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

May 16, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

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

Dear Mr. Stawick:

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

We appreciate the opportunity to provide comments to the Commission, and we strongly support the Commission's efforts. We look forward to continuing to work with the Commission on this issue, as we share the Commission's commitment to preserving market integrity.

## I. Summary

The Commission has asked for comments on all aspects of its Proposed Interpretive Order, published March 18, 2011 in the Federal Register.[2] MFA commends the Commission's work to incorporate the comments submitted by interested parties in response to the Commission's earlier Advance Notice of Proposed Rulemaking and Request for Comments ("ANPR") on this topic.[3] The Proposed Interpretive Order (the "Order") represents significant progress insofar as it clearly

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1 MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

2 Antidisruptive Practices Authority, Proposed Interpretive Order, 76 Fed. Reg. 14943 (Mar. 18, 2011) [hereinafter Proposed Interpretive Order].

3 MFA submitted a comment letter in response to the Commission's ANPR. Letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, to David A. Stawick, Secretary, Commodity Futures Trading Commission (Dec. 28, 2010) (available at http://www.managedfunds.org/downloads/MFA%20Antidisruptive%20Practices%20final%2012.28.10.pdf) [hereinafter MFA December Comment Letter].

acknowledges the *scienter* requirements for Sections 4c(a)(5)(B) and 4c(a)(5)(C), and has augmented the definitions of the key terms "violates bids or offers," "orderly" and "closing period," and "spoofing." Additionally, the determination that Section 4c(a)(5) will not apply to block trades or exchanges for related positions ("EFRPs") transacted in accordance with the rules of a designated contract market or swap execution facility or bilaterally negotiated swap transactions represents an important clarification.

Although the Order addresses some of the comments submitted for the ANPR, MFA believes the Order still leaves the nature of much of the proscribed conduct sufficiently unclear to provide instructive guidance to market participants. If finalized in its current form, the Order will have a chilling effect on legitimate market conduct, as its remaining vagueness further perpetuates the view that Section 747 will encompass all behavior short of market manipulation. If market participants cannot gain additional clarity, the section's vagueness will discourage market participation, inhibit liquidity, and stifle market innovation. Moreover, despite the increased clarity the Order provides, MFA is still concerned that in the absence of further clarification Section 747 as written is vague and may be vulnerable to constitutional challenge by market participants.[4] MFA therefore, in continuing support of the Commission's work, submits the following comments and recommendations:

- Despite the Commission's agreement that a "multi-layered, coordinated approach is required to prevent disruptive trading practices and ensure fair and equitable trading,"[5] MFA believes that the Commission should delegate in the first instance supervisory and disciplinary authority in the area of market disruption to the swap execution facilities ("SEFs") and designated contract markets ("DCMs") (together "platforms");

- If the Commission chooses to promulgate rules or issue a Final Interpretive Order, the Commission should continue to refine the definitions of "violates bids or offers," "closing period" and "orderly," and "spoofing" so these terms specifically and narrowly describe the conduct proscribed by Section 747;

- In addition, although the Commission specified intent requirements for Sections 4c(a)(5)(B) and 4c(a)(5)(C), MFA maintains that Section 4c(a)(5)(A) should also contain an intent requirement and should not be actionable in the absence of a manipulative intent to influence price, and that the intent requirements for Sections 4c(a)(5)(B) and 4c(a)(5)(C) should be heightened so as to exclude the prohibition of legitimate conduct.

## II. The Commission Should Delegate Supervisory and Disciplinary Authority in the Area of Market Disruption to SEFs and DCMs.

As stated in our letter dated December 28, 2010 submitted in response to the Commission's ANPR (the "MFA December Comment Letter"),[6] MFA believes that the traditional supervisory structure in the futures and derivatives markets and the Dodd-Frank Act support delegating to platforms responsibility for regulating and monitoring market disruptions. The Commodity Exchange Act

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4 *See* MFA December Comment Letter, *supra* note 3, at 4.

5 Proposed Interpretive Order, *supra* note 2, at 14945, *citing* Letter from John M. Damgard, President, Futures Industry Association to David A. Stawick, Secretary, Commodity Futures Trading Commission (Dec. 23, 2010).

6 MFA December Comment Letter, *supra* note 3.

("CEA"), both prior to and since the enactment of the Dodd-Frank Act, recognizes the role of platforms as the first line of defense in preventing market disruptions. The SEFs and DCMs have or will have the experience, tools, and flexibility to regulate and monitor market disruptions, and the Commission's guidance should reinforce their role.

Moreover, preserving the distinction between the Commission and platforms with respect to disciplinary authority will reinforce the current regulatory and monitoring roles of SEFs and DCMs. Market disruptions are traditionally the purview of the platforms because, unlike market manipulation (traditionally the purview of the Commission), disruptions could exist that are not engineered to earn illegal or unfair profits. In combination with the ambiguity that persists in Section 747 around market behavior that does not constitute manipulation, a shift in authority over disruptions from platforms to the Commission will further chill legitimate market activity. We urge that the Commission's regulations preserve the CEA's delegation of primary disciplinary responsibility in the area of market disruptions, while allowing the Commission to exercise its authority if SEFs or DCMs fail to do so, and in extreme cases requiring the Commission's enforcement.

## III. The Commission Should Continue to Refine the Definitions of Key Terms.

As MFA has previously expressed to the Commission, "[w]e believe regulators should provide clear guidance under Section 747 before bringing enforcement actions to provide market participants with notice as to what constitutes violative trading activity."[7] Such guidance is necessary to help market participants operate efficiently using legitimate trading strategies. Without further guidance, Section 747 will "undermine the Commission's enforcement efforts to deter and prevent price manipulation [,] have a chilling effect on legitimate trading practices [,]"[8] and be vulnerable to constitutional challenge by market participants.

To provide the necessary guidance, MFA has and continues to urge the Commission, should it decide to promulgate rules, to continue refining definitions of key statutory terms and to include *scienter* requirements in Section 747's provisions. Although the Commission's Order provided additional guidance as to the meaning of key terms in Section 747 and the *scienter* requirements, we respectfully suggest that the Commission further refine these terms to ensure traditional concepts of due process are satisfied.

### a. **The Commission Should Further Refine the Term "Violates Bids or Offers."**

The Commission's Order narrows the definition of the term "violates bids or offers" by interpreting the term to prohibit "any person from buying a contract at a price that is higher than the lowest available offer price and/or selling a contract at a price that is lower than the highest available bid price."[9] The Order further narrows the range of conduct to which the term applies by excluding block trades, certain EFRPs, bilaterally negotiated swap transactions, transactions undertaken in environments

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7 *Id.* at 4.

8 *Id.*

9 Proposed Interpretive Order, *supra* note 2, at 14945-46.

where electronic trading systems with algorithms automatically match the best bid and offer, and instances where an individual is "buying the board."[10]

First, we urge that the Commission clarify the Order to also exclude conduct on SEFs from the prohibition. In particular, request for quote ("RFQ") procedures should allow parties to select counterparties without concern that they may be violating bids or offers. The breadth of conduct permitted on SEFs should not be subject to such a vague prohibition.

In addition, the Order does not interpret Section 4c(a)(5)(A) to include an intent requirement as MFA and others previously suggested. MFA continues to urge the Commission to require that a violation of bids or offers be actionable only if undertaken with manipulative intent to influence prices.[11] Without such a requirement, market participants who are acting in good faith and do not intend to move the market may become unwitting subjects of enforcement proceedings. This risk may prevent regular market participants from entering the markets, and ultimately result in decreased liquidity and market depth. Moreover, the lack of a specific intent requirement, together with the vague definitions of the section's key terms, makes the statute vulnerable to constitutional challenge on the ground of vagueness.[12]

b. **The Commission Should Further Refine the Terms "Orderly" and "Closing Period."**

The Commission's Order adds some helpful guidance with respect to the terms "orderly" and "closing period," but the definitions still do not provide sufficient clarity for market participants. The definition of the term "orderly" is not only vague, but also subjective and would allow for *post hoc* judgments as to what constitutes violative, disruptive conduct. Given the unpredictable nature of futures and swaps markets—where a trade that is not disruptive one day may be disruptive the next—such vague definitions preclude market participants from effectively evaluating whether their conduct constitutes legitimate trading activity or prohibited behavior.

Moreover, the definition of the term "closing period" is overly broad and inconsistent. First, the Commission "interprets the closing period to be generally defined as the period in the contract or trade when the daily settlement price is determined under the rules of that trading facility."[13] Then, however, the Commission says that potentially disruptive conduct outside the closing period may also form the basis of an investigation under this section and others.[14] The Order also allows for swaps executed on a

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10 *See id.*

11 *See* MFA December Comment Letter, *supra* note 3, at 4 (*citing DiPlacido* v. *CFTC*, 2009 WL 3326624, at *1 (2d Cir. Oct. 16, 2009)).

12 *See Colautti* v. *Franklin*, 439 U.S. 379, 395 (1979) ("This Court has long recognized that the constitutionality of a vague statutory standard is closely related to whether that standard incorporates a requirement of *mens rea*."). *See also DiPlacido*, 2009 WL 3326624, at *1 ("Due process requires that 'a regulation carrying penal sanctions . . . give fair warning of the conduct it prohibits or requires.") (*citing Rolling Envtl. Servs. (NJ) Inc.* v. *U.S. E.P.A.*, 937 F.2d 649, 653 n.2 (D.C. Cir. 1991)); *Satellite Broadcasting Co.* v. *FCC*, 824 F.2d 1, 3 (D.C. Cir. 1987) ("Traditional concepts of due process incorporated into administrative law preclude an agency from penalizing a private party for violating a rule without first providing adequate notice of the substance of the rule.") (internal citations omitted).

13 Proposed Interpretive Order, *supra* note 2, at 14946.

14 *Id.*

SEF to be subject to Section 4c(a)(5)(B) if a closing period or daily settlement price exists for a particular swap, and allows the section to apply to cash market pricing, without any legal basis. This is a clear example of why supervisory authority of disruptive conduct should primarily be delegated to SEFs and DCMs. Market participants are already accustomed to their definitions. To ensure specificity and consistency, any definition of a closing period should be established by the applicable SEF or DCM, and not by the Commission.

Additionally, the Order does not apply an intent requirement sufficient to protect market participants acting in good faith in an unpredictable market from the risk of an enforcement action. The Order only requires that "a market participant must at least act recklessly" to violate Section 4c(a)(5)(B), excluding accidental or even negligent conduct and practices.[15] Despite this heightened requirement, MFA continues to believe that this clause should impose an even stricter requirement of either manipulative intent, or at the very least, extreme recklessness.[16] Lesser requirements would encompass legitimate market behavior because the nature of futures and swaps markets prevents market participants from predicting whether or not their trades will be disruptive. As previously discussed, a trade that is not disruptive one day may be disruptive the next, and a recklessness standard could capture such a trade. Therefore, anything less than an extreme recklessness intent requirement would deprive market participants of adequate notice of what constitutes proscribed behavior under Section 747.

### C. The Commission Should Further Refine the Term "Spoofing."

The Commission's Order further defines "spoofing" by providing examples of conduct prohibited under Section 4c(a)(5)(C). These examples—such as submitting or cancelling bids or offers to overload the quotation system of a registered entity; submitting or cancelling bids or offers to delay another person's execution of trades; and submitting or cancelling multiple bids or offers to create an appearance of false market depth—do provide needed guidance to market participants, but they do not provide sufficient clarity in a context where traders may enter and cancel orders as part of a legitimate trading strategy. As previously outlined in our MFA December Comment Letter, at times traders enter larger than necessary orders with the intention to cancel part of the order. This practice is a legitimate trading strategy that helps ensure the trader's order is filled, but it could constitute proscribed conduct pursuant to the Commission's current interpretation. High-frequency traders that enter and cancel orders at high volumes are also engaged in legitimate trading strategies that would be arguably indistinguishable from "spoofing" if the Commission promulgates rules using its current proposed definition. Moreover, the current proposed definition would allow for the prosecution of a market participant who intended to withdraw an order, but ultimately did not. The Commission should not, in effect, expand its spoofing prohibition to "attempted" spoofing.

In the futures or derivatives markets, cancellations of orders can serve legitimate purposes and do not necessarily imply manipulative or otherwise bad intent. Accordingly, the Commission's proposed

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15 *Id.*

16 *See* MFA December Comment Letter, *supra* note 3, at 7 n.15, *citing Phillips* v. *LCI Int'l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999); *SEC* v. *Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992); *Hollinger* v. *Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (*en banc*); *Ross* v. *Bank South, N.A.*, 885 F.2d 723, 730 n.10 (11th Cir. 1989); *Hackbert* v. *Holmes*, 675 F.2d 1114, 1118 (10th Cir. 1982); *Broad* v. *Rockwell*, 642 F.2d 929, 961 (5th Cir. 1981) (*en banc*); *McLean* v. *Alexander*, 599 F.2d 1190, 1197 (3d. Cir. 1979); *Mansbach* v. *Prescott, Ball, & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *Greebel* v. *FTP Software*, 194 F.3d 185, 198 (1st Cir. 1999); and *Camp* v. *Dema*, 948 F.2d 455, 461 (8th Cir. 1991) as examples of securities law cases involving unsophisticated retail investors where courts imposed heightened standards such as severe recklessness.

definition and its "some degree of intent" [17] requirement do not adequately clarify and define for market participants the conduct proscribed by Section 747. In order to help market participants distinguish between legitimate trading strategies and prohibited conduct constituting "spoofing," MFA respectfully urges the Commission to further narrow the definition of "spoofing" and to require manipulative intent before such conduct or practices would constitute prohibited behavior.

## IV. The Commission Should Make Clear That Any Rules or Orders Apply Only to the Three Categories Enumerated in Section 747.

"[S]ection 747 also amends Section 4c(a) by granting the CFTC authority under the new CEA Section 4c(a)(6) to promulgate such 'rules and regulations as, in the judgment of the Commission, are reasonably necessary to prohibit the trading practices' enumerated therein, 'and any other trading practice that is disruptive of fair and equitable trading.'"[18] The current Order does not reflect any intent to expand enforcement to cover disruptive practices not embraced by the three enumerated categories. MFA urges the Commission to affirm that its antidisruptive enforcement will apply only to the three categories specified in Sections 4c(a)(5)(A), 4c(a)(5)(B) and 4c(a)(5)(C), and not to any other unspecified conduct, behaviors or activities.

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

Respectfully submitted,

/s/ Stuart J. Kaswell

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

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

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17 Proposed Interpretive Order, *supra* note 2, at 14947.

18 *Id.* at 14944.