Futures & Derivatives Law REPORT
The Journal on the Law of Investment & Risk Management Products
April 2015 ■ Volume 35 ■ Issue 3

The CFTC's Manipulative and Disruptive Trading Authority in an Algorithmic World

BY KENNETH W. MCCRACKEN AND CHRISTINE SCHLEPPEGRELL

Kenneth W. McCracken is a partner at Schiff Hardin LLP in its Washington D.C. offices in the firm's Financial Markets & Products Group. Prior to joining private practice, Mr. McCracken was a Chief Trial Attorney at the Commodity Futures Trading Commission, where he was a member of the Manipulation and Disruptive Trading Squad and supervised investigations into, and litigation charging manipulation, disruptive trading and fraud. Christine Schleppegrell is an associate in the firm's Washington D.C. office and a member of the Financial Markets & Products Group. *The authors wish to acknowledge the generous assistance of Jacob Kahn, an associate in the firm's Chicago office and a member of the Financial Markets & Products Group.* *The case summaries, analysis and discussions of the cases contained herein are based solely on the facts made publicly available. The views expressed in this article are those of the authors and do not necessarily reflect the views of other attorneys at Schiff Hardin LLP or of any clients of the firm.*

As a result of the Dodd-Frank Act,[1] the Commodity Futures Trading Commission ("CFTC" or the "Commission") has new broader authority to prosecute manipulation and disruptive trading in the derivative and swaps markets. However, the commodity and derivative industry's increasing reliance on algorithmic trading systems makes the breadth of this authority challenging to apply in a practical sense. This new authority will be shaped as the courts continue to rule on actions brought by the Commission in the future.[2] During this period, it will be challenging to operate a legally compliant trading company when the unpredictable regulatory environment means waiting for lawsuits and investigations to learn if one's daily business and trading might be seen by its regulator as illegal. This article aims to guide practitioners and derivative trading companies on how the Commission may wield its expanded authority.

Pursuant to amended Section 6(c)(1) of the Commodity Exchange Act (CEA) and Regulation 180.1, the CFTC's Division of Enforcement can now bring a civil action against any person who directly or indirectly uses or employs (or attempts to use or employ) intentionally or recklessly any manipulative or deceptive device or contrivance in connection with a swap, contract of sale of any commodity in interstate commerce or for future delivery.[3] The CFTC maintains its traditional manipulation authority under Section 6(c)(3) and Regulation 180.2, which require specific intent scienter, and asserts it

CONTINUED ON PAGE 3

Article REPRINT

Reprinted from the Futures & Derivatives Law Report. Copyright © 2015 Thomson Reuters. For more information about this publication please visit legalsolutions.thomsonreuters.com

THOMSON REUTERS

© 2015 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651)687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

For subscription information, please contact the publisher at: west.legalworkspublications@thomson.com

Editorial Board

STEVEN W. SEEMER
Publisher, West Legal Ed Center

RICHARD A. MILLER
Editor-in-Chief, Prudential Financial
Two Gateway Center, 5th Floor, Newark, NJ 07102
Phone: 973-802-5901 Fax: 973-367-5135
E-mail: richard.a.miller@prudential.com

MICHAEL S. SACKHEIM
Managing Editor, Sidley Austin LLP
787 Seventh Ave., New York, NY 10019
Phone: (212) 839-5503
Fax: (212) 839-5599
E-mail: msackheim@sidley.com

PAUL ARCHITZEL
Wilmer Cutler Pickering Hale and Dorr
Washington, D.C.

CONRAD G. BAHLKE
Strook & Strook & Lavan LLP
New York, NY

ANDREA M. CORCORAN
Align International, LLC
Washington, D.C.

W. IAIN CULLEN
Simmons & Simmons
London, England

IAN CUILLERIER
White & Case LLP
New York

WARREN N. DAVIS
Sutherland Asbill & Brennan
Washington, D.C.

SUSAN C. ERVIN
Davis Polk & Wardwell LLC
Washington, D.C.

RONALD H. FILLER
New York Law School

DENIS M. FORSTER
New York, NY

THOMAS LEE HAZEN
University of North Carolina at Chapel Hill

DONALD L. HORWITZ
North American Derivatives Exchange
Chicago, IL

PHILIP MCBRIDE JOHNSON
Washington, D.C.

DENNIS KLEJNA
New York, NY

PETER Y. MALYSHEV
Latham & Watkins
Washington, D.C., and New York, NY

ROBERT M. MCLAUGHLIN
Fried, Frank, Harris, Shriver & Jacobson LLP
New York, NY

CHARLES R. MILLS
K&L Gates, LLP
Washington, D.C.

DAVID S. MITCHELL
Fried, Frank, Harris, Shriver & Jacobson LLP
New York, NY

RITA MOLESWORTH
Willkie Farr & Gallagher
New York, NY

PAUL J. PANTANO
Cadwalader, Wickersham & Taft LLP
Washington, D.C.

GLEN A. RAE
Banc of America Merrill Lynch
New York, NY

KENNETH M. RAISLER
Sullivan & Cromwell
New York, NY

KENNETH M. ROSENZWEIG
Katten Muchin Rosenman
Chicago, IL

THOMAS A. RUSSO
American International Group, Inc.
New York, NY

HOWARD SCHNEIDER
Charles River Associates
New York, NY

LAUREN TEIGLAND-HUNT
Teigland-Hunt LLP
New York, NY

PAUL UHLENHOP
Lawrence, Kamin, Saunders & Uhlenhop
Chicago, IL

SHERRI VENOKUR
Venokur LLC
New York, NY

Futures & Derivatives Law Report
West LegalEdcenter
610 Opperman Drive
Eagan, MN55123

© 2015 Thomson Reuters

One Year Subscription ■ 11 Issues ■ $820.00
(ISSN#: 1083-8562)

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered. However, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

CONTINUED FROM PAGE 1

will be guided by the traditional four-part test for manipulation that was developed in case law arising under Section 6(c) and 9(a)(2).[4] In actions that occurred post-Dodd-Frank, the CFTC has exercised both its new manipulation authority (e.g. in the recent JPMorgan "London Whale" order), and its traditional manipulation authority (e.g. in the FX fix cases), as discussed further herein.

Further, the CFTC can now bring disruptive trading actions pursuant to amended Section 4c(a)(5) of the Commodity Exchange Act, making it unlawful for any person to engage in a trading practice that (1) violates bids or offers, (2) intentionally or recklessly disregards the orderly execution of transactions during the closing period, or (3) is, or is of the character of, spoofing.[5]

In an effort to guide practitioners and derivative trading companies on the CFTC's expanded authority, we first describe the Commission's new authority regarding a "manipulative or deceptive device or contrivance" and contrast it with the CFTC's traditional authority to police market manipulation. Second, we discuss the CFTC's new authority as it relates to disruptive trading. Third, we summarize the Commission's recent enforcement actions under Section 6(c)(1), Regulation 180, and Section 4c(a)(5), as well as recent matters brought by the CFTC under its traditional manipulation authority just prior to Dodd-Frank, including matters that appear to have encompassed the trading actions now prohibited by Section 4c(a)(5). Fourth, we advise practitioners and derivative traders on the likely application of the Commission's new legal authority to certain trading practices that the Commission may scrutinize in light of its expanded authority.

I. THE CFTC'S NEW MANIPULATION AUTHORITY UNDER AMENDED SECTION 6(c) AND REGULATION 180

The Dodd-Frank Act laid the groundwork for changes to the CFTC's standards in commodities manipulation cases.[6] Section 6(c)(1) of the Commodity Exchange Act makes it unlawful for any person "to employ, or attempt to use or employ, in connection with any swap, or contract of sale of any commodity in interstate commerce, or for future delivery ... any manipulative or deceptive device or contrivance, in contravention of [Commission rules and regulations]."[7]

To implement the changes required by Dodd-Frank, the CFTC adopted Regulation 180.1, which became effective on August 15, 2011 and, in relevant part, makes it unlawful for any person:

> **in connection with any swap, or contract for sale of any commodity in interstate commerce, or exchange-traded futures contract to intentionally or recklessly: (1) Use or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud; (2) Make, or attempt to make, any untrue or misleading statement of a material fact or to omit to state a material fact necessary in order to make the statements made not untrue or misleading; (3) Engage, or attempt to engage, in any act, practice, or course of business, which operates or would operate as a fraud or deceit upon any person ....[8]**

Together, Section 6(c)(1) and Regulation 180.1 "augment the Commission's existing authority to prohibit fraud and manipulation."[9] The CFTC has taken the position that this expanded authority prohibits "manipulative and deceptive devices, i.e., fraud and fraud-based manipulative devices and contrivances employed intentionally or recklessly, regardless of whether the conduct in question was intended to create or did create an artificial price."[10]

Additionally, practitioners and derivative trading firms should be aware that the CFTC also takes a broad view of the phrase "in connection with." In particular, the CFTC asserts that "Section 6(c)(1) and Commission Regulation 180.1 reach all manipulative or deceptive conduct in connection with the purchase, sale, solicitation, execution, pendency, or termination of any swap, or contract of sale of any commodity in interstate commerce, or contract for future delivery…"[11]

The Commission's new authority over manipulation activity is vastly different than its historical authority. The Commission's historical authority is codified in Section 6(c)(3) and Regulation 180.2, which require specific intent scienter. Traditionally, the Commission took the position that its authority over manipulation covered:

> **any and every operation or transaction or practice, the purpose of which is not primarily to facilitate the movement of the commodity at prices freely responsive to the forces of supply and demand; but, on the contrary, is calculated to produce a**

> **price distortion of any kind in any market either in itself or in its relation to other markets…Any and every operation, transaction, device, employed to produce those abnormalities of price relationship in the future market, is manipulation.**[12]

Under its traditional authority, the Commission argued that any device *intentionally* employed to distort pricing relationships could be manipulative.[13] The Commission stated that Regulation 180.2 will be applied using the traditional four-part test for manipulation: (1) the accused had the ability to influence market prices; (2) the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) artificial prices existed; and (4) the accused caused the artificial prices.[14] Specific intent is required to satisfy the requirements under Regulation 180.2, and recklessness will not suffice as it does under Regulation 180.1.

The difficulty the CFTC encountered in trying to prove the traditional four-part test for manipulation and the intent standard is well known.[15] Regardless, the Commission still retains its traditional authority to bring manipulation cases with the four-part test pursuant to Section 6(c)(3) and Regulation 180.2.

It should be noted, however, that there is disagreement in the interpretation of the case law regarding whether the requirement of "specific intent" in traditional manipulation cases is satisfied merely by evidence that the defendant intended to "affect" or "influence" prices, as the CFTC would argue, or whether the CFTC must instead prove that the defendant intended to cause "artificial" prices – i.e., prices that do not reflect natural forces of supply and demand in the market.[16] This issue of what constitutes sufficient intent under the law will continue as the new authority under Section 6(c)(1) and Regulation 180.1 is utilized by a CFTC that intends to bring manipulation actions "regardless of whether the conduct in question was intended to create or did create an artificial price."[17]

Whereas the traditional manipulation and attempted manipulation authority requiring specific intent (whether to create an artificial price or merely to affect or influence prices) appeared to focus more on the *subjective* intent of the defendant, the new authority allowing for reckless intent shifts the focus to a more *objective* determination.[18] This progression of reducing the burden on the government by allowing it to show a diminished level of intent, from specific intent to recklessness, in a manipulation claim only heightens the challenge of operating a legally compliant derivative trading business.

II. THE CFTC'S NEW DISRUPTIVE TRADING AUTHORITY UNDER AMENDED SECTION 4c(a)(5)

Dodd-Frank Act amendments to Section 4c(a) of the Commodity Exchange Act resulted in the prohibition of three types of transactions designated "disruptive trading." Section 4c(a)(5) makes it unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that: (A) violates bids or offers; (B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or (C) is, is of the character of, or is commonly known to the trade as "spoofing."[19]

A. Violates Bids or Offers

Section 4c(a)(5)(A) makes it a per se offense to engage in any trading, practice or conduct that violates bids or offers. As a result, the Commission is not required to show that a person acted with either the intent to disrupt fair and equitable trading or with the intent to violate bids and offers.[20] An example of this prohibited behavior is "buying a contract on a registered entity at a price that is higher than the lowest available price offered for such contract or selling a contract on a registered entity at a price that is lower than the highest available price bid for such contract."[21] The electronic-order-matching system of an exchange would likely prevent a trader from entering an order that would violate bids or offers. Consequently, this subsection probably would be applicable only to pit trading.

B. Intentional or Reckless Disregard for Orderly Execution During the Closing Period

Section 4c(a)(5)(B) makes it unlawful to engage in any trading, practice, or conduct that demonstrates an intentional or reckless disregard for the orderly execution of transactions during the closing period. Here, though accidental or negligent trading will not result in a violation, the Commission can charge recklessness. Recklessness has consistently been defined as "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.'"[22]

© 2015 THOMSON REUTERS

This subsection encompasses "any bids and offers submitted by market participants that disrupt the orderly execution of transactions during the closing period."[23] An example of this prohibited behavior would include a market participant accumulating a large position in a product or contract immediately before or during a closing period with the intent to disrupt, or reckless disregard of the possibility of disrupting, the orderly execution of the transactions during the closing period, such as "banging" or "marking the close."[24] The Commission has clarified its position that conduct *outside* the closing period may also disrupt the orderly execution of transactions during the closing period and may be the basis for a violation under this subsection and other applicable CEA sections.[25] The fact that a person's execution of orders before or during the closing period had a substantial effect on a contract's settlement price would not by itself result in a violation, absent an intent to disrupt or reckless disregard for orderly transactions. And, indeed, this is often fertile ground for defense arguments in these types of cases.

The Commission explained that a person with manipulative intent when attempting to "bang" or "mark the close" could also separately have intent to disrupt the orderly execution of transactions during the closing period.[26] As a result, while the presence of manipulative intent is not a prerequisite to finding a violation of Section 4c(a)(5)(B), the CFTC appears to believe that in certain situations a person could possibly possess dual intent (to disrupt the market and to manipulate), which may foreshadow how the CFTC plans to address this type of conduct under its new legal authority.

C. Spoofing

Section 4c(a)(5)(C) makes it unlawful to engage in any trading, practice, or conduct on a registered entity that is, is of the character of, or is commonly known to the trade as, "spoofing." In order for a violation to occur under this subsection, a market participant must bid or offer with the intent of canceling the bid or offer before execution. Accordingly, to engage in spoofing, a market participant must "act with some degree of intent, or scienter, beyond recklessness."[27] The Commission intends to evaluate the market context of trading, but the fact that a trade is partially filled does not automatically exempt it from being classified as "spoofing"; such trades could still violate subsection (C).[28] However, the CFTC interprets the statute such that a "legitimate, good-faith cancellation or modification of orders (e.g., partially filled orders or properly placed stop-loss orders) would not violate section CEA 4c(a)(5)(C)."[29] The Commission also interprets this section to include all bids and offers in pre-open periods or during other exchange-controlled trading halts.

The Commission has taken the position that spoofing behavior includes, but is not limited to, the following four examples: "(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 canceling multiple bids or offers to create an appearance of false market depth, and (iv) submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards."[30] While the Commission stated it intends to evaluate all of the facts and circumstances of each particular case, including a person's trading practices and patterns, it does not intend to make a pattern of trading activity a requirement of a violation. In fact, a single instance of trading activity could be a violation of Section 4c(a)(5)(C), provided it was conducted with the prohibited intent.[31]

The specific reference in at least one of the spoofing examples of the "intent to create artificial price movements" indicates the Commission likely views some spoofing behavior as potentially manipulative. While the interpretive guidance and a few existing cases have provided practitioners and derivative trading companies with some limited examples of disruptive trading practices,[32] whether the CFTC may also view these disruptive practices as part of a broader manipulative scheme requires further analysis, particularly as to how the Commission has brought and will bring future manipulation charges.

III. CFTC CASES ON MANIPULATION AND DISRUPTIVE TRADING

As noted above, the Commission's manipulative authority has expanded after the changes from Dodd-Frank. However, to date the CFTC has only had a few occasions to apply these new standards to conduct that occurred *after* its expanded authority became effective. On each occasion, the manipulative conduct was not scrutinized by a neutral legal body but was described in settlement orders negotiated with the Commission. After comparing post-Dodd-Frank manipulation and disruptive trading cases with pre-Dodd-Frank manipulation cases, the development in the CFTC's loosely defined, but expansive authoritative posture becomes evident.

A. Post-Dodd-Frank Manipulation Cases – Under the New Manipulative Device Theory and the Traditional Manipulation Theory

The Commission first used its new authority under amended Section 6(c)(1) and Commission Regulation 180.1 in an October 2013 settlement with JPMorgan, in what has become known as the "London Whale" case. However, the Commission has since settled five matters involving attempted manipulation of foreign exchange (FX) benchmark rates where the charges, with respect to conduct on or after the effective date of the Dodd-Frank amended version of Section 6(c), were not based on the use of manipulative devices but instead relied on Section 6(c)(3) and Regulation 180.2, the CFTC's traditional manipulation authority. These cases suggest that the CFTC may conveniently apply its old or new manipulation authority based on the strength of evidence it decides will support the element of intent.[33]

1. Manipulation by Manipulative Device – The "London Whale" Case[34]

In March 2014, the CFTC settled administrative charges against JPMorgan Chase Bank alleging that traders in JPMorgan's London branch investment office acted recklessly in employing an aggressive trading strategy in a type of credit default swap (CDS) known as a credit default index (CDX). The order stated that JPMorgan's traders purchased and sold default protection in a portfolio of CDX and other credit default indices and at the end of 2011 held a multi-billion dollar net position in them. These traders marked to market the positions in this swaps portfolio using various measures of market prices for the credit default index positions in order to assign a value to the portfolio. These marks were subsequently used to calculate the profits and losses (P&L) in the office. According to the order, in January 2012, though the swaps portfolio had been profitable, it began suffering large daily losses. The Commission found that on February 29, 2012, just ahead of month-end internal portfolio valuations, the traders, in an effort to reduce these mark-to-market losses in the P&L, took the actions that the Commission would determine to be a "manipulative device."

As described in the order, the traders sold on net more than $7 billion in volume in a particular CDX, of which $4.6 billion was sold in a three-hour period on February 29. The Commission found that the swaps portfolio value stood to benefit on a mark-to-market basis from the decline of market prices in this particular CDX. In the order, the Commission emphasized the value comparisons it determined existed between the JPMorgan traders' positions and those of the entire market in that contract. For example, the Commission order stated that the net volume in that contract sold by the JPMorgan trader in the three days at month-end was "roughly one-third of the volume traded for the *entire month* of February by all other market participants" (emphasis in original) and that the volume of default protection sold by JPMorgan on February 29 made up greater than 90% of the market net volume that day, and was approximately 15% of the net volume for the entire market for the month of February. The order stated that the market price of the contract dropped substantially during this period, but did not state that the actions of the JPMorgan traders led to or affected the market price declines.[35] The Commission found that the traders characterized their own actions as "defending the position" or "fighting" market participants as the traders traded large and concentrated volumes of the CDX.

The facts used against JPMorgan, characterized under the "manipulative device" purview, were the traders' activities in connection with the selling of enormous volumes of the CDX in a short period of time at month-end. Additionally, these same facts were also the basis the Commission used to establish "recklessness." The order stated that the traders recognized that the size and timing of the transactions in a concentrated period had the potential to affect or influence price and that they recklessly disregarded the possible consequences to legitimate market forces. The Commission found that such activity designed to "defend" a position or "fight" market participants, whether done in a concentrated fashion or not, was prohibited by Section 6(c)(1) and Regulation 180.1.[36] The Commission's Order did not, however, explain what factors it considered in deciding that the actions taken were "manipulative devices or contrivances" in violation of the law.

2. Traditional Manipulation - The "FX Fix" Cases[37]

The Commission recently found in a consent order that Royal Bank of Scotland (RBS) attempted to manipulate the global foreign exchange (FX) benchmark rates, including the World Markets/Reuters Closing Spot Rates (WM/R Rates) – one of the most widely referenced rates in the United States and globally – by coordinating its trading with traders at other banks to benefit its own trad-

© 2015 THOMSON REUTERS

ing positions or those of certain traders.[38] The order found the traders used private electronic chat rooms to plan their attempts to manipulate, by disclosing confidential information on positions, altering positions to accommodate their collective interests, and agreeing to trading strategies. In one example in the order, the Commission described an RBS trader offering, during a chat room discussion, to place the 25 million buy order of another trader with the RBS trader's 50 million Australian dollar buy order so he would have more "ammo" for the fix window.

Because the relevant period of this conduct bridged the periods before and after the amended Section 6(c) became effective on August 15, 2011, the charges reflected both versions of the CFTC's traditional manipulative authority under the CEA. The actions taken after the amendment were found to be in violation of Section 6(c)(3) and Regulation 180.2 as they roughly mirror the traditional manipulation standard, requiring specific intent as in the four-part test developed in case law arising under Sections 6(c) and 7 U.S.C. § 9(a)(2).[39]

The facts of the Commission's order allege a manipulative scheme involving the exchange of confidential bank information regarding the size and direction of a bank's net orders and the traders actually increasing the volume of their trades above the volume necessary to manage the risk of their banks' buy and sell orders. However, the order does not allege the use of any "manipulative devices" by the traders. It would make sense that where fraud or deception is used in a manipulative scheme, the Commission would allege the use of manipulative devices. Yet it is not clear when comparing the JPMorgan "London Whale" order alongside the five FX Fix orders when the CFTC believes fraud may or may not have occurred. In both situations, the traders (one group trading swaps bilaterally and the other group trading foreign currency pairs) were alleged to have conducted schemes apparently undetected by the banks that employed them.[40] The CFTC found in the London Whale case that traders "defending a position" by trading enormous volumes of commodities in a short period of time to influence prices employed a manipulative device. However, the RBS traders who secretly agreed in private electronic chat rooms to buy or sell multiple millions of foreign currency in a one-minute fix period window to influence a price were not alleged to have employed a manipulative device.

Because the RBS order is based on Section 6(c)(3) and Regulation 180.2, with its stricter specific intent standard, and because the JPMorgan order follows the recklessness standard from Section 6(c)(1) and Regulation 180.1, it appears that whether the CFTC alleges the presence of a "manipulative device" may be determined by the level of intent the CFTC feels it can prove, or perhaps negotiate, in a particular matter. As a result, the CFTC has inconsistently (but conveniently) applied its old and new manipulation authority.

The Commission first used its new authority under the amended Section 4c(a)(5) regarding disruptive trading in a July 2013 settlement with Panther Energy Trading LLC (Panther) and Michael J. Coscia (Coscia) involving alleged spoofing.[41] While spoofing behavior could have been around since electronic trading began in the financial markets, and has been charged by the Securities and Exchange Commission (SEC) as far back as 2001,[42] it was only recently made a specific violation of the Commodity Exchange Act. However, as will be further addressed below, conduct similar to spoofing has been a part of CFTC enforcement actions on prior occasions.

In the Panther case, the Commission entered an order finding that from August 2011 through October 2011 the respondents engaged in the disruptive practice of "spoofing" in 18 futures contracts traded on four exchanges. In particular, it found that the traders had utilized an algorithmic trading program designed to place bids and offers and then quickly cancel them before execution. The Commission found, for example, that the respondents placed a small sell order at or near the best price and then placed large buy orders at progressively higher prices to give the market the impression that there was significant buying interest and that prices would soon rise in the market, with the goal of increasing the likelihood that market participants would buy the original small sell order. The Commission found that the respondents intended to cancel the buy orders before they could be executed, utilizing this spoofing algorithm hundreds of times a day in a particular futures market. By these actions, the Commission stated that the respondents intended to capture an immediate profit, because if the respondents' sell order was successfully filled the algorithm was designed to promptly operate in reverse in order to offset, or close out, the original order.

Although the Commission found in the Panther case that the algorithmic trading system used by the respondents was designed specifically to spoof the markets, it is not clear from the order how the CFTC came to learn this information, as there is no mention of communications (e.g. emails or text messages) reflecting the respondents' intent.

While there is currently a definition of "spoofing" contained in the Commodity Exchange Act, the scope of that definition remains unclear until ruled on by the courts.[43] There is considerable disagreement in the industry regarding the type of conduct that might be considered to be spoofing as there is no accepted meaning of the term in the futures markets.[44]

Prior to the Panther case, which is the only case to date to use the new disruptive trading authority of the CFTC under Section 4c(a)(5), the CFTC had alleged that the actions that it now considers "disruptive trading" (i.e. violating bids and offers, banging the close, and spoofing) constituted parts of a scheme to manipulate or were overt acts in an attempt to manipulate the markets. These actions that were formerly considered only pieces of manipulation schemes are now considered individual violations.

B. Pre-Dodd-Frank Manipulation and Disruptive Trading Cases – Including Actions that Became "Disruptive Trading"

The Commission's history of manipulation matters over the years includes traditional manipulation and attempted manipulation actions, but has more recently moved toward the acts now specifically prohibited under Section 4c(a)(5). While traditional manipulation actions were still occurring, the continuous shift to electronic trading from pit trading over the last 10 to 15 years coincided with the Commission bringing more cases of manipulation and attempted manipulation where the underlying scheme alleged involved "banging the close" or spoofing activity, acts now specifically prohibited under Section 4c(a)(5).

1. Traditional Manipulation - The LIBOR Cases[45]

The Commission recently found in a consent order that Lloyds Banking Group plc and Lloyds Bank plc (Lloyds) attempted to manipulate the London Interbank Offered Rate (LIBOR) benchmark interest rates to benefit its own trading positions or create a market impression that the bank was financially healthy.[46] The order stated that Lloyd's traders had coordinated their trading with traders at other banks who were part of the submitting panel of banks that would ultimately set LIBOR, to make false submissions and attempt to manipulate various LIBOR rates, and to successfully manipulate LIBOR rates in certain instances. The factual allegations against the LIBOR respondents all roughly mirror the types of facts contained in the FX fix cases discussed above. Each contains communications representing coordinated activity of collusion to submit false statements or attempt to manipulate, or manipulate the respective markets in violation of the pre-Dodd-Frank version of Section 6(c) and 7 U.S.C. § 9(a)(2).

2. "Banging the Close" Manipulation

The Commission has brought and settled multiple matters of manipulation when the underlying action or scheme involved what is known as "banging the close."[47] In each matter defendants were alleged to have taken a large position on one side of the market near the close in an effort to drive the settlement price up or down and increase the value of their positions. In all of these matters, the Commission focused on determining defendants' intent to time their trading to influence the closing price.

The trading strategy known as "banging the close" or "marking the close" has been described as trading or placing bids/offers of a significant volume of futures contracts during, and many times before, the closing or settlement period of the particular contract in an effort to influence or affect the settlement price in the trader's favor.[48] As the settlement price of futures contracts can affect the value of a trader's overall position in the market or, depending on the type of underlying commodity, a trader's broader financial portfolio of cash and derivative positions, it can carry enormous weight in the successful economics of derivatives traders. With the advent of electronic trading, and the increasing speed at which traders can execute trades via computer algorithms, the volume of trading activity in particular contracts has increased as well.[49] Below is a summary of some of the CFTC's recent actions involving pre-Dodd-Frank conduct regarding banging the close as a part of a manipulative scheme.

In November 2013, the Commission filed a complaint in federal court in New York for manipulation and attempted manipulation against Donald Wilson and his company, DRW Investments LLC. The Commission alleged that the defendants manipulated and attempted to manipulate the IDEX USD Three-Month Interest Rate Swap Futures Contract (Three-Month Contract) on the NASDAQ OMX Futures Exchange (NFX).[50] The Commission alleged that defendants engaged in a scheme to exploit the pricing and valuation of the Three-Month

© 2015 THOMSON REUTERS

Contract pricing in their favor, taking a large long position in the contract and then strategically placing bids at higher rates in the closing period to influence the settlement price and drive up the value of their positions.[51] The Commission further alleged that the defendants then cancelled those higher bids after the settlement period ended and before they were executed in the market.[52]

Also in November 2013, the Commission issued an order against Daniel Shak and SHK Management LLC for attempted manipulation.[53] The Commission found that respondents attempted to manipulate the price of Light Sweet Crude Oil (WTI) futures contracts traded on NYMEX. The Commission found that, by heavily trading on one side of the market during the close, respondents attempted to drive up the settlement price of futures contracts. The facts of the order focused on the following aspects of respondents' trading strategy: (i) respondents established substantial net short positions through Trading At Settlement (TAS) WTI future contracts that are priced at the daily settlement price; (ii) then immediately prior to the close, Shak and SHK offset some of their TAS positions by buying a significant volume of outright futures contracts at a rapid pace to start driving the price of contracts higher; and (iii) respondents bought at a rapid pace during the close.[54] The Commission found that respondents executed this strategy by attempting to drive the settlement price of WTI futures contracts higher than the average cost of the long position respondents established before the start of trading during the close.[55] The Commission asserted that respondents' goal was to profit based on a favorable differential between the higher settlement price of its short position and the lower prices at which it bought WTI futures contracts.[56] These actions were characterized in the order as "banging the close."[57]

As stated in the interpretive guidance for disruptive trading, the Commission believes it is a violation of the CEA "when a market participant accumulates a large position in a product or contract in the period immediately preceding the closing period with the intent (or reckless disregard) to disrupt the orderly execution of transactions during the…defined closing period."[58] Each of the cases described above involved actions similar to the description of "banging or marking the close" and they were brought as manipulation or attempted manipulation charges under the CFTC's pre-Dodd-Frank authority.[59] Will the new disruptive trading authority make a "banging the close" manipulation a thing of the past, or, more likely, will the CFTC use it with its new manipulation authority to continue to expand its regulatory reach?

3. "Spoofing" Manipulation

The Commission previously brought and settled multiple matters of attempted manipulation or false reporting when the underlying action or scheme involved what the CFTC would likely call "spoofing" under its new post-Dodd-Frank authority. In each matter discussed below, the respondents employed trading strategies that involved bidding and cancelling orders in order to influence settlement prices or create the appearance of market depth to their benefit.

In December 2012, the CFTC filed a complaint in federal court in New York against Eric Moncada, BES Capital LLC, and Serdika LLC for attempted manipulation of the December 2009 Wheat Futures Contract. Specifically, the Commission alleged that Moncada engaged in three trading tactics as part of his scheme: (1) manually placing and immediately cancelling numerous large-lot orders without the intent to have them filled, but instead to create a misleading impression of liquidity in the market; (2) placing these large-lot orders at or near the best bid or best offer price in a manner to avoid being filled by the market; and (3) placing small-lot orders on the opposite side of the market with the intent to take advantage of any price movements caused by his large-lot orders.[60] Though the CFTC did not specifically label the described trading activity as "spoofing" in the complaint, when the CFTC later moved for summary judgment it specifically argued that Moncada's actions were "spoofing" and his intent to manipulate the market was evident.[61] Although the court denied summary judgment on the issue of attempted manipulation on the ground that the Second Circuit prefers intent issues to go to trial, the court noted its "[agreement] with the CFTC that the most compelling inference one might draw from the trading records is that Moncada was indeed trying to manipulate the market."[62] In October 2014, shortly after the summary judgment ruling, Moncada agreed to a consent order with the CFTC on the attempted manipulations.[63] The significance of this case lies not only in the apparent absence of any direct evidence that Moncada acted with specific intent, but also in the court's apparent willingness to agree with the CFTC that sufficient evidence of the defendant's intent may be inferred from the defendants' pattern of trading.

In July 2011, the Commission found in an order that Ecoval Dairy Trade, Inc. attempted to manipu-

late the daily settlement prices of Non-Fat Dry Milk futures contracts. The Commission found that the respondent engaged in trading strategies designed to push the prices of certain futures contracts higher in an effort to establish a large short position at higher prices. The Commission found that the respondent engaged in the following trading strategies: (1) lifting offers and then immediately bidding a higher price than just paid in the trade; (2) placing both bids and offers above prevailing market prices to establish higher price ranges in the market; (3) placing bids above the opening price or above the prevailing price across multiple contracts; and (4) bidding and then quickly cancelling bids without the intent to have the bids filled.[64] Again, though the term is not used in the order, it is clear that part of the trading activity described in the order the Commission likely would now claim is of the character of spoofing.[65]

In its interpretive guidance for disruptive trading, the CFTC emphasizes the significance of intent and states that establishing a pattern of behavior is not a requirement for finding a violation under 4c(a)(5)(C). This approach is reflected in the spoofing cases discussed above, where the focus was on intent and even circumstantial evidence indicating that intent. In each of these cases, actions similar to the CFTC's description of "spoofing" occurred and the CFTC brought charges for attempted manipulation or false reporting using its pre-Dodd-Frank authority.

How will the new disruptive trading authority affect the CFTC's view on banging the close and spoofing behavior in future manipulative schemes? Will the potential for dual intent – intent to disrupt and intent to manipulate – create multiple actions under the new authority born from the same conduct? Will the CFTC bring more enforcement actions under its new authority versus traditional authority, thereby shifting the focus on the element of intent from a subjective to objective determination? As is often true, history is instructive for the future. An analysis of how the CFTC might apply its new manipulation and disruptive trading authority will provide some practical tips for practitioners and market participants on how to face the challenges of the new regulatory environment.

IV. WHAT WILL THE CFTC CONSIDER MANIPULATIVE OR DISRUPTIVE DEVICES?

In addition to creating the potential for increased liability for participants in the derivatives industry, amended Section 6(c)(1) of the CEA should also raise the awareness level of attorneys practicing before the Commission on several fronts. The intersection of manipulation and disruptive trading, as shown above, has always been part of the regulatory landscape. However, before Dodd-Frank all of the actions that would today fall under "disruptive trading" were thrown together by the CFTC under one umbrella of manipulation and attempted manipulation (still requiring proof of specific intent). The Commodity Exchange Act of today expands the ability of the CFTC to successfully investigate and litigate manipulation and disruptive trading, while also increasing the burden on defense attorneys and market participants, particularly algorithmic traders, to navigate the risks of regulatory action.

So how does a derivative industry dominated by algorithmic trading prepare for this new regulatory authority and a CFTC with a bigger enforcement club? First, market participants must understand the legal interactions of the new laws and regulations on manipulation and disruptive trading and how the CFTC may utilize them together. Second, the derivatives industry must become more vigilant about understanding how the motives and mechanisms of new methods of trading may be interpreted by the CFTC under this legal authority. Whether the Commission applies the traditional manipulation authority, under Section 6(c)(3), or the new authority, under Section 6(c)(1), will likely depend on the level of intent demonstrated by the trading behavior at issue. In cases where the CFTC is struggling to demonstrate specific intent, an enforcement action is most likely to be brought under the new authority requiring only recklessness. However, if the CTFC has evidence of specific intent, or can negotiate it within a settlement order, the traditional authority will likely be used.

A. The Legal Interaction of Manipulation and Disruptive Trading

Under the CFTC's current manipulative and disruptive trading authority, it is now more likely that one type of trading activity by market participants will lead to prosecutions for multiple violations of the CEA. The interplay between the different legal sections and regulations of the CEA and the different levels of scienter needed to prove liability is informative as to how the CFTC will likely act in the future.

The CFTC's traditional manipulation authority is preserved under Section 6(c)(3) and Regulation 180.2, which carry the specific intent standard. Where the manipulative scheme is perhaps of the

© 2015 THOMSON REUTERS

old-fashioned corner or squeeze variety, prosecutions of which are becoming rarer, or where part of the underlying scheme includes spoofing, which requires the same level of scienter, then the CFTC may decide to bring actions under the traditional manipulation laws. Further, when the contemporaneous evidence of intent exists in an email or instant message, it is more likely that the CFTC will bring traditional manipulation charges under Section 6(c)(3) and Regulation 180.2. For example, the taped telephone calls or instant messages and emails found in the FX fix and LIBOR matters made it possible to settle those matters under this stricter standard.

In alleged spoofing situations, an additional analysis regarding the potential for manipulation charges by the CFTC will likely follow. In a spoofing scenario – absent some contemporaneous evidence reflecting the defendant's intent – *e.g.*, emails, instant messages, phone recordings, etc. – the CFTC will need to prove intent using circumstantial evidence, such as evidence of trading patterns. For example, the facts in the *Ecoval* order discussed above mentioned both trading data and emails regarding the respondent's intent. If a similar case occurred under the new Section 6(c) authority, the CFTC might bring charges under the stricter standard in Section 6(c)(3) and Regulation 180.2, as well as under Section 4c(a)(5) for disruptive trading. In other words, the CFTC might now charge under two statutes what it previously charged under one.

In contrast, in the *Moncada* case, where it appears to the CFTC that spoofing activity occurred, the facts do not mention any direct evidence of specific intent. The facts discuss the trading data in detail, but it appears from the CFTC's complaint and the subsequent summary judgment order that the evidence of intent was circumstantial based on the defendant's trading activities, without any mention of other evidence that may show specific intent. If similar conduct occurred today, the CFTC might bring an action under the reckless standard of manipulation in Section 6(c)(1) and Regulation 180.1. While the CFTC was apparently willing to bring a matter with circumstantial evidence of intent under the specific intent requirement pre-Dodd-Frank, it would not need to do so under the new post-Dodd-Frank authority.

Should market participants be concerned that spoofing or trading that "is of the character of" spoofing is also a manipulative device or contrivance prohibited under Section 6(c)(1)? In other words, if the CFTC lacked the requisite specific intent to bring either a Section 4c(a)(5) spoofing charge or Section 6(c)(3) manipulation charge, might it bring a manipulation case under the lower "reckless" authority? Unfortunately for traders and firms, the CFTC likely will find this an attractive option.

Additionally, the CFTC might also elect to use this option when the underlying actions are of the "banging the close" variety. Banging or marking the close trading actions are often difficult to distinguish from legitimate trading activity due to the large volume of trading that already takes place before and during the closing period of a contract. It follows that evidence of intent is difficult to evaluate in these situations. But, because banging the close charges can now also be based on "reckless disregard," the CFTC may opt to bring manipulation actions under Section 6(c)(1) and Regulation 180.1 (with its reckless standard) rather than the more difficult traditional manipulation law.

As discussed in the cases above, for example, if a respondent took a large long position in a contract, and then strategically placed bids at higher rates during the closing period to influence the settlement price and drive up the value of its positions, the CFTC might characterize this conduct as a "manipulative or deceptive device or contrivance." Therefore, as in the spoofing matters described above, if the evidence of intent in a similar banging the close situation did not rise to the level of specific intent, either through some direct or indirect evidence, then the CFTC could choose to charge the matter as a manipulation under the lower recklessness standard. Because the scienter standard under Section 4c(a)(5)(B) (banging the close) is met by evidence of reckless disregard *or* specific intent, both charges are possible.

In fact, market participants should expect that whenever the underlying facts support a Section 4c(a)(5) disruptive trading charge, the CFTC will consider bringing a manipulation charge, under either Section 6(c)(1) or Section 6(c)(3), as well as disruptive trading charges.[66] This new authority appears to empower the CFTC to bring manipulation charges for conduct that would be characterized as disruptive trading, even if there is no evidence of specific intent. Because neither the CFTC nor the courts have defined a "manipulative or deceptive device or contrivance" other than where respondents trade large volumes in brief time periods, and make the mistake of internally characterizing the trading as an effort to "defend" a position (as described in the "London Whale" matter), there is a risk that almost any trading activity may serve as the basis for a manipulation charge — with the "right" evidence of intent.

B. What Could the CFTC Consider a Manipulative or Disruptive Device?

Defense counsel and derivative traders alike should be wary of the risk of liability for manipulation in this new regulatory era. As shown above, if the CFTC can use banging the close and spoofing activity, both made illegal under a new statutory section, as evidence of an undefined "manipulative or deceptive device or contrivance" definitional evaluation, what other trading activity, both illegal or legal, could fit this definition?

Because intent is the predominant hurdle for the CFTC in proving violations of this new authority, evidence of motive may become even more important in the CFTC's analysis. The hypotheticals that follow address some motives the CFTC may consider when reviewing trading conduct under its new expanded manipulation or disruptive trading authority.

1. Wash Trading

Wash or fictitious trading is illegal under Section 4c(a) of the CEA, provided there is a specific intent to enter a noncompetitive trade.[67] A "wash" or fictitious sale is one in which a trader submits its transactions to the open market with the intent and purpose that the transactions would offset each other while negating the risk of price competition incident to such market.[68] However, the high volume of trading used by many algorithmic and high frequency traders can produce hundreds of instances of unintentional or incidental wash trading (i.e. accidental wash transactions) on a daily basis. While these trades may lack the requisite intent to be considered illegal as a wash trade, could this activity constitute a manipulative device in the eyes of the CFTC?

It has been reported that the CFTC has recently scrutinized whether high-speed traders' wash trades were being used to create a false impression of higher volume in the market.[69] The report noted that incidental wash trading (presumed accidental) that occurs on a large scale from one entity may appear intentional to regulators based on its sheer volume alone.[70] Similar to comparisons the CFTC has made before in the prior cases discussed above, if an algorithmic trader had a higher volume of incidental wash trading in a market than the rest of the market participants, the CFTC might view the cumulative weight of the trading data as circumstantial evidence of the trader's intent to commit a wash trade. The CFTC might also evaluate if this conduct is a manipulative or deceptive device or contrivance, in the hypothetical discussed below.

Hypothetical: A firm's trading algorithm creates incidental wash trades at a high volume. The high incidents of wash trades may create the impression to other market participants of increased activity at certain times in the market. As a part of its program the firm's trading algorithm may detect and analyze all other market activity while the other market participants are reacting to this increased impression of market activity by placing bids or offers to try to capture some of the perceived volume. The firm's algorithm places bids/offers to hit these new bids/offers by the other market participants and the market price moves in the direction of the trades. The firm may capture a benefit from the price move that was generated by the false impression created by its own incidental wash trades.

Would the CFTC view this scenario as regular trading activity and the unintended consequence of incidental wash trading? The Commission has clarified that good-faith mistakes or negligence will not constitute a violation of Rule 180 or Section 6(c)(1).[71] Or, might the CFTC find that, based on circumstantial evidence, the firm was aware of the potential consequences of its high volume of incidental wash trading and was motivated to take advantage of the situation such that its actions "depart so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what [it] was doing"? This illustrates how the CFTC may approach these issues—and the risks that such an approach creates for algorithmic trading firms.

This incidental wash trading scenario could be further complicated by a firm's activities in related commodity markets or by the fact that the firm may have multiple trading entities, of which it is the parent, in the same markets.

2. Latency[72]

Algorithmic and high frequency trading firms have attempted to reduce latency in the derivatives market with faster computer and routing systems and co-location services at the exchanges. At the same time, traders may look to exploit time delays in the system through latency arbitrage - the advantage in access and response time that allows a trader to make a profit. The concept of latency arbitrage is not new. When trading mostly occurred in the trading pits, market participants looking to buy always tried to capture the attention of another market participant looking to sell before their competitors could. Thus, latency arbitrage is not itself illegal. However, regulators may see this latency issue in the electronic marketplace as a motiva-

© 2015 THOMSON REUTERS

tion for algorithmic and high frequency traders to potentially exploit an advantage over other market participants that do not trade in milli- or microseconds. The CFTC has apparently considered issues of latency and impartial access to information in the markets.[73] The CFTC might conduct the following analysis to determine the existence of a manipulative or deceptive device or contrivance.

Hypothetical: Assume a high frequency trading firm has the ability to quantify the latency it encounters in placing orders at an exchange, while at the same time determining that the latency of other market participants is much higher.[74] The firm submits multiple bids or offers solely in an effort to overload the quotation system at an exchange with an aim to increase the latency within a market during a particular time[75] (i.e. a specific example of a method of spoofing that the CFTC has stated would be illegal under Section 4c(a)(5)).[76] The firm then uses this latency advantage to act on the market information it receives before other market participants and thereby reap a financial benefit.

While part of the activity mentioned above is similar to conduct prohibited by Section 4c(a)(5), the evidence of specific intent may be lacking. Further, the CFTC may consider circumstantial evidence of intent based on trading data is not strong enough to charge either a disruptive trading violation or a traditional manipulation violation, particularly since that trading data involves the technically complex issue of latency. Nevertheless, based on the CFTC's actions to date, the Commission may view the evidence above as sufficient to deem the activity to be a manipulative or deceptive device or contrivance for purposes of a Section 6(c)(1) and Regulation 180.1 violation.

While the hypothetical scenarios above are possibilities, direct evidence of fraudulent intent or recklessness by the firms would obviously increase the likelihood of an investigation or litigation by the CFTC. However, based on how broadly the CFTC described the concept of a manipulative or deceptive device or contrivance in the only enforcement case settled to date under Rule 180.1 (the "London Whale" case), it is unfortunately not very difficult to imagine other types of trading activities that the Commission might attempt to fit within that definition.

CONCLUSION

The Commission's authority under amended Section 6(c), new Section 4c(a)(5), and Regulation 180 is expansive, and has already proven effective in extracting settlements from respondents who probably preferred not to test the statutory and regulatory breadth in court. In an ever increasing algorithmic world, where a trader's intent is less likely to be found in an email or instant message, the CFTC will likely focus on reckless intent to support a charge under Section 6(c)(1) and Regulation 180.1, while reserving the use of the more traditional manipulative authority under Section 6(c)(2) and Regulation 180.2 for those occasions when specific intent is clear (or not challenged in a court). Further, while banging the close and spoofing conduct used to serve as the building blocks of manipulation and attempted manipulation cases prior to Dodd-Frank, now not only will these actions result in distinct and separate charges for disruptive trading, but they may be seen by the CFTC as a "manipulative or deceptive device or contrivance" as well. For the time being, to paraphrase the Eighth Circuit[77] from its discussion of the breadth of manipulative schemes, the meaning of "manipulative or deceptive device or contrivance" is limited only by the ingenuity of the CFTC.

NOTES

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 747, 124 Stat. 1376, 1739 (2010).
2. While Article III Courts might be best suited to provide balanced interpretative rulings on this new authority, the Commission may bring some of these future actions through its own administrative court process. Stephanie Russell-Kraft, *CFTC Plans More Administrative Actions, Criminal Crackdowns*, Law 360 (November 7, 2014) (quoting Director of Enforcement as stating that the agency will bring more matters administratively and clarifying how the CFTC plans to exercise its new authority), http://www.law360.com/articles/594484/cftc-plans-more-administrative-actions-criminal-crackdowns.
3. 7 U.S.C. § 9(1) (2012), Commodity Exchange Act, 17 C.F.R. § 180.1 (2012). Though the CFTC had manipulation authority prior to Dodd-Frank, its authority was limited to prosecution of intentional acts and did not cover reckless behavior.
4. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,407 (Jul. 14, 2011) (codified at 17 C.F.R. pt. 180).
5. Commodity Exchange Act § 4c(a)(5), 7 U.S.C. § 6c(a)(5) (2012).

6. Dodd-Frank, *supra* note 1, at Section 753 amending the Commodities Exchange Act § 6(c), 7 U.S.C. § 9.
7. Commodity Exchange Act § 6(c)(1), 7 U.S.C. § 9 (2012).
8. 17 C.F.R. § 180.1 (2012).
9. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, *supra* note 4, at 41,401.
10. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, *supra* note 4.
11. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, *supra* note 4, at 41,406; *See R & W Tech. Servs. Ltd. v. CFTC,* 205 F.3d 165, 171-173 (5th Cir. 2000) ("in connection with" requirement interpreted broadly); *see also Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.,* 404 U.S. 6, 12 (1971) ("Section 10(b) must be read flexibly, not technically and restrictively").
12. *In re Indiana Farm Bureau Coop. Ass'n, Inc.,* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, 1982 WL 30249, at *4, (C.F.T.C. Dec. 17, 1982), citing *Volkart Bros. , Inc. v. Freeman*, 311 F.2d 52, 58 (5th Cir. 1962) (quoting testimony before a Senate subcommittee of Arthur R. Marsh, a former president of the New York Cotton Exchange).
13. See, e.g., *DiPlacido v. CFTC*, 364 F. App'x 657, 661 (2d Cir. 2009) (summary order) (noting the traditional standards of proof under Commission case law including intent "to influence market prices").
14. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398, 41,407; *In re Indiana Farm Bureau Cooperative Assn., Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) para. 21,796 (C.F.T.C. Dec. 17, 1982), citing *Volkart Bros., Inc. v. Freeman*, 311 F.2d 52 (5th Cir. 1962); *In re Hohenberg Bros. Co.*, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) para 20,271 (C.F.T.C. Feb. 18, 1977); *In re Cox* [1986-1987 Transfer Binder], Comm. Fut. L. Rep. (CCH) para 23,786, 1987 CFTC LEXIS 325, at *9, 1987 WL 106879, at *3 (C.F.T.C. Jul.15, 1987).
15. To date, the CFTC has successfully litigated only one manipulation case to final judgment. *See In re Anthony J. DiPlacido*, CFTC Docket No. 01-23, 2008 WL 4831204 (C.F.T.C. Nov. 5, 2008), aff'd sub nom., *DiPlacido v. CFTC*, 364 Fed. Appx. 657 (2d Cir. Oct. 16, 2009) (summary order); Bart Chilton, CFTC Commissioner, "The Waiting": Statement by Commissioner Bart Chilton Regarding Anti-Fraud and Anti-Manipulation Final Rules, Washington DC (July 7, 2001), (characterizing the manipulation test as "nearly an impossible manipulation standard" for the CFTC), http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement070711.html.
16. Compare see *supra* note 12, *In re Indiana Farm Bureau Coop. Ass'n, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 21,796, 1982 WL 30249, at *5-6 ("it is not enough to prove simply that the accused intended to influence price"; rather the evidence must show that the defendant "acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand") and *CFTC v. Delay*, No. 7:05cv5026, 2006 WL 3359076, at *3 (D. Neb. Nov. 17, 2006) ("it is not a violation of the [manipulation provisions of the CEA] to report feeder cattle sales to the USDA with the intention of moving the CME index up or down") with *In re Amaranth Natural Gas Commodities Litig.*, 587 F. Supp. 2d 513, 539 n.167 (S.D.N.Y. 2008) (explaining that "specific intent" could exist if a defendant purchased "commodity for no reason other than the hope that her purchase would cause the price to rise") and *In re Soybean Futures Litig.*, 892 F. Supp. 1025 (N.D. Ill. 1995) (holding that "specific intent" exists when the defendant acts for the purpose "of influencing prices").
17. See *supra* note 10.
18. The CFTC has historically recognized that intent to manipulate has always been the most important element in a commodities manipulation case. *See Indiana Farm Bureau*, 1982 WL 30249, at *5 (observing that it is "the intent of the parties which separates otherwise lawful business conduct from unlawful manipulative activity").
19. Antidisruptive Practices Authority, 78 Fed. Reg. 31,890 (May 28, 2013).
20. *Id*. at 31,893.
21. *Id*. at 31,895.
22. Antidisruptive Practices Authority, *supra* note 19, at 31,895; *Drexel Burnham Lambert Inc. v. CFTC*, 850 F.2d 742, 748 (DC Cir. 1988); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), cert. denied, 434 U.S. 875 (1977); *SEC v. Platforms Int'l Wireless Corp.*, 617 F.3d 1072, 1093-94 (9th Cir. 2010).
23. Commodity Exchange Act § 4c(a)(5)(B), 7 U.S.C. § 6c(a)(5)(B) (2012).
24. Antidisruptive Practices Authority, *supra* note 19, at 31,895.
25. *Id.*
26. *Id.*
27. *Id*. at 31,896.
28. *Id*.
29. *Id*.

© 2015 THOMSON REUTERS

30. *Id*.
31. *Id*.
32. After the CFTC guidance did not clarify the various elements of "spoofing" behavior for market participants, the Chicago Mercantile Exchange (CME) issued Rule 575 as a result of the amendments to Section 4c(a) of the Commodity Exchange Act. See CME Market Regulation Advisory Notice, Disruptive Practices Prohibited, Rule 575, Advisory Number RA1405-5R at p. 5 (September 15, 2014) (providing guidance to market participants regarding situations of spoofing, including a non-exclusive list of 17 factors that CME Market Regulation may consider when determining what conduct violates this rule).
33. In April 2015, as this article was going to press, the CFTC filed a complaint exercising both its authority under Section 6(c)(1) and Section 6(c)(3) alleging manipulation of wheat futures contracts and cash wheat. *CFTC v. Kraft Foods Group, Inc. and Mondelez Global LLC*, Complaint No. 15-2881, Case No. 1:15-cv-02881 (N.D. Ill. Apr. 1, 2015).
34. *In the Matter of JPMorgan Chase Bank, N.A.*, CFTC Docket No. 14-01, 2013 WL 6057042 (C.F.T.C. Oct. 16, 2013).
35. The settlement order did not include any charge against the individual traders at JPMorgan. However, in footnote three it noted that two traders were facing criminal charges for the alleged deceptive practices they used in marking the swaps portfolio to market.
36. One CFTC Commissioner dissented from the settlement order, specifically commenting that the CFTC's new "manipulative device" authority should be tested in the courts as it was a matter of first impression to the Commission.
37. *In the Matter of Royal Bank of Scotland plc*, CFTC Docket No. 15-05, 2014 WL 6068388 (C.F.T.C. Nov. 11, 2014); *In the Matter of Citibank, N.A.*, CFTC Docket No. 15-03, 2014 WL 6856847 (C.F.T.C. Nov. 11, 2014); *In the Matter of JPMorgan Chase Bank, N.A.*, CFTC Docket No. 15-04, 2014 WL 6068387 (C.F.T.C. Nov. 11, 2014); *In the Matter of UBS AG*, CFTC Docket No. 15-06, 2014 WL 6068389 (C.F.T.C. Nov. 11, 2014); *In the Matter of HSBC Bank plc*, CFTC Docket No. 15-07, 2014 WL 6068390 (C.F.T.C. Nov. 11, 2014).
38. The order against RBS was one of five consent orders issued by the Commission on November 12, 2014, the others being against respondents Citibank, HSBC, JPMorgan, and UBS (collectively the "FX fix orders"). As the five orders are substantially the same as to the attempted manipulation charges and underlying facts, the RBS order will be used for purposes of brevity in this paper.
39. See *supra* note 14.
40. *In the Matter of JPMorgan Chase Bank, N.A.*, CFTC Docket No. 14-01 at 9; *In re The Royal Bank of Scotland plc and RBS Securities Japan Limited*, CFTC Docket No. 13-14 at 7 (Both orders indicate that the respondent banks either acknowledged material weakness in internal controls in subsequent regulatory filings or were found to have lacked adequate internal controls).
41. *In the Matter of Panther Energy Trading LLC and Michael J. Coscia*, CFTC Docket No. 13-26, 2013 WL 7118968 (C.C.H.) (C.F.T.C. Jul. 22, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfbeattyorder093014.pdf (last visited Dec. 15, 2014).
42. *See* "SEC Files Actions Against Six Individuals for Spoofing," Litigation Release No.17221 (Nov. 5 2001), available at http://www.sec.gov/litigation/litreleases/lr17221.htm (last visited Dec. 7, 2014).
43. Commodity Exchange Act § 4c(a)(5)(C), 7 U.S.C. § 6c(a)(5)(C) (2012),
44. *See e.g.* CFTC Staff Roundtable on Disruptive Trading Practices (Dec. 2, 2010) (Discussions at pp. 64, 111, 171, and 176-77).
45. *In re Lloyds' Banking Group, PLC*, CFTC Docket No. 14-18, 2014 WL 4059663 (C.C.H.) (C.F.T.C. Jul. 28, 2014) ($105 million penalty); *see also* CFTC Press Release No. 6966-14; *In re RP Martin Holdings Limited and Martin Brokers (UK) Ltd.*, CFTC Docket No. 14-16, 2014 WL 2731650 (C.C.H.) (C.F.T.C. May 15, 2014) ($1.2 million penalty); see also CFTC Press Release No. 6930-14; *In re Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank)*, CFTC Docket No. 14-02 (C.F.T.C. Oct. 29, 2013) ($475 million penalty); see also CFTC Press Release No. 6752-13; *In re ICAP Europe Limited*, CFTC Docket No. 13-38, 2013 WL 7118960 (C.F.T.C. Sept. 25, 2013) ($65 million penalty); see also CFTC Press Release No. 6708-13; *In re The Royal Bank of Scotland plc and RBS Securities Japan Limited*, CFTC Docket No. 13-14 (C.F.T.C. Feb. 6, 2013) ($325 million penalty); see also CFTC Press Release No. 6510-13; *In re UBS AG and UBS Securities Japan Co., Ltd.*, CFTC Docket No. 13-09, 2012 WL 6642376 (C.F.T.C. Dec. 19, 2012) ($700 million penalty); see also CFTC Press Release No. 6472-12; *In re Barclays PLC, Barclays Bank PLC, and Barclays Capital Inc.*, CFTC Docket No. 12-25, 2012 WL 2500330 (C.F.T.C. Jun. 27, 2012) ($200 million penalty); *see also* CFTC Press Release No. 6289-12.
46. The order against Lloyds was one of many consent orders issued by the Commission over the last few years, the others being against Barclays, RBS, ICAP, Rabobank, RP Martin, and UBS, among others (collectively the "LIBOR" orders).

As the orders are substantially the same as to the attempted manipulation charges and underlying facts, the Lloyds order will be used for purposes of brevity in this paper.

47. *CFTC v. Donald R. Wilson and DRW Investments, LLC*, Complaint No. 13-CV-7884, 2013 WL 5940001 (S.D.N.Y. Nov. 6, 2013); *In the Matter of Christopher Louis Pia*, CFTC Docket No. 11-17, 2012 WL 3228315 (C.F.T.C. Jul. 25, 2011); *In the Matter of Daniel Shak and Shak Management LLC*, CFTC Docket No. 14-03, 2013 WL 7085760 (Nov. 25, 2011); *CFTC v. Amaranth Advisors L.L.C., Amaranth Advisors (Calgary) ULC and Brian Hunter*, Complaint No. 07-CV-6682, 2007 WL 2211181 (S.D.N.Y Jul. 25, 2007) (Consent orders filed Aug. 2009 and Sept. 2014, respectively); *In re DiPlacido*, 2008 WL 4831204 (CFTC 2008), aff'd in pertinent part, *Di Placido v. CFTC*, 364 Fed Appx. 657, 2009 WL 3326624 (2d Cir. 2009), cert denied, 130 S. Ct. 1883 (Mar. 22, 2010).
48. *Id.*
49. Terrence Hendershott, "Electronic Trading in Financial Markets," IT Pro, (July/August 2003), http://faculty.haas.berkeley.edu/hender/ITpro.pdf.
50. *CFTC v. Donald R. Wilson and DRW Investments, LLC*, *see supra* note 47.
51. *Id.* at ¶¶ 34-61.
52. *Id.*
53. *In the Matter of Daniel Shak and Shak Management LLC*, *see supra* note 47.
54. *Id.*
55. *Id.* at 2.
56. *Id.*
57. The CFTC had other prior banging the close cases that should be noted. In July 2011, the CFTC found in an order that a trader entered market-on-close buy orders that were executed in the last 10 seconds of the closing period for both the palladium and platinum contracts, *In the Matter of Christopher Louis Pia*, *see supra* note 47; and in August 2009, the CFTC settled an action of attempted manipulation in natural gas futures that alleged respondents banged the close by timing a substantial number of trades with the intent to change the closing price, *CFTC v. Amaranth Advisors LLC, Amaranth Advisors (Calgary) ULC and Brian Hunter*, *see supra* note 47. Additionally, banging the close served as the basis for charges brought in *In re Anthony J. DiPlacido*, a case in which DiPlacido sold NYMEX PV electricity futures contracts at prices less than the prevailing price, purchased NYMEX PV electricity futures contracts at prices higher than the prevailing price, purchased NYMEX COB electricity futures contracts at prices higher than the prevailing price, entered into a noncompetitive trade, and placed large orders without legitimate economic reasons or considerations. CFTC Docket No. 01-23, 2008 WL 4831204 (C.F.T.C. Nov. 5, 2008) (applying the four-part test to determine whether manipulation occurred and finding that DiPlacido had the ability to influence prices during the close of the day), aff'd sub nom., *DiPlacido v. CFTC*, 364 Fed. Appx. 657, 2009 WL 3326624 (2d Cir. Oct. 2009) cert denied, 130 S.Ct. 1883 (Mar. 22, 2010).
58. *See supra* note 19, at 31,895.
59. *See supra* note 47.
60. *U.S. Commodity Futures Trading Commission v. Eric Moncada, BES Capital LLC, and Serdika LLC*, 12-CV-8791, Docket No. 77, 2014 WL 3533990 (S.D.N.Y Jul. 15, 2014) (memorandum order granting default order in favor of CFTC).
61. Mem. in Supp. of Pl.'s Mot. for Summ. J. Against Def. Eric Moncada at 2 and 23, *U.S. Commodity Futures Trading Commission v. Eric Moncada, BES Capital LLC, and Serdika LLC*, 12-CV-8791, Docket No. 53, 2014 WL 2945793 (S.D.N.Y. Jan. 29, 2014).
62. *See supra* note 60 (granting summary judgment on the two charges of fictitious trading against Moncada).
63. *U.S. Commodity Futures Trading Commission v. Eric Moncada, BES Capital LLC, and Serdika LLC*, 12-CV-8791, Docket No. 80 at 14 (consent order).
64. *In the Matter of Ecoval Dairy Trade, Inc.*, CFTC Docket No. 11-16, at 2-3; 2011 WL 2835811 (C.F.T.C. Jul. 19, 2011).
65. In fact, the Commission subsequently cited to *Ecoval* when it observed that "[s]ome traders have used the 'spoofing' technique to place orders in the market to give the impression of interest on one side of the market, but cancel the order before it can be filled…" Mem. in Supp. of Pl.'s Mot. for Summ. J. Against Def. Eric Moncada, *supra* note 61 (citing, inter alia, *In the Matter of Ecoval Dairy Trade, Inc.*, [2011-2012 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶32,013 at 66,926-28 (C.F.T.C. Jul. 19, 2011). In two other matters, the Commission issued orders against respondents that engaged in activity that was of the nature of spoofing in the pre-open period of the market. However, in each order the Commission found prices were reported that were not true and bona fide, in violation of Section 4c(a)(2)(B), and that there were false reports, in violation of Section 9(a)(2). *In the Matter of Bunge Global Markets, Inc.*, CFTC Docket No. 11-10, 2011 WL 1099346 (C.F.T.C. Mar. 22, 2011); *In the Matter of Gelber Group*, LLC, CFTC Docket No. 13-15, 2013 WL 525839 (C.F.T.C. Feb. 8, 2013).
66. Additionally, the authority to charge false reports under Section 6(c)(1)(A) would likely be

© 2015 THOMSON REUTERS

used in this same manner as both the Bunge and Gelber Group orders had charges for false reports under 9(a)(2) when the underlying behavior was of the spoofing nature in the pre-open market.

67. Commodity Exchange Act § 4(c)(a)(5), 7 U.S.C. § 6c(a)(5) (2012).

68. *Stoller v. CFTC*, 834 F. 2d 262 (2d Cir. 1987); *In re Collins*, [1986-87 Transfer Binder] Comm. Fut. L. Rep. (C.C.H.) ¶ 22,982 (Apr. 6, 1986). As a side note, in consideration of other possible implications around the future use of Section 4c(a)(5) by the CFTC, in *In the Matter of J.P. Morgan Securities LLC*, CFTC Docket No. 12-14, 2012 WL 8137851 (C.F.T.C. Mar. 8, 2012), the CFTC cited to an old order that found that a commodity broker had a duty under Section 4c(a) to inquire when receiving suspect orders.

69. Scott Patterson, "'Wash Trades' Scrutinized," Wall Street Journal, (March 17, 2013), http://www.wsj.com/articles/SB10001424127887323639604578366491497070204.

70. *Id.*

71. Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, *see supra* note 4, at 41,404.

72. For purposes of this paper, latency will be defined as the measure of time delay between the execution of an order or receipt of the order and the receipt of notice of that execution or quote of the order in the market.

73. Mark S. Nelson, "Senate panel eyes high frequency trading; Sen. Chambliss pitches new derivatives end user bill," Securities Regulation Daily, (May 13, 2014) ("McGonagle [Director of Division of Market Oversight at the CFTC] said commenters who have already remarked on the concept release's discussion of latency, or slowed trading speeds, raised worries about a "race to the bottom" mentality, especially if risk controls have latency requirements that only some firms adopt." Further, "Kirlienko [former CFTC Chief Economist and now Professor of the Practice of Finance at MIT's Sloan School of Management] testified that HFT [high frequency trading] is 'highly, highly concentrated' which puts pressure on these firms to outpace each other.").

74. Since trading and order placement can occur in mill- and microseconds in the markets, a much higher latency time could still be as little as a few more milliseconds.

75. The hypothetical makes the assumption that an overload of the quotation system would affect latency in the market. The authors are currently not aware of any news reports or academic research on whether there is a direct connection between quote stuffing and increased latency in the marketplace for market participants. However, studies have shown that quote stuffing can degrade market quality and create decreased liquidity. *See* Michael Goldstein, *Computerized and High-Frequency Trading*, 49 The Financial Review 177, 177-202 (2014). Additionally, the CME recently fined a firm when its algorithmic trading system sent 27,000 messages on the Globex platform that resulted in the Exchange initiating a port closure and failure of a Globex gateway, thus causing the cancellation of thousands of customer orders and a loss in customer priority. *See 303 Proprietary Trading, LLC*, CME Disciplinary Action 13-9440-BC (Chicago Mercantile Exchange December 19, 2014).

76. CFTC, Q & A Interpretive Guidance and Policy Statement on Disruptive Practices, http://www.futuresindustry.org/downloads/dtpinterpretiveorder_qa.pdf; CFTC, Interpretive Guidance and Policy Statement on Disruptive Practices, http://www.futuresindustry.org/downloads/dtp_factsheet.pdf.

77. *Cargill, Inc. v. Hardin*, 452 F.2d 1154 (8th Cir. 1971), cert. denied, 406 U.S. 932 (1972) ("The methods and techniques of manipulation are limited only by the ingenuity of man.").