerry W. Markham, *"Front-Running" – Insider Trading Under the Commodity Exchange Act*, 38 CATH. U. L. REV. 69, 72–92 (1988).

[11] "Front-running easily falls within the ambit of Rule 10b-5. It is a manipulative and deceptive practice detrimental to the interests of institutional investors. Front-running is the type of practice Rule 10b-5 was designed to guard against. When a broker front-runs a security, he meets all the necessary elements of an SEC Rule 10b-5 cause of action. Thus, front-running is prohibited by Rule 10b-5." *See* David M. Bovi, *Rule 10b-5 Liability for Front-Running: Adding a New Dimension to the "Money Game,"* 7 ST. THOMAS L. REV. 103, 122 (1994).

activity constitutes a violation of Rule 10b-5.[12] To avoid a similar result in the judicial interpretation of the CEA, we recommend that the Commission clarify in the Proposal that these rules expressly prohibit front running and similar misuse of customer information by swap dealers as a form of market manipulation or fraud. To the extent the Proposal originally was not intended by the Commission to ban front running, Freddie Mac recommends that the Commission amend the Proposal to explicitly prohibit front running and similar practices as a form of market manipulation or fraud. Such an interpretation would be consistent with the Commission's own precedent and that of the courts in the context of the futures markets and with the Commission's acknowledgment that judicial precedent applying Exchange Act Section 10(b) and SEC Rule 10b-5 should "guide, but not control" implementation of the proposed rules.[13]

Prohibiting Front Running as a Matter of Business Conduct

The Commission has long recognized the danger of front running and similar practices in the context of futures transactions as a matter of its business conduct rules. Under Part 155 of the Commission's current rules, futures commission merchants ("FCMs"), introducing brokers ("IBs"), and their affiliated persons are prohibited from using their knowledge of customer orders to the customer's disadvantage.[14] Such rules have helped the Commission to deter improper practices, including "front-running" and "trading ahead."[15] In particular, CFTC Rules 155.3(a)(1) and 155.4(a)(1) require that FCMs and IBs establish and enforce internal controls to ensure that employees "do not take advantage of their relationship with customers by using their knowledge of customer orders to trade ahead of or against the interests of such customers for their own benefit or that of their preferred customers."[16]

Part 155, which was adopted in 1976, is derived in part from the CEA's general anti-fraud authority under Section 4b of the Act, 7 U.S.C. § 6b. The CFTC consistently has denied exemptive relief from these provisions for persons seeking to place customer and proprietary account orders contemporaneously.[17] Moreover, it has extended this prohibition over time, first to IBs[18] and, following passage of the Commodity Futures Modernization Act of 2000, to FCMs

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[12] For example, in *SEC v. Pasternak*, the SEC alleged that a securities broker was operating a front running scheme by concealing from institutional customers the manner in which "not held" orders were worked, including the use of a delayed execution scheme which obscured the quality of the execution price, and allowed the brokerage to profit on a higher spread. However, the federal court focusing on the particular facts of the defendant's activities found that the alleged scheme was not a typical front running operation and rejected the SEC's claims. *SEC v. Pasternak*, 561 F. Supp. 2d 459 (D.N.J. 2008).

[13] 75 Fed. Reg. at 67659.

[14] 17 C.F.R. Part 155.

[15] *See* CFTC Exemptive Letter 03-29 (July 16, 2003).

[16] CFTC, Records of Cash Commodity and Futures Transactions; Trading Standards for Floor Brokers and Futures Commission Merchants, 41 Fed. Reg. 56134, 56139 n. 18 (Dec. 23, 1976). *See also* CFTC, Introducing Brokers and Associated Persons of Introducing Brokers, Commodity Trading Advisors and Commodity Pool Operators; Registration and Other Regulatory Requirements, 48 Fed. Reg. 14933, 14954 (Apr. 6, 1983) (stressing the importance of a "customer first" principle in Part 155).

[17] *See* CFTC Letters 03-29 and 03-30 (July 26, 2003).

[18] 17 C.F.R. § 155.4(a)(1).

intermediating orders for customers on "derivative transaction execution facilities."[19] Where such customers are institutional customers, the rule states that:

> No futures commission merchant, introducing broker or affiliated person thereof shall misuse knowledge of any institutional customer's order for execution on a registered derivatives transaction execution facility.[20]

Section 731 of the Dodd-Frank Act, which adds Section 4s(h) to the CEA, expanded the Commission's authority to prohibit fraud, manipulation and other "abusive practices" with respect to swap transactions and the Commission recently has proposed business conduct standards under Section 731 that would require employees of swap dealers and major swap participants to provide for confidential treatment of counterparty information and would ban trading ahead of customers and front running counterparty swap transactions.[21] In implementing that authority, the Commission has proposed rules that expressly prohibit swap dealers and major swap participants from "front running or trading ahead of counterparty swap transactions"[22] – trading practices that the Commission reiterated are "fraudulent practices."[23] Freddie Mac urges the Commission also to ensure that the Proposal explicitly addresses front running and misuse of customer information as a form of market manipulation or fraud under Section 753 of Dodd-Frank. Ensuring that this form of misconduct is covered by the Commission's Part 180 rules could help avoid potential legal uncertainty as to the proper scope of the anti-manipulation prohibition and further deter misconduct in light of the monetary sanctions and private right of action available under Section 753 of the Dodd-Frank Act.

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For the reasons stated above, while the Proposal presents a significant step toward curbing market manipulation and fraud, Freddie Mac believes that the Commission should clarify in new Part 180 of the rules that Section 6(c) of the CEA, as amended, prohibits front running and similar practices as a form of market manipulation or fraud. This clarification would be consistent with the Commission's prevailing precedent as well as judicial and scholarly views of the treatment of front running as a prohibited fraudulent practice. We believe that addressing these forms of misconduct in this rulemaking could help deter manipulative practices and avoid potential legal uncertainty as to the proper scope of the prohibition against market manipulation in Section 753 of the Dodd-Frank Act.

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[19] 17 C.F.R. § 155.6

[20] 17 C.F.R. § 155.6(b).

[21] *See* CFTC, Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 75 Fed. Reg. 80638, 80642, 80658 (Dec. 22, 2010).

[22] 75 Fed. Reg. at 80642,

[23] *Id.* at 80642 (citing 17 C.F.R. 155.3-4).

Freddie Mac appreciates the opportunity to provide our views in response to the Proposal. Please contact me if you have any questions or would like further information.

Sincerely,

Lisa M. Ledbetter