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# United States Senate

COMMITTEE ON  
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS  
WASHINGTON, DC 20510-6250

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January 3, 2011

David A. Stawick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

RE: Proposed Rules Regarding: (1) Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (RIN: 3038-AD26) and (2) Prohibition on Market Manipulation (RIN: 3038-AD27)

Dear Mr. Stawick:

The purpose of this letter is to express support for and offer some ideas to strengthen the rules proposed by the Commodity Futures Trading Commission ("CFTC") under Sections 6(c) and 4c(a) of the Commodity Exchange Act ("CEA") to combat market manipulations and disruptive trading practices.

The proposed rules are intended to implement:

- (1) Section 753 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which amended the CEA to clarify and expand the authority of the CFTC to prohibit manipulative behavior; and
- (2) Section 747 of the Dodd-Frank Act, which amended the CEA to prohibit certain disruptive trading practices and provide the CFTC with authority to identify and prohibit additional activities it deems disruptive.

While the proposed rules would make significant and welcome progress in harmonizing CFTC regulations with those of the Securities and Exchange Commission ("SEC"), they do not appear to fully capture all potentially manipulative and disruptive trading activities that occur in today's high-speed, interconnected marketplace. Accordingly, the CFTC should consider strengthening its proposed rules to provide it with greater flexibility to combat market manipulations and disruptive activities. These strengthening measures include targeting manipulative or disruptive trade orders in addition to trade executions, eliminating timing considerations that could constrain enforcement actions, and ensuring the CFTC can prevent cross-market and cross-product manipulations and disruptions.

## SUBCOMMITTEE INVESTIGATIONS OF MANIPULATIVE AND DISRUPTIVE TRADING

For more than five years, the Permanent Subcommittee on Investigations, which I chair, has examined issues related to CFTC-regulated markets, including price manipulations, excessive speculation, and market disruptions.

Most recently, on December 8, 2010, the Permanent Subcommittee on Investigations held a joint hearing with the Securities, Insurance, and Investment Subcommittee that focused on how the interconnectedness of the futures, options, and equities markets poses new challenges for regulators seeking to protect the stability and integrity of the markets.<sup>1</sup>

That hearing highlighted how today's professional traders will often seek to make money and hedge their risks using futures, options, and equities markets interchangeably. Private actors seeking to arbitrage prices in the futures, options, and equities markets can cause prices in one set of products regulated by the CFTC to directly impact prices in related products regulated by the SEC.<sup>2</sup> Indeed, highly sophisticated market participants will receive information directly from trading venues for stocks, options, and futures contracts, make decisions on whether to trade based on that information, and then execute their trades in less time than it takes to blink an eye.<sup>3</sup>

In addition to this most recent hearing, the Subcommittee has held several hearings and released reports examining the operation of the markets for crude oil, natural gas, and wheat. These hearings and reports have featured case histories that showed how massive speculative trading by a single hedge fund distorted natural gas prices, how traders using both the futures and over-the-counter (OTC) markets affected commodity prices, and how commodity index traders in the aggregate caused price convergence problems in the wheat market.

During the course of the Subcommittee's year-long investigation into the wheat markets, for example, the Subcommittee compiled and analyzed millions of trading records from U.S. wheat futures markets in Chicago, Minneapolis, and Kansas City, as well as pricing data from various wheat cash markets. After reviewing the trading data and other documents, and interviewing numerous experts, the Subcommittee's investigation concluded that a huge number of wheat futures contracts were purchased by derivative dealers to support commodity index financial instruments, and that those purchases had collectively constituted excessive speculation in the Chicago wheat market, resulting in unwarranted price changes.

A portion of the futures contracts reviewed were purchased by derivative dealers selling commodity-based Exchange Traded Funds ("ETFs") linked to agriculture commodities, including wheat. Essentially, the report found that the purchase of wheat futures contracts to support the commodity index financial instruments, including ETFs, swaps, and exchange traded notes, had created a new demand for those futures contracts; had distorted the prices of those

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<sup>1</sup> Examining the Efficiency, Stability, and Integrity of the U.S. Capital Markets: Joint Hearing Before the Senate Subcommittee on Securities, Insurance, and Investment and the Senate Permanent Subcommittee on Investigations, 111<sup>th</sup> Cong. (2010) (statement of Sen. Carl Levin, Chairman of the Permanent Subcommittee on Investigations).

<sup>2</sup> *Id.*, (statement of Mary Schapiro, Chairman of the SEC); see also *id.* (statement of Gary Gensler, Chairman of the CFTC).

<sup>3</sup> *See, e.g., id.*, (statement of Manoj Narang, Chief Executive Officer of Tradeworx Inc.).



futures contracts by overwhelming normal supply and demand factors; had interfered with the convergence of wheat futures and cash prices; and had hurt American businesses and consumers by causing unreliable wheat prices and hedging failures.

The Subcommittee's hearings and reports have also shown how traditional forces of supply and demand no longer fully account for sustained price increases and volatility in the crude oil and gasoline markets, estimating in one case that market speculation accounted for \$20 out of a \$70 barrel of oil. The Subcommittee's work helped the enactment of legislation to close the Enron loophole exempting electronic trading facilities for large traders from CFTC oversight, strengthen CFTC oversight of OTC markets, and strengthen CFTC regulatory and enforcement authority over U.S. traders trading U.S. commodities on foreign exchanges with trading terminals in the United States.

Collectively, the Subcommittee's investigations show how a number of trading strategies, even ones executed without malicious intent, may result in manipulative or disruptive trading.

In our most recent hearing on December 8, 2010, we learned that while intentional market manipulations used to be performed with large positions and were executed over hours or days, today's modern market manipulators can do their work in microseconds, skimming fractions of pennies across market venues and products. The Dodd-Frank Act provided the CFTC and SEC with the directive to establish better, more-coordinated rules to effectively prohibit these modern manipulations and disruptive practices. The proposed rules help implement that directive, but they should be strengthened as described below to better fulfill their statutory objectives.

## **ENHANCEMENTS TO THE PROPOSED RULES**

**Enhance Harmonization Between CFTC and SEC Regulations.** The CFTC and SEC share many similar objectives, including their overarching public policy goals of protecting investors and ensuring market integrity.

Although the concepts of manipulation are similar in the futures and securities markets, the types and fact patterns of manipulation cases have traditionally differed between them. In futures markets, the primary concern has traditionally been with policing manipulations such as market corners and squeezes. The securities markets have traditionally focused on insider trading and "pump and dump" schemes. However, given the interconnectedness of these markets today, the manipulations and disruptive trading strategies in both markets are converging.

Enhanced coordination and cooperation between the SEC and CFTC would strengthen effective oversight, provide greater legal certainty, and minimize duplication and regulatory burdens. The CFTC and SEC staffs, in a joint report, have already attested to the importance of coordinating efforts to deter market manipulation.<sup>4</sup> That October 2009 report indentified market manipulation as an area in which there were some "divergence" between the securities and

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<sup>4</sup> A Joint Report of the SEC and CFTC on Harmonization of Regulation, Securities and Exchange Comm'n and Commodity Futures Trading Comm'n, Oct. 16, 2009, *available at* <http://www.sec.gov/news/press/2009/cftcjointreport101609.pdf>.



futures laws and recommended strengthening futures manipulation enforcement efforts to more closely align with securities enforcement efforts.<sup>5</sup>

The proposed rules would make significant progress in harmonizing the CFTC and SEC regulatory structure for combating disruptive and manipulative activities. The proposed rules would benefit, however, from additional clarity in addressing potential areas of manipulation and market disruption, and strengthening the CFTC and SEC's authority to police electronic trading.

**Prohibit Manipulative or Disruptive Trade Orders.** One key improvement would be for the proposed rules to explicitly apply to trade order activity—in addition to completed trades—because orders can and do affect market prices. Traders suspected of placing manipulative or disruptive orders could also be required to demonstrate that their order activities (including excessive cancellations, if applicable) were not motivated by an intentional or reckless disregard for the orderly execution of transactions. Shifting the burden of proof onto traders who place potentially manipulative or disruptive orders could significantly improve enforcement of disruptive and manipulative trading.

In addition, some disruptive and manipulative trading strategies, such as “spoofing” in which a firm layers orders to give the false appearance of buying or selling pressure, executes trades in the opposite direction at artificial prices, and then cancels the phony orders, are conceptually well known, even if not well-defined.<sup>6</sup> The CFTC should work with the SEC, the Financial Industry Regulatory Authority (“FINRA”), and others to develop a comprehensive understanding of “spoofing,” as well as identify other abusive activities that may be used to manipulate prices.

When evaluating potentially manipulative or disruptive practices upon which to focus, the CFTC should keep in mind the activities described in FINRA's recent settlement with Trillium Trading LLC. In that case, Trillium's traders were allegedly manipulating the equities markets through combinations of legitimate, bona fide orders and phony orders.<sup>7</sup> To execute their strategy, Trillium's traders would first enter a legitimate buy or sell order in a stock on the NYSE Arca or Nasdaq market venues.<sup>8</sup> In those venues, the traders would then place several phony orders that they never intended to execute on the opposite side of the market a layer or two deep in the order book.<sup>9</sup> These orders were intended to show potential size on the other side of the market.<sup>10</sup>

Other market participants saw the orders and tried to trade ahead of what they falsely believed was the size on the other side of the market, which caused the legitimate order to be filled.<sup>11</sup> The phony orders were then immediately cancelled—and the size pressure on the other

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<sup>5</sup> *Id.*

<sup>6</sup> Although the term “spoofing” has previously been used as industry slang terminology, the CFTC has now been directed to define it. CEA Section 4c(a)(5)(C), as amended by Dodd-Frank Act Section 747.

<sup>7</sup> *In re Trillium Trading LLC*, Financial Industry Regulatory Authority Letter of Acceptance, Waiver and Consent, No. 20070076782-01.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*



side evaporated.<sup>12</sup> The market would then either fall back to its initial position on its own, or the Trillium trader would reverse the process. Over just the three month period examined, Trillium's traders did this manipulation strategy more than 46,000 times, netting profits of more than \$575,000.<sup>13</sup> After four years and thousands of hours of investigation and analysis, FINRA ultimately entered into a settlement with Trillium over its alleged violations of NASD Rules.

**Clarify Broad Preventive Authority.** In the several years since the conduct involved in the Trillium case occurred, the markets have become increasingly complex and interconnected—providing sophisticated traders with new opportunities to engage in potentially manipulative and disruptive practices, including spoofing, quote stuffing, momentum ignition strategies, front-running, undisclosed proprietary trading, and improperly taking advantage of insider order flow information, that can involve one or more products and markets.

The CFTC should ensure that the proposed rules provide it with sufficiently broad authority to prevent and punish this wide range of manipulative and disruptive activities. The rules should clarify that the CFTC has the authority to prohibit any order or trading activity that may be detrimental to the normal price discovery process. For example, in some circumstances, recklessly or knowingly submitting an order to the market that will trade through the order book may constitute a disruptive practice. Traders and their executing brokers could be required to have policies and procedures in place to assess whether orders they intend to submit will unreasonably impact the orderly functioning of the markets. For example, orders above certain size thresholds may need to be assessed on a pre-trade basis to ensure that they do not undermine the orderly functioning of the markets. Similarly, traders who submit orders in sufficient volume or frequency could be required to assess the impact, if any, that their orders (or cancellations) may have on the orderly functioning of the markets.

To address these problems, the CFTC should take a comprehensive view of “spoofing” under CEA Section 4c(a)(5)(C) to ensure activities like those of Trillium are captured, while also using its authority under Section 4c(a)(7) to prohibit other types of order activity and trading activities that are intended to manipulate prices in any way.

**Eliminate Timing Considerations.** The proposed rule could also be strengthened by eliminating any consideration of timing issues, making it clear that timing considerations do not excuse manipulative or disruptive activity. The timing of when disruptive activity occurs – at the opening of a market, during the day, or at the close – should be irrelevant: if the activity is found to be manipulative or disruptive, the CFTC should be able to effectively prohibit it.

**Prevent Cross-Market and Cross-Product Manipulation.** The proposed rules should also be strengthened by making it clear that the CFTC can regulate orders and transactions in its markets to prevent manipulative and disruptive activities where the impacts may only be felt in other markets where trading may be effected—including markets and products regulated by the SEC. As currently drafted, the proposed rules may not allow the CFTC to effectively regulate market activity that is intended to or actually does artificially change prices in another market or product.

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<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

Today, the complexity of the marketplace has created an entanglement of the futures, options, equities, and commodity cash markets. For example, if various orders in futures contracts are being placed with the intent to artificially influence prices in the cash markets, the CFTC might be unable to enforce the proposed anti-manipulation rule since no artificial prices are affecting a futures product; rather the artificial prices may occur solely in another market which is under another agency's jurisdiction. The proposed rules should be modified to clarify that the CFTC has the authority to prevent such cross-market and cross-product manipulations and disruptions.

Thank you for this opportunity to comment on the proposed rules.

Sincerely,



Carl Levin  
Chairman

Permanent Subcommittee on Investigations