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EXPERT ANALYSIS

The U.S. Government's Charge Against 'Spoofing'

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Signaling a new area of criminal and civil securities enforcement, federal regulators are flexing their newly acquired powers under the Dodd-Frank Wall Street Reform and Consumer Protection Act to curb a trading practice known as "spoofing."

This enforcement push involves increased coordination with the futures exchanges, heralding a "task force"-type approach to pursuing and sanctioning market participants that engage in spoofing at all levels.

The government's focus on this new area is yet another way that asset managers and other firms active in the derivatives markets are facing increased scrutiny and — by extension — greater compliance challenges.

WHAT IS SPOOFING?

"Spoofing" is a form of market manipulation using sophisticated computer algorithms that are deployed to rapidly place — and then cancel just before execution — hundreds or even thousands of large-volume trades.

Dismissed by many as unprosecutable, spoofing failed to garner significant media or regulatory attention for years.

Perhaps because of these prosecutorial obstacles, Section 747 of Dodd-Frank amended the Commodity Exchange Act to add Section 4c(a)(5).

This provision makes it unlawful for a person to engage in any trading, practice or conduct on or subject to the rules of a registered entity (such as a futures exchange) that "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)."

With this change in law, civil and criminal enforcement authorities now have a clear mandate for pursuing this trading practice.

Less clear, however, is how firms should determine what conduct is specifically prohibited so that they can conform their trading practices to avoid sanctions.

In an effort to address these challenges, the Commodity Futures Trading Commission published interpretive guidance on spoofing and other disruptive trading practices in May 2013. *See* Commodity Futures Trading Comm'n, Antidisruptive Practices Authority, 78 Fed. Reg. 31890 (May 28, 2013).

Among other salient points, the CFTC guidance clarifies that:

- The CFTC "interprets a [spoofing] violation as requiring a market participant to act with some degree of intent, or scienter, beyond recklessness" to violate the statute.
- "[L]egitimate, good-faith cancellation or modification of orders (e.g., partially-filled orders or properly placed stop-loss orders) would not" be considered unlawful spoofing.
- "When distinguishing between legitimate trading … and 'spoofing,' the [CFTC] intends to evaluate the market context, the person's pattern of trading activity (including fill characteristics), and other relevant facts and circumstances."
- The prohibition on spoofing covers "bid and offer activity on all products, traded on all registered entities" and is not restricted to "trading platforms and venues only having order book functionality."

The CFTC also provided the following four "non-exclusive examples" of unlawful spoofing:

- Submitting or canceling bids or offers to overload the quotation system of a registered entity.
- Submitting or canceling bids or offers to delay another person's execution of trades.
- Submitting or canceling multiple bids or offers to create an appearance of false market depth.
- Submitting or canceling bids or offers with the intent to create artificial price movements upward or downward.

Although the CFTC's guidance sheds some light on the agency's views on spoofing, it is not a binding limitation on the commission's jurisdiction or enforcement authority.

The CFTC cautioned that a "pattern of activity" was unnecessary and that "even a single instance" of spoofing could constitute a violation of the statute.

Although the guidance sheds some light on the CFTC's views on spoofing, it is not a binding limitation on the agency's jurisdiction or enforcement authority. Nor does the CFTC's guidance meaningfully restrict the power of prosecutors and regulators.

Recent enforcement actions brought under Dodd-Frank's anti-spoofing provisions against two individuals and their respective firms have brought this nascent offense into sharper and more immediate focus.

MICHAEL COSCIA CASE

A grand jury sitting in the U.S. District Court for the Northern District of Illinois on Oct. 1, 2014, returned a 12-count indictment against Michael Coscia, founder of Panther Energy Trading.

The first spoofing case brought under Dodd-Frank accused Coscia and Panther Energy of unleashing a sophisticated computer trading algorithm called "Flash Trader."

The algorithm allegedly placed, and then promptly canceled just before execution, virtually all trades to create the illusion of market interest, or disinterest, in different commodities markets to artificially move prices in Coscia's favor.

Only after the market reacted to these spurious trades did Coscia place and fill real trades, reaping $1.5 million in profits.

Each of the six counts of commodities fraud under 18 U.S.C. § 1348 is punishable by a maximum sentence of 25 years' imprisonment and a $250,000 fine.

All six counts of spoofing under Dodd-Frank, 7 U.S.C. §§ 6c(a)(5)(C) and 13(a)(2), are punishable by a maximum sentence of 10 years' imprisonment and a fine of the greater of $1 million or triple the violator's monetary gain.

Coscia moved to dismiss the charges on the grounds that Congress' prohibition on spoofing was impermissibly vague. U.S. District Judge Harry D. Leinenweber recently denied the motion. *United States v. Coscia*, No. 14-CR-551, 2015 WL 1805955 (N.D. Ill. Apr. 16, 2015).

Deeming Coscia's position unconvincing, Judge Leinenweber stressed the presumptive validity of Congress' enactments and concluded that Dodd-Frank fairly apprised Coscia that his specific trading activities were illegal.

While recognizing the "contentious disagreement about the precise meaning of the term 'spoofing,'" the judge nonetheless accepted the government's position that "there was never any serious debate" that the statute barred Coscia's charged conduct — "offer[ing] non bona fide offers for the purpose of misleading market participants and exploiting that deception for [Coscia's] benefit."

Further, Judge Leinenweber clarified that the key question was really whether the statute was unconstitutionally vague "as applied to Coscia's conduct" — not whether the conduct of "hypothetical legitimate traders" would constitute unlawful "spoofing."

Accordingly, any imprecision in the statute's contours, in the judge's view, did not preclude the government's prosecution of Coscia, who allegedly placed orders with the intent to "immediately cancel" and "fraudulently induce other market participants to react to the deceptive market information that he created."

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Coscia also sought dismissal of the commodities fraud charges against him but Judge Leinenweber rejected the demand, finding that even though no "false statement or material misrepresentation" was identified, the government adequately alleged a scheme to defraud.

Indeed, Coscia allegedly carried out his trading strategy "to create a false impression regarding the number of contracts available in the market, and to fraudulently induce other market participants to react to the deceptive market information," and "intended to trick others into reacting to the false price volume information he created with his fraudulent and misleading quote orders."

This was enough, the judge concluded, to sustain the government's prosecution of Coscia for commodities fraud. "[F]alse representations or material omissions are not required under Section 1348(1)," the judge said, provided that there is "(1) fraudulent intent, (2) a scheme or artifice to defraud, and (3) a nexus with a security."

Lastly, Judge Leinenweber concluded that the statute was not unconstitutionally vague because Coscia could reasonably anticipate that his scheme constituted commodities fraud.

NAVINDER SARAO CASE

The CFTC filed a civil complaint in April 2015 against London-based high-frequency trader Navinder Sarao and his firm, Nav Sarao Futures Ltd. *CFTC v. Nav Sarao Futures Ltd. PLC et al.*, No. 1:15-cv-03398, 2015 WL 1843321, *complaint filed* (N.D. Ill. Apr. 17, 2015).

The agency alleges Sarao manipulated the Chicago Mercantile Exchange's E-mini S&P 500 futures contract by placing — and then promptly canceling or modifying just before execution — hundreds or thousands of "exceptionally large" trades.

In so doing, Sarao primed the market, artificially moving contract prices in his favor just before placing and filling real trades and netting millions of dollars in profits.

The CFTC further alleges that Sarao's "aggressive[] and persistent spoofing tactics" contributed to "an extreme order book imbalance in the E-mini S&P market" on May 6, 2010 — dubbed the "Flash Crash" day because of the market's precipitous drop on that date — and that this "order book imbalance contributed to market conditions that caused the E-mini S&P price to fall 361 basis points."

The CFTC is seeking monetary penalties and disgorgement of Sarao's ill-gotten gains.

CHALLENGES AND IMPLICATIONS

The government is betting that its enforcement actions against Coscia and Sarao will send a strong message to would-be violators that spoofing will no longer go unpunished.

Judge Leinenweber's denial of Coscia's dismissal motion should help reinforce the government's message, but whether regulators can deter spoofing effectively may hinge on whether federal prosecutors and the CFTC are not only able to bring but also to prevail against Coscia and Sarao in this novel, largely untested area of the law.

To do so, federal prosecutors and the CFTC must clear a number of hurdles.

The government must distill evidence from reams of financial, market and trading data establishing that Coscia and Sarao deployed sophisticated computer algorithms to place and cancel the relevant orders — not for legitimate trading activities, but rather to manipulate market prices.

The first spoofing case brought under Dodd-Frank accused Michael Coscia and Panther Energy Trading of unleashing a sophisticated computer trading algorithm called "Flash Trader."

The dearth of legal precedent interpreting Dodd-Frank's anti-spoofing provisions only complicates the government's task.

Nonetheless, the government's aggressive enforcement of Dodd-Frank's anti-spoofing prohibitions suggests that firms should proceed with care in this evolving area of the law.

PRACTICAL CONSIDERATIONS

Although it is generally helpful to tackle a new compliance challenge head-on, spoofing can present special challenges.

As explained above, the precise nature and scope of this offense remain ill-defined.

Spoofing is a priority among prosecutors and regulators alike, and there is a general sense that brokers and exchanges are closely monitoring market participants for potential wrongdoing. For instance, brokers have asked firms to provide and substantiate their reasons for low fill rates during specific periods.

Firms should assume that any response they provide to a broker will be shared with the exchanges and possibly law enforcement.

For these reasons and others, firms may find it prudent to review their trading algorithms and strategies with the CFTC's guidance and recent court cases in mind.

Firms that perform this review should begin by focusing on trading strategies that deploy algorithms, involve a high overall volume of market activity, or have lower fill rates.

Within that universe, firms should consider whether any activity could raise red flags for regulators, including whether,

- Trading algorithms call for cancellation of bids and offers in all cases, even when prices move in a favorable direction.
- Cancellation of bids and offers was meaningfully higher during closing periods.
- There is any potential connection between cancellation activity and market prices.

- Cancellations were driven by trading in other markets (such as where a strategy is pursued through both the futures markets and the securities markets).

Except in obvious cases, the specific types of trading activity prohibited by anti-spoofing provisions remain murky and will be the subject of ongoing debate.

Accordingly, firms would be well-served by monitoring legal developments and following commonsense steps for reviewing their trading activities in this emerging area of criminal and civil enforcement.



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