Professional Perspective

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CME Broadens Scope of Prohibited Trading Practices

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On July 19, 2021, CME Group Inc. (the CME), the parent company of derivatives exchanges including the Chicago Mercantile Exchange and New York Mercantile Exchange, issued a Market Regulation Advisory Notice amending prior guidance on prohibited disruptive trading practices. The CME's amended Advisory Notice RA2107-5 (Advisory Notice), took effect on August 2, 2021, and impacts the types of trading behavior for which individual traders and their employers may be held liable.

The Advisory Notice underscores the CME's expectations in two key areas: market participants' internal controls for risk management; and the integrity of messaging data that traders submit to the CME. The Advisory Notice sets forth scenarios under which compliance failures in either of these two areas might constitute a disruptive trading practice. Of course, violations of CME's disruptive trading practice rules can result in significant fines, a bar from exchange access, and follow-on enforcement actions from other market regulators. Thus, it is significant that the Advisory Notice takes aim at internal controls that are not typically associated with market manipulation but can nonetheless result in regulatory enforcement.

Background

The Advisory Notice from the CME relates to Rule 575, which proscribes the use of disruptive trading practices, including well-known variants of market manipulation, like spoofing or quote stuffing. In particular, the Advisory Notice amends the "Frequently Asked Questions" (FAQs) for Rule 575, through which the CME addresses dozens of issues that traders commonly face when navigating the CME's prohibition against disruptive trading.

The Advisory Notice was issued amid a wave of aggressive regulatory enforcement actions and federal prosecutions against individual traders and firms alleged to have engaged in market manipulation. In its 2020 annual report, the Commodity Futures Trading Commission (CFTC) reported that it brought the three largest spoofing cases in the Commission's history, including a matter in which the CFTC imposed its highest-ever fine, exceeding $900 million. Notably, those enforcement actions relied heavily on the CFTC's automated market surveillance program, which analyzes market data to flag trading patterns or positions that may warrant further investigation.

Federal prosecutions have also continued apace, though with somewhat mixed outcomes. Since 2014, the U.S. Department of Justice (DOJ) has targeted at least 20 traders with criminal commodities fraud or market manipulation charges based on spoofing allegations. The DOJ has reached multimillion-dollar settlements with entities ranging from large multinational banks to proprietary trading firms. In August, 2021, a Chicago federal jury in U.S. v. Bases et al. convicted two former precious metals traders of placing fake orders to manipulate prices on a CME exchange.

Against this backdrop, the CME's Advisory Notice signals a continued commitment to combat disruptive trading. It also serves as a tacit reminder that market participants are expected to deploy internal controls to mitigate the consequences of unanticipated market events, and failure to do so can result in regulatory consequences.

Amended Guidance

The CME's Advisory Notice clarifies responsibilities and expectations for market participants related to internal controls, risk, and market data. The changes also bring the CME's guidance further in step with previous CFTC guidance, reducing the risk that traders may comply with one set of regulations but not the other.

FAQ 5

The Advisory Notice amends FAQ 5, which addresses whether orders entered by mistake—and now, "error"—could violate Rule 575's prohibition against disruptive trading practices. Rule 575 continues to provide leeway for unintentional or accidental orders, but the Advisory Notice clarifies that, "Market participants are expected to take reasonable steps or otherwise have controls to prevent, detect, and mitigate the occurrence of errors or system anomalies, and their impact on the market. Failure to take reasonable steps to prevent, detect, and mitigate such errors, anomalies, or impacts may violate Rules 575.C.2., 575.D., 432.W. ('Failure to Supervise'), or other Exchange rules."

The CME's focus on prevention, detection, and mitigation echoes the CFTC's September 2020 guidance on factors to be used in evaluating corporate compliance programs in connection with enforcement actions. Specifically, the CFTC's framework is centered on a compliance program's ability to prevent, detect, and remediate misconduct. Thus, the CME's update to FAQ 5 largely mirrors the CFTC guidance, although perhaps allowing for a more measured expectation of "mitigation" versus full "remediation" of misconduct.

It is less clear whether the CME intends FAQ 5's additions to apply to trading operations more broadly, beyond orders entered by mistake or error. However, market participants should have controls in place to prevent, detect, and remediate potentially disruptive or manipulative trading conduct—regardless of whether the conduct is intentional or the result of a mistake or error.

FAQ 11

The Advisory Notice amends FAQ 11 relating to CME Rule 575.D, which generally prohibits traders from entering orders "with intent to disrupt, or with reckless disregard for the adverse impact on, the orderly conduct of trading of the fair execution of transactions." FAQ 11 previously addressed whether market participants may enter orders larger than they expect to trade in electronic markets subject to a pro-rata matching algorithm. This algorithm is a technology that fills orders at a particular price, in proportion to the size of the buy order.

The CME's prior guidance provided that, if intended to aid order execution, such orders are permissible. But the CME cautioned that it could be a violation of exchange rules for a market participant to "enter an order without the ability to satisfy, by any means, the financial obligations attendant to the transaction."

The Advisory Notice amends FAQ 11 to make explicit the expectation that traders utilizing pro-rata matching algorithms must also be prepared and capable of managing the "risk" attendant to the full execution of their orders "without disrupting the market." The amendment to FAQ 11 further provides that,"[i]n no circumstance may a participant intentionally or recklessly disregard the orderliness of the market in offsetting the risk associated with a large fill event."

The FAQ 11 amendments echo Rule 575.D's prohibition against an intentional or "reckless" disregard for the orderly conduct of trading. It is noteworthy, however, that the amendments call particular attention to disruptive practices associated with "offsetting the risk associated with a large fill event." In other words, reliance on pro-rata matching algorithms does not provide a "safe harbor" against allegations of disruptive conduct. Further, the disruptive conduct at issue is not just limited to placing larger orders on a pro-rata market without the financial ability to satisfy such orders. Rather, the FAQ 11 amendments signal that even the inability to satisfy large fills attendant to significant or unprecedented market swings could be viewed as a disruptive practice.

FAQ 13

Also related to Rule 575.D—the CME amended FAQ 13, which discusses how the CME defines the "orderly conduct of trading or the fair execution of transactions." CME's explanation in FAQ 13 had previously cited the CFTC, which considers factors like "a rational relationship between consecutive prices, a strong correlation between price changes and the volume of trades, [and] levels of volatility that do not dramatically reduce liquidity…." The amendments to FAQ 13 added "the impact to other market participants' ability to trade, engage in price discovery, or manage risk" to this list.

In assessing whether a trading pattern constitutes a disruptive practice, market regulators often look at the impact of the conduct in question on other market participants. They frequently view it as an aggravating factor in assessing the severity of the conduct at issue and the extent of alleged economic harm caused by the conduct. This reality is now reflected in the discussion for FAQ 13.

FAQ 23

The CME amended FAQ 23, which relates to Rule 575C.2, prohibiting market participants from intentionally or recklessly submitting an "actionable or non-actionable message" that has the "potential to disrupt the systems of the Exchange." When the CME first added Rule 575C.2 in July 2020, it explained that one purpose of the Rule was to address tactics utilized by market participants to reduce latency in order messaging to the exchange. Given the speed at which trading occurs—often in nanoseconds—any reduction in time for trade messaging to reach the exchange can prove invaluable.

As the CME explained, though, some market participants continuously streamed partial order messages so that the participant always had a partial message to complete (or corrupt) upon the occurrence of a market event predetermined by the trader. By sending a portion of the order message in advance, the trader was able to reduce his or her latency.

But, as reflected in Rule 575.C.2, the CME has determined that such actions have the potential to disrupt its exchange systems. Of course, corrupted or malformed data messaging could also interfere with market regulators' automated market surveillance systems and their ability to analyze an irregular or questionable trading pattern.

In a subtle but significant tweak to its prior guidance, the CME amended FAQ 23 to clarify that it prohibits the "submission of intentionally corrupted or malformed data packets" and not merely the purposeful corruption of submitted data. Thus, the Advisory Notice imposes a higher standard on market participants to not only avoid corrupting data, but also to avoid submitting any corrupted or malformed data.

Compliance Implications Moving Forward

While not a sea change, the amendments are consistent with regulators' focus on combatting disruptive trading techniques and their expansive view on what practices could be considered market manipulation. Compliance and legal teams should internally evaluate their existing programs and practices and ask themselves the following:

- What kind of processes are in place to prevent disruptive trading practices in the first instance? Are automated or technological solutions part of the internal control environment, where possible? Is the trading firm staying abreast of new technological solutions as they continue to emerge? Have more traditional methods of prevention—like education and training—also been deployed and regularly updated?

- How effective are existing internal controls at detecting and preventing disruptive trading practices? Are systems periodically audited or otherwise tested to ensure optimal performance? Are any such audits documented to ensure a clear record exists if questions later arise about the trading firm's oversight of its program?

- When instances of disruptive trading practices do arise, is meaningful action taken to remediate or mitigate the root cause—regardless of whether it is believed that the order was entered by mistake or error? Are such remediation and mitigation efforts documented accordingly, including up to the completion of any necessary follow-up action items?

- Have legal or compliance teams consulted with risk management stakeholders to consider how regulators' expanding views on "orderliness of the market" might translate into additional internal gatekeeping measures related to risk, generally, and surrounding large fill events in pro-rata markets in particular?

- Have legal or compliance teams considered tools or other strategies that would help guard against even submission of corrupted or malformed data?

It is not uncommon for compliance programs to grow stale, even with the best of intentions. However, a proactive and responsive compliance program may help avoid missteps. More importantly, it is likely to prove invaluable when trading firms find themselves defending against an enforcement action by market regulators, or seeking relief from being impacted by a disruptive trading event.

This is especially true for firms seeking to avoid "failure to supervise" charges. The CME's Advisory Notice signals that market regulation is looking at more than just a "rogue trader" when assessing disruptive trading, and firms should be looking holistically at their internal controls and risk management protocols.