
Thursday, September 25, 2014

Effective September 15, 2014, the Chicago Mercantile Exchange, Chicago Board of Trade, New York Mercantile Exchange and Commodity Exchange, Inc. (collectively, the CME) adopted a new Rule 575 to prohibit:

1. "spoofing" (i.e., submitting or cancelling bids or offers to create a misleading appearance of market depth or artificial price movements);
2. "quote stuffing" (i.e., submitting or cancelling bids or offers to overload the quotation system of a registered entity or delay another person's execution of transactions during the closing period); and
3. the disorderly execution of transactions during the closing period.

The text of the new Rule 575 reads as follows:

All orders must be entered for the purpose of executing bona fide transactions. Additionally, all non-actionable messages must be entered in good faith for legitimate purposes.

A. No [P]erson shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution;

B. No Person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to mislead other market participants;

C. No Person shall enter or cause to be entered an actionable or non-actionable message or messages with intent to overload, delay, or disrupt the systems of the Exchange or other market participants; and

D. No [P]erson shall enter or cause to be entered an actionable or non-actionable message with intent to disrupt, or with reckless disregard for the adverse impact on, the orderly conduct of trading or the fair execution of transactions.

To the extent applicable, the provisions of this Rule apply to open outcry trading as well as electronic trading activity. Further, the provisions of this Rule apply to all market states, including the pre-opening period, the closing period and all trading sessions (emphasis added).

The CME also prepared CME Group RA1405-5 (the Advisory Notice) to provide additional guidance in interpreting the new rule. The Advisory Notice provides a non-exhaustive list of examples considered to be disruptive and in violation of Rule 575. As to the standard of proof, under A16 of the Advisory Notice, it states:

Proof of intent is not limited to instances in which a market participant admits its state of mind. Where the conduct was such that it more likely than not was intended to produce a prohibited disruptive consequence...
without justification, intent may be found. **Claims of ignorance, or lack of knowledge, are not acceptable defenses** to intentional or **reckless** conduct. Recklessness has been commonly 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. See *Drexel Burnham Lambert, Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1988).

Based on the Advisory Notice, the "intent" required under parts A-C of Rule 575 (as provided above) is likely a lower standard than market participants anticipated. Further, claims of ignorance, or lack of knowledge, would not be acceptable defenses to intentional (or reckless) conduct. For the catchall under part D, a plain recklessness standard applies. Such low thresholds for the CME to show intent and/or recklessness could have a particularly sharp impact on high frequency trading and algorithmic trading firms. Such firms should carefully consider the impact on the new rule on their trading.

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