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First Spoofing Conviction To Fuel More Prosecutions

By **Tom Zanki**

Law360, New York (November 4, 2015, 8:53 PM ET) -- The landmark conviction Tuesday of a high-speed trader accused of making and canceling huge numbers of orders for commodities futures — the first of its kind since the Dodd-Frank Act outlawed the market-manipulation practice known as spoofing — will likely persuade prosecutors and civil plaintiffs that there's fertile hunting ground in the futures markets.

Morgan Lewis & Bockius LLP partner and former federal prosecutor David Miller said that before Tuesday's speedy and precedent-setting result, some questioned the ability of prosecutors to secure guilty verdicts in high-frequency trading cases, given the complexity of the trading and algorithms involved.

"The Coscia case shows that spoofing prosecutions are viable and are not too complicated for a jury to understand," said Miller, a former assistant U.S. attorney in the Southern District of New York who prosecuted securities and commodities fraud cases. "It is likely that the [Department of Justice] and [Commodity Futures Trading Commission] will be emboldened by this conviction to bring more of these kinds of cases."

An Illinois jury on Tuesday convicted Michael Coscia, the founder of New Jersey-based Panther Energy Trading LLC, on six counts of commodities fraud and six counts of spoofing after five hours of closing remarks and just over an hour of deliberation. Spoofing is a term for the practice of entering orders that a trader never intends to execute in order to create artificial momentum and profit from manipulated prices.

Michael Friedman, general counsel at Trillium Trading LLC, said while prosecutors could have previously sued alleged spoofers using general anti-fraud laws — but faced much higher legal hurdles in doing so — they now benefit from a specific tool. Dodd-Frank amended the Commodities Exchange Act to make spoofing more easily prosecutable by declaring it unlawful to bid on or offer a security with intent to cancel that bid or offer before execution.

Coscia became the first person ever indicted for spoofing in October 2014. The U.S. government alleged Coscia created two computer algorithms known as Flash Trader and Quote Trader that posted orders to the Chicago Mercantile Exchange and ICE Futures Europe with intent to cancel before completion. Prosecutors say Coscia took advantage of the resulting price fluctuations to rake in $1.3 million in three months.

The jury was unconvinced by closing arguments laid down by Coscia's counsel: that he wanted to trade on every single buy and sell order he placed through the computer programs but market logic dictated that he create a method to cancel orders that became too old, typically in a matter of milliseconds.

Friedman said the jury's decisiveness should end speculation that such transactions are too complex to figure out or that jurors can easily be persuaded that such activity is legitimate.

"There is no rational reason for entering that sequence of buy orders and sell orders other than to manipulate prices in his favor," Friedman said.

To prove spoofing, Miller said, successful prosecutors going forward will need to gather evidence of intent to cancel the order of sale, which can come from witness testimony, emails, instant messaging or chats, recorded conversations, and the trading patterns themselves.

Friedman also expects more civil enforcement actions as a result. He cited comments made by Aitan Goelman, the CFTC's head of enforcement, at a Securities Industry and Financial Markets Association conference Monday in which Goelman said he was watching the outcome of the Coscia trial in deciding whether to pursue more enforcement actions.

The Coscia conviction comes as two other high-profile spoofing cases move through courts. The. U.S. is currently pursuing extradition against U.K. trader Navinder Sarao, who is accused of contributing to the 2010 flash crash and spoofing afterward, netting himself $40 million over five years. Sarao was indicted on Sept. 2 on charges including 22 counts of alleged manipulation and wire and commodities fraud.

The CFTC has also accused Igor Oystacher and his Chicago-based 3Red Trading of routinely placing orders that were never intended to be filled but instead created a misleading picture of the market. Apart from those cases, Friedman said, the outcome of the Coscia case will likely shine light on lesser-known spoofing crimes.

"I think you are likely to see cases that are in a holding pattern, not made public yet, that are going to be pushed forward," Friedman said.

Barnes & Thornburg LLP partner Vincent "Trace" Schmeltz said the ruling also provides lessons for defense attorneys now that the government has revealed the playbook from its first conviction. For one, Schmeltz said, the case demonstrated that ordinary citizens are highly suspicious of high-speed trading, partly a fallout from the financial crisis.

Schmeltz said an argument can be made that high-frequency trading plays a role in price discovery by helping define the bid-ask spread at any point in time, but defense lawyers will have to do a better job in the future of convincing juries that a particular algorithm was designed for that purpose.

"The defense needs to figure out how to carefully and simply explain to a jury how high-frequency trading works," said Schmeltz, co-chair of Barnes & Thornburg's financial and regulatory litigation group. "High-frequency trading is just a faster version than what went on in the pits. This is how people have traded for 100 years, just faster."

In any event, attorneys also expect more regulatory scrutiny on algorithmic trading to result from the conviction.

Schmeltz said he would rather see future spoofing cases be handled on the civil side, through agencies like the CFTC and entities like ICE Futures Europe and the Chicago Mercantile Exchange, but he expects the guilty verdict to encourage more aggressive prosecution now that the government has a new tool in its box.

“You buy a hammer from the hardware store, you are going to use it,” Schmeltz said. “You can’t expect it sit on the shelf.”

--Additional reporting by Jessica Corso. Editing by Jeremy Barker and Mark Lebetkin.