DISRUPTIVE TRADING PRACTICES

FAQs

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Questions regarding this FAQ may be directed at marketregulation@nadex.com.

Section 4c(a) of the Commodity Exchange Act ("CEA"), subparagraph (5) of Section 747 of the Dodd-Frank Act states:

> *(5) DISRUPTIVE PRACTICES – It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that –*
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> > *(A) violates bids or offers;*
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> > *(B) demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period; or*
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> > *(C) is, is of the character of, or is commonly known to the trade as, "spoofing" (bidding or offering with the intent to cancel the bid or offer before execution).*

On May 16, 2013, the Commodity Futures Trading Commission ("CFTC") issued an interpretive guidance and policy statement ("Policy Statement") to provide direction on the aforementioned section of the CEA. In this Policy Statement, "spoofing," or the act of bidding and offering with the intent to cancel the bid or offer before execution, is described to include the following: (i) submitting 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 cancelling multiple bids or offers to create an appearance of false market depth, or (iv) submitting or cancelling bids or offers with intent to create artificial price movements upwards or downwards.

Nadex Rules ("the Rules") relating to disruptive trading practices include, but are not limited to, the following:

> **5.5(iv)** Any Member submitting orders, or any other messages directly to the Exchange, including but not limited to messages related to the cancellation or amendment of an order, whether manually or via automated functionality, must ensure adequate controls are in place to prevent excessive messaging or other activity that may be deemed detrimental or disruptive to the Exchange.
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> **5.19(c)** No Person shall enter into or attempt to enter into any trade on the Market that: (1) does not result in a change in beneficial ownership, (2) is designed to unnaturally inflate trading volume, (3) in any way attempts to circumvent the Market's order processing, trade ordering, trade execution

systems, or otherwise to circumvent exposure of the order to open and competitive bidding on the Market, or (4) that has some other illegitimate purpose.

5.19(d) No Person shall enter into any trade designed or used to cause any price for a Contract other than a true and bona fide price to be reported, registered, or recorded by the Market.

5.19(i) No Person shall engage in any activity that adversely affects the integrity of the Market or its underlying systems.

5.19(w) No Person shall engage in any activity that constitutes fraudulent or abusive trading, including but not limited to violating bids or offers; demonstrating intentional or reckless disregard for the orderly execution of transactions during the closing period; or spoofing.

Disruptive Trading Practices Prohibited - FAQs

Q1: What factors may be considered by Nadex Market Regulation in assessing a potential violation of the Rules regarding disruptive trading practices, including spoofing?

A1: Market Regulation may consider a variety of factors in assessing whether conduct violates the relevant sections of the Rules, including, but not limited to:

- whether the market participant's intent was to induce others to trade when they otherwise would not;
- whether the market participant's intent was to affect a price rather than to change his or her position;
- whether the market participant's intent was to create misleading market conditions;
- market conditions in the impacted market(s) and related markets;
- the effect on other market participants;
- the market participant's historical pattern of activity;
- the market participant's order entry and cancellation activity;
- the size of the order(s) relative to market conditions at the time the order(s) was placed;
- the size of the order(s) relative to the market participant's position and/or account value;
- the number of orders;
- the duration for which the order(s) is exposed to the market;
- the queue position or priority of the order in the order book;
- the prices of preceding and succeeding bids, offers, and trades;
- the change in the best offer price, best bid price or other price that results from entry of the order; and
- the market participant's activity in related markets.

Q2: Is there a specific amount of time an order should be exposed to the market to demonstrate that it does not constitute a disruptive practice?

A2: Although the amount of time an order is exposed to the market may be a factor that is considered when determining whether the order constituted a disruptive trading practice, there is no prescribed "safe" time frame for order exposure where an order will automatically be disqualified from constituting a disruptive practice. Market Regulation will consider a variety of factors, including exposure time, to determine whether an order or orders constitute a disruptive practice.

Q3: Is it a violation of the Rules to modify or cancel an order once it has been entered?

A3: An order, entered with the intent to execute a bona fide transaction, that is subsequently modified or cancelled due to a perceived change in circumstances does not constitute a violation of the relevant sections of the Rules.

Q4: Will orders that are entered by mistake constitute a violation of the Rules?

A4: An unintentional, accidental, or "fat-finger" order will not be considered "spoofing," but such activity may be a violation of other Exchange Rules, including, but not limited to, Rules pertaining to acts that are detrimental to the best interests of the Exchange (such as Nadex Rule 5.5(iv) or 5.19(i) above). Market participants are expected to take steps to mitigate the occurrence of errors, and their impact on the market. This is particularly true for entities and/or individuals that run algorithmic trading applications, or otherwise submit large numbers of automated orders to the market, if applicable.

Q5: Does a partial fill of an order demonstrate that the order did not violate the Rules?

A5: While execution of an order, in part or in full, may be one indication that an order was entered in good faith, an execution does not automatically cause the order to be considered compliant with the Rules. Orders must be entered with intent to execute a trade. A variety of factors may lead to a violative order ultimately achieving an execution. Market Regulation will consider a multitude of factors in assessing whether the relevant sections of the Rules have been violated.

Q6: Under this rule, is a market participant prohibited from making a two-sided market with unequal quantities (e.g., 100 bid at 10 offered)?

A6: No – market participants are not precluded from making unequal markets as long as the orders are entered for the purpose of executing bona fide transactions. If either (or both) order(s) are entered with prohibited intent, including recklessness, such activity will constitute a violation of the relevant sections of the Rules.

Q7: Is a market participant allowed to enter order(s) at various price levels throughout the order book in order to gain queue position, but subsequently cancel those orders as the market changes?

A7: It is understood that market participants may want to achieve queue position at certain price levels and, given changing market conditions, may wish to modify or cancel those orders. In the absence of other indications that the orders were entered for disruptive or misleading purposes, or with reckless disregard for the adverse impact on the orderly conduct of trading or the fair execution of transactions, they would not constitute a violation of the relevant sections of the Rules.

Q8: How does the Exchange define "intentional or reckless disregard for the orderly execution of transactions?"

A8: Whether a market participant demonstrates an intentional or reckless disregard for the orderly execution of transactions may be evaluated only in the context of the specific instrument, market conditions, and other circumstances present at the time in question. Some of the factors that may be considered in determining whether there was orderly execution were described by the Commission as follows: "[A]n orderly market may be characterized by, among other things, parameters such as a rational relationship between consecutive prices, a strong correlation between price changes and the volume of trades, levels of volatility that do not dramatically reduce liquidity, accurate relationships between the price of a derivative and the underlying such as a physical commodity or financial instrument, and reasonable spreads between contracts for near months and for remote months." Antidisruptive Practices Authority, 78 Fed. Reg. at 31,895-96. Volatility alone, however, will not be presumptively interpreted as disorderly or disruptive as market volatility can be consistent with markets performing their price discovery function.

Q9: Is a market participant precluded from entering orders that may be considered large for a particular market, and thus may have a potential impact on the market?

A9: If the size of an order or cumulative orders may be deemed to violate the relevant sections of the Rules if the entry results in disorderliness in the markets, such as price or volume aberrations, or if the size of the order distorts the integrity of settlement prices. Accordingly, market participants should be cognizant of the market characteristics of the products they trade and ensure that their order entry activity does not result in market disruptions. Exigent circumstances may be considered in determining whether a violation of the relevant sections of the Rules have occurred and, if so, what the appropriate sanction should be for such violation.

Q10: What is meant by "the closing period" in Rule 5.19(w)?

A10: "Closing Period" typically refers to the period during which transactions, or bids and offers (midpoints) in the underlying instrument are reviewed for purposes of informing settlement price determinations.

Q11: What factors will the Exchange consider in determining if an act was done with the prohibited intent or reckless disregard of the consequences?

A11: 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, 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).

Q12: Are orders entered for the purpose of igniting momentum in the market prohibited by the relevant sections of the Rules?

A12: A "momentum ignition" strategy occurs when a market participant initiates a series of orders or trades in an attempt to ignite a price movement in that market or a related market. If it is determined the intent of the strategy was to disrupt the orderly execution of transactions, if the conduct was reckless, or if the conduct distorted the integrity of the determination of settlement prices, then the conduct may be deemed a violation of the relevant sections of the Rules. Further, this activity may violate the relevant sections of the Rules if the momentum igniting orders were intended to be cancelled before execution, or if the orders were intended to be fraudulent or abusive of the Exchange's settlement process. If the conduct was intended to create artificially higher or lower prices, this may also constitute a violation of the relevant sections of the Rules.

Q13: Are "Spread Squeeze" orders prohibited by the relevant sections of Rule 5.19?

A13: Spoofing activity that is commonly referred to as a Spread Squeeze is defined as the entry of orders or trades for the purpose of causing a market reaction which drives the best bid and/or offer in a favorable direction in order to execute a trade. In a Spread Squeeze, a market participant places orders on one side of the market at successively higher or lower prices within the spread to "squeeze" it in one direction, enticing other market participants to join or beat the newly established top of the book. The market participant then switches sides and executes against those market participants. The spoof side orders are cancelled, often after execution, and the market typically returns to its previous state. The Exchange recognizes there are many variables that can cause a market participant to change that market participant's perspective of the market. The relevant sections of the Rule, therefore, do not, in and of itself, prohibit a market participant from changing that market participant's bias from short (long) to long (short). However, certain activity may be considered disruptive to the marketplace.

Q14: Is it a violation to enter orders for the purpose of testing?

A14: Testing should take place in Nadex's demo environment. The entering of an order(s) in a non-test product, or not in the demo environment, without the intent to execute a bona fide transaction, including for the purpose of verifying connectivity, checking a data feed, or testing a strategy, is not permissible. The aforementioned prohibition does not preclude a market participant from entering a bona fide order that is intended to be executed.