



August 14, 2013

Via Electronic Submission

Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

**Re: CME Group Market Regulation Advisory Notice RA1308-5
CME/CBOT/NYMEX/COMEX/KCBT Submission # 13-272**

Dear Ms. Jurgens:

Managed Funds Association (“MFA”)¹ appreciates the opportunity to submit comments to the Commodity Futures Trading Commission (“CFTC” or “Commission”) and the Exchanges² on the CME Group’s proposed Market Regulation Advisory Notice for Exchange Rule 534 (Wash Trades Prohibited) (“Proposed MRAN”).³ MFA supports clarification of the standards for prohibited wash trades.

¹ MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, the Americas, Australia and many other regions where MFA members are market participants.

² “Exchanges” is herein defined as Chicago Mercantile Exchange Inc., The Board of Trade of the City of Chicago, Inc., New York Mercantile Exchange, Inc., Commodity Exchange, Inc. and Kansas City Board of Trade.

³ See CME Group, Regulation 40.5(a) Rule Certification, Request for Approval: Chicago Mercantile Exchange Inc., The Board of Trade of the City of Chicago, Inc., New York Mercantile Exchange, Inc., Commodity Exchange, Inc. and Kansas City Board of Trade, Inc. Issuance of CME Group Market Regulation Advisory Notice RA1308-5 CME/CBOT/NYMEX/COMEX/KCBT Submission # 13-272 (July 9, 2013) *hereinafter* “Proposed MRAN.”

We would also like to express support for the CME Globex Self-Match Prevention functionality (“**SMP functionality**”) as an important step toward addressing inadvertent self-matches on the Exchanges.⁴ We anticipate that the SMP functionality will be helpful to MFA members and others working to address marketplace challenges in connection with inadvertent self-matches. MFA supports efforts to prevent inadvertent self-matches and notes that such a result economically disadvantages market participants because of the associated execution fees.

MFA commends the Exchanges’ efforts to bring clarity to the wash trade prohibition, and believes that the Proposed MRAN represents an important effort toward that end. In this comment letter, we discuss parts of the Proposed MRAN where we suggest that the CME Group should consider providing greater clarity in order to redress vagueness in the legal standards that will otherwise chill legitimate trading activity of market participants.

I. The Final Rulemaking Should be Consistent with Well-Settled CFTC Wash Trade Case Law and Should Not Create a New Standard

MFA is concerned that the Proposed MRAN will unnecessarily expand the wash trade definition beyond the standards articulated in well-settled CFTC case law. In so doing, the Proposed MRAN risks replacing the instructive value of existing legal precedent with the uncertainty of the Proposed MRAN’s vague legal standards.⁵ Under the market regulation advisory notice currently in place (“**Existing MRAN**”), liability attaches to market participants who knew or should have known, that “the intent of the orders is to avoid taking a bona fide market position exposed to market risk.”⁶ The Proposed MRAN widens the scope of liability to include market participants who knew, or reasonably should have known that the trading “would produce a wash result.”⁷

The new formulation of the CME Group wash trade rule will improperly penalize market participants who—for reasons beyond their control—experience few, yet consistent, instances of inadvertent self-matches despite a lack of intent to achieve this result. Under the existing standard, and consistent with well-settled law, such a market participant is shielded from liability because of the lack of intent to avoid taking a bona fide market position exposed to market risk. However, the new standard could reach the market participant to the extent that the trading consistently results in an inadvertent self-

⁴ See CME Globex Self-Match Prevention Functionality FAQ available at <http://www.cmegroup.com/globex/resources/smpfaq.html>.

⁵ See *In re Goldwurm*, 7 Agric.Dec. 265,274 (1948) (stating that the “essential and identifying characteristic of a ‘wash sale’ seems to be the intent not to make a genuine, bona fide trading transaction...”) See also, *Reddy v. CFTC*, 191 F.3d 109, 119 (2d Cir. 1999) (stating that the CFTC “must prove intent to establish a violation of either Section 4b or 4c of the CEA.”)

⁶ See CME Group, RA0913-5R (June 28, 2013) *reissuing* CME Group, Notice RA0913-5 (Nov. 3, 2009).

⁷ Proposed MRAN at FAQ 1 (emphasis added).

match because the Proposed MRAN re-defines liability from “avoid[ing] taking a bona fide market position exposed to market risk” to merely “producing a wash result.”

II. Guidance Around “Unintentional and Incidental” Self-Matches is Helpful, but Greater Clarity is Needed to Avoid Creating a Chilling Effect on Trading

MFA appreciates the Proposed MRAN’s guidance concerning the meaning of “unintentional and incidental” self-matches discussed in the Existing MRAN, but additional guidance is necessary in order to address the vagueness that still remains. In order to bring about a workable standard, MFA recommends that the CME Group more clearly articulate the costs and benefits of a rule that will restrict inadvertent self-matches.

As a practical matter, market participants are unable to determine if their trading could be violative because the CME Group has not clarified the harm to be redressed by the Proposed MRAN. Without explaining the harm and discussing the potential loss of liquidity that the Exchanges are prepared to accept, market participants are left to conjecture where the dividing line is located. The Existing MRAN is silent regarding the meaning of “unintentional and incidental” self-matching and there is limited enforcement precedent to guide market participants. The Proposed MRAN offers an improvement by explaining that the standard “will be evaluated in the context of the activity of the trader, trading group, or algorithm(s), and relative to the trades and volume in the instrument traded.” The factors that will carry weight in the analysis of this standard remain unclear because, for example, the meaning of the “context of the trader” is vague. We are concerned that this vagueness may create a chilling effect on trading that is necessary for markets to operate efficiently.

The Proposed MRAN amplifies the chilling effect of the legal standard’s ambiguity because exceeding “de minimis self-matching in this context ... may be deemed to violate the prohibition on wash trades....” This language represents a sharp departure from the Existing MRAN, which did not state that self-matches in excess of the unintentional and incidental standard would constitute a violation. Instead, the Existing MRAN “strongly encourage[s]” market participants who frequently enter orders which may have a tendency to self-match “to employ functionality designed to minimize or eliminate their buy and sell orders from matching with each other.”⁸

Insofar as these standards are being articulated for the first time as the basis for a possible wash trade violation, we request that if the Commission approves these changes that the Exchanges exercise discretion and that they first warn market participants when they observe potentially problematic trading. In the absence of formal guidance, this approach would allow market participants to conform their business practices to the CME Group’s interpretation.

⁸ Existing MRAN at FAQ 11 (emphasis added).

III. The CME Group Should Make Clear that Inadvertent Self-Matches by Independent Trading Algorithms Will Not Trigger Wash Trade Liability Just as Inadvertent Self-Matches by Independent Decision Makers Will Not Trigger Wash Trade Liability

The Proposed MRAN states that self-matching orders “independently initiated for legitimate and separate business purposes by independent decision makers” will not constitute a wash trade violation; the CME Group should make clear that independent trading algorithms will likewise not trigger liability. Independent trading algorithms operate as independent decision makers because they gauge market conditions and related factors without any input from other independent trading algorithms when calculating their orders.⁹

MFA reads the “independent decision maker” language of the Proposed MRAN to encompass independent trading algorithms, but the final rulemaking should bring clarity to this point of confusion. If “independent decision maker” does not incorporate independent trading algorithms, then market participants will face serious issues regarding how much a trader can rely on quantitative trading or risk models before the role of the trading model causes the trader not to be considered an independent decision maker within the meaning of the wash trade prohibition.

The Proposed MRAN also places undue emphasis on the independence of personnel overseeing independent algorithms or automated trading systems, and we recommend that the CME Group address this point. It is common for personnel to oversee numerous automated trading systems, and such common oversight does not increase the risk of intentional self-matches. Unlike entirely separate manual trading teams, independently operating automated trading systems overseen by common personnel operate without the systems communicating with each other. Retaining this unnecessary emphasis on separation of personnel overseeing automated trading systems under Frequently Asked Question (“FAQ”) 12, will unnecessarily restrict liquidity and impair legitimate market activity.

IV. MFA Supports the Optionality of the CME Group’s SMP Functionality

MFA supports the optionality of the SMP functionality which avoids a one-size-fits-all approach to a community of market participants that is diverse in terms of strategies and trading needs.¹⁰ The SMP functionality, in its current form, includes limitations that are incompatible with the trading needs of some market participants. MFA encourages the CME Group and other exchanges to continue development of

⁹ Proposed MRAN at FAQ 12 does provide that “[f]irms have an obligation to supervise the trading by their employees and algorithms, must be able to demonstrate the independence of the traders/trading groups/algorithms, and should have and enforce policies and procedures that preclude the traders from having access to or knowledge of one another’s orders.”

¹⁰ See Proposed MRAN at FAQ 16 (stating that “Use of CME Group SMP functionality is optional...”)

greater configurability to accommodate the varied trading needs among market participants.

For example, the current SMP functionality offers only “cancel oldest” technology, which cancels the resting order and replaces it with the incoming order. As a result, an inadvertent order on the other side of the market will cause a market participant to lose its resting orders, even if they have been working in the queue. Moreover, the market participant will lose the entire resting order because the SMP functionality does not currently offer “decrement” technology, which would decrease the larger order by the size of the smaller order and cancel the smaller order.¹¹ In addition, the SMP functionality should be extended to accommodate orders executed through multiple brokers.

MFA has concerns that a market participant that is “responsible for minimizing the potential for, and the occurrence of, self matches” may interpret the Proposed MRAN to require SMP functionality.¹² The answer to FAQ 15 goes on to state that “if there is the potential for more than de minimis self-match events, market participants are expected to either adjust their trading strategies or employ functionality to mitigate the occurrence of self-match events.”¹³ Market participants fear that not electing the SMP functionality will make them susceptible to an inference of intent despite the many valid reasons that market participants may not elect to use the SMP functionality.

We further request that the CME Group provide clarification regarding the scope of FAQ 17, which explains that self-matches involving implied orders will be deemed unintentional.¹⁴ It is our understanding that FAQ 17 would apply in the context of two spread orders for which the implied legs match. We also read FAQ 17 to apply in the context of a spread order for which one of the implied legs matches an outright order because this cross involves two different products. Finally, we note that the SMP functionality does not prevent self-matches of implied legs of spread orders, and we would therefore ask the CME Group to clarify that FAQ 17 applies whether or not the market participant has registered for the SMP functionality.

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¹¹ Some exchanges currently offer greater configurability including “cancel newest” and “decrement” technology. *See, e.g.*, NYSE Euronext, Client Notice, Four New Self-Trade Prevention Modifiers (June 24, 2009) available at www.nyse.com/pdfs/STP_Modifier.pdf.

¹² Proposed MRAN at FAQ 15.

¹³ *Id.* (emphasis added).

¹⁴ *See* Proposed MRAN FAQ 17 (stating that “[a]bsent evidence to the contrary, self-match events involving implied orders will be deemed unintentional.”)

MFA would like to thank the Commission and the Exchanges for the opportunity to comment on the Proposed MRAN. We hope that our perspective will inform the rulemaking process and help to bring about clarity through collaboration. We look forward to working with the Commission and the Exchanges to make further improvements to these requirements. If you have any questions about these comments, or if we can provide further information, please do not hesitate to contact Jennifer Han, Associate General Counsel, or the undersigned at (202) 730-2600.

Sincerely,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing
Director, General Counsel

cc: Honorable Gary Gensler, Chairman
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
Honorable Mark Wetjen, Commissioner