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"Spoofing" as Fraud: A Novel and Untested Theory of Prosecution

By Jodi Misher Peikin and Justin Roller

In June 2018, we published an article discussing the government's efforts to prosecute defendants who engage in a form of trading activity on commodity futures exchanges known as "spoofing," which the law defines as "bidding or offering with the intent to cancel the bid or offer before execution." *See*, Jodi Misher Peikin & Brent M. Tunis, "When Is a Bid or Offer a 'Spoof'?," *Business Crimes Bulletin* (June 2018) (https://bit.ly/2SK7s5N). In that article, we observed that the failure of the Commodity Futures Trading Commission (CFTC) to define what specific conduct qualifies as spoofing has left market participants uncertain about when cancellation of a bid or offer crosses the line from an acceptable trading strategy to an illegal "spoof." This ambiguity is compounded by the fact that rapid cancellation of orders is prevalent in the commodities markets. *See*, Richard Haynes & John S. Roberts, CFTC, "Automated Trading in Futures Markets" at 9 (2015) ("[J]ust over 50 percent of market orders are cancelled within half a second, approximately the speed of human reaction.") (https://bit.ly/2OIUNtZ).

Notwithstanding this confusion, the Department of Justice (DOJ) has signaled its intent to pursue spoofing prosecutions aggressively. The lead prosecutor in the spoofing case against New Jersey-based algorithmic trader Michael Coscia described that prosecution as "just the tip of the iceberg." Greg Trotter, "Trader Michael Coscia 1st in nation to be sentenced under 'anti-spoofing' law," *Chi. Tribune* (July 13, 2016) (https://bit.ly/2I7L56i). This ominous proclamation was realized in January 2018, when DOJ announced a "spoofing takedown" bringing a litany of criminal charges, including commodities fraud and wire fraud, against eight individuals alleged to have engaged in spoofing-related activity. *See*, Press Release, DOJ, "Acting Assistant Attorney General John P. Cronan Announces Futures Markets Spoofing Takedown" (Jan. 29, 2018) (https://bit.ly/2jLZKoA).

In the months since we published our last article in June 2018, however, several of the defendants in these recent spoofing prosecutions have pushed back, raising arguments that call into question whether the government may properly target spoofing under the commodities-fraud and wire-fraud statutes. In particular, these defendants have argued, among other things, that the government cannot charge spoofing as fraud because spoofing does not involve the making of a false statement — a necessary element of a fraud charge. Rather, the defendants assert that when a trader enters an executable order on an exchange, the only information conveyed to the market is completely accurate, *i.e.*, that the trader placing the order will transact at a certain price and quantity for so long as the order is not cancelled. *See generally*, *United States v. Flotron*, No. 17-cr-220 (D. Conn.); *United States v. Bases*, No. 18-cr-48 (N.D. Ill.); *United States v. Vorley*, No. 18-cr-35 (N.D. Ill.).

This article begins with a brief discussion of the elements that the government must prove to establish commodities fraud and wire fraud. It then examines the recent spoofing prosecutions in *Flotron*, *Bases*, and *Vorley*. Each of these cases raises important questions about the applicability of the traditional fraud statutes to spoofing-related activity. How the federal courts answer these open questions will have significant implications for participants in the commodities markets.


Jodi Misher Peikin and Justin Roller

The Elements of Commodities Fraud And Wire Fraud

In 2002, Congress passed the Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002), which created a new provision in the federal criminal code making it a crime to execute a scheme to defraud in connection with any registered security. *See*, 18 U.S.C. §1348. Violations of the securities-fraud provision are punishable by fines and up to 25 years in jail. *Id.* Congress expanded the statute to include commodities fraud in 2009. *See*, Fraud Enforcement and Recovery Act of 2009, §2(e)(1), Pub. L. 111-21, 123 Stat. 1618 (2009).

The commodities-fraud statute may be violated in two distinct ways: 1) by knowingly executing "a scheme or artifice to defraud any person in connection with any commodity for future delivery," 18 U.S.C. §1348(1); or 2) by knowingly executing a fraudulent scheme to obtain money by making "false or fraudulent pretenses, representations, or promises … in connection with the purchase or sale of any commodity for future delivery," *id.* §1348(2). The elements of commodities fraud under Section 1348(1) are: 1) fraudulent intent; 2) a scheme or artifice to defraud; and 3)

Jodi Misher Peikin, a member of this newsletter's Board of Editors, is a principal at Morvillo Abramowitz Grand Iason & Anello PC, New York. **Justin Roller** is an associate with the firm.

a nexus with a security. *United States v. Mahaffy*, 693 F.3d 113, 125 (2d Cir. 2012); *see also*, *United States v. Coscia*, 866 F.3d 782, 797 (7th Cir. 2017) (same).

Unlike the commodities-fraud statute, which is of relatively recent vintage, the wire-fraud statute is more firmly rooted in American jurisprudence. Enacted into law in July 1952, the statute makes it a crime to devise "any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises" through the use of interstate wire communications. 18 U.S.C. §1343. Violations of the wire-fraud statute carry stiffer maximum penalties than the commodities-fraud statute, including fines up of to $1 million and up to 30 years in jail. *Id*.

The essential elements of wire fraud are: 1) a scheme to defraud; 2) money or property as the object of the scheme; and 3) use of the wires to further the scheme. *United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, 822 F.3d 650, 657 (2d Cir. 2016). The Seventh Circuit — the locus of many commodities-fraud cases due to the prominence of the Chicago Mercantile Exchange (CME) — has held that "a necessary element" in a wire-fraud case "is the making of a false statement or material misrepresentation, or the concealment of a material fact." *United States v. Stephens*, 421 F.3d 503, 508 (7th Cir. 2005).

In sum, under the current law, the government is not required to prove a false statement to establish a commodities-fraud violation under Section 1348(1). By contrast, to establish wire fraud, the government must prove beyond a reasonable doubt that a defendant's scheme to defraud "involved a materially false or fraudulent pretense, representation, or promise." Seventh Cir. Pattern Crim. Jury Instr., §§1341, 1343, at p. 402 (2012 ed.). In general, the government has opted to prosecute defendants in spoofing cases under Section 1348(1) because federal courts have held that that statute does not require proof of a false statement. *See*, *e.g.*, *Coscia*, 866 F.3d at 796. In more recent prosecutions described below, however, the government has taken a more aggressive approach, indicting alleged spoofers under the wire-fraud statute, which unequivocally does require proof of a false statement.

Flotron: Spoofing Can Be Charged As Commodities Fraud

In September 2017, the government indicted Andre Flotron, a former trader at UBS AG, on one count of conspiracy to commit spoofing, commodities fraud (under Section 1348(1)), and wire fraud. *See*, Indictment ¶¶11-12, *United States v. Flotron*, No. 17-cr-220, ECF No. 14 (D. Conn. Sept. 26, 2017). The indictment alleged that Flotron placed large "Spoof Orders" for precious metals futures contracts that he intended, at the time he entered the orders, to cancel before execution. The government alleged that Flotron intended for the so-called "Spoof Orders" to mislead market participants about increased supply and demand for precious metals futures. *Id*. ¶14(a). While the "Spoof Orders" were pending, Flotron allegedly placed smaller "Primary Orders" — *i.e.*, orders that he hoped to execute at prices influenced by the "Spoof Orders" — on the other side of the market. *Id*. For example, Flotron allegedly placed a "Primary Order" to buy five gold futures contracts at a price of $1,284.80 and, less than a second later, placed a "Spoof Order" to sell 55 gold futures contracts at a price of $1,285.10 — conceivably, to drive up the price of gold futures contracts and thereby increase the likelihood that the "Primary Order" would be filled. *Id*. ¶15(c).

The *Flotron* case has a circuitous procedural history. On Jan. 30, 2018, the day after DOJ announced its "spoofing takedown" charging eight precious metals traders across three federal districts, the government filed a superseding indictment against Flotron tacking on six new charges in addition to the original conspiracy charge. The new charges included three substantive counts of commodities fraud and three substantive counts of spoofing. *See*, Superseding Indictment ¶¶21-25, *Flotron*, ECF No. 58. Tellingly, however, the superseding indictment also amended the original conspiracy count, alleging only that Flotron conspired to commit spoofing and commodities fraud under Section 1348(1), which courts have held does not require proof of a false statement, but *not* wire fraud, which clearly does. *See*, *id*. ¶¶11-20.

Flotron quickly moved to dismiss the six new charges for lack of venue, arguing that the government had improperly charged him in the District of Connecticut for alleged spoofing activity that took place in the Northern District of Illinois, where trades on the CME's various exchanges occur. *See*, Mot. to Dismiss, *Flotron*, ECF No. 64. In a sharply worded order, the district court granted Flotron's motion, noting that "[f]ederal grand juries in Connecticut don't ordinarily indict bank robberies in Boston, kidnappings in Kansas, or drug dealing in Dallas." *See*, *United States v. Flotron*, 2018 WL 940554, at 3 (D. Conn. Feb. 19, 2018). The court bristled at what it described as the government's "bad faith," refusing to dismiss the Connecticut-based conspiracy charge so that the government could re-file broader charges in Illinois. *Id*. at 7-8.

Notwithstanding this significant victory, Mr. Flotron was unable to convince the court to dismiss the remaining charge of conspiracy to commit spoofing and commodities fraud as a matter of law. Flotron argued that the government could not establish the underlying commodities-fraud violation because he made no false or fraudulent representation to any market participant when he entered the so-called "Spoof Orders," each of which was a *bona fide* order that was available to be traded upon by any market participant until later cancelled before execution. *See*, Mem. Supp. Mot. to Dismiss at 11-12, *Flotron*, ECF No. 67.

The court rejected Flotron's argument, holding that the possibility that the alleged Spoof Orders may have been executed prior to cancellation "does not legitimate the conduct as a matter of law," especially if a defendant places "trick" orders "believing it unlikely that any or many of these orders would end up being filled before he could cancel them or if he otherwise stood willing to accept the possibility of some of the 'trick' orders being filled as merely an inconvenient cost of doing (fraudulent) business." *United States v. Flotron*, 2018 WL 1401986, at 3 (D. Conn. Mar. 20, 2018). In reaching this conclusion, the court declined to follow the reasoning of *United States v. Radley*, 659 F. Supp. 2d 803 (S.D. Tex. 2009), *aff'd*, 632 F.3d 177 (5th Cir. 2011).

In *Radley*, both the district court and the Fifth Circuit concluded that traders of TET propane futures did not commit wire fraud by placing multiple bids at the same time (causing a price increase) because the bids were in and of themselves lawful and the traders were prepared to and did follow through on the bids if executed. *See*, 659 F. Supp. 2d at 815-16; 632 F.3d at 183-84. The court in *Flotron* expressly disagreed with the reasoning in *Radley*, commenting that "[t]he fact that a

trader may make good on some portion of market-manipulating bids that he did not intend or expect to have to fulfill neither detracts from nor sanitizes the fraudulent nature of such bids if they were placed in the first instance for no reason other than to create a false impression in the market and to shift prices in the trader's favor on the opposite side of the market." 2018 WL 140986, at 4. The disagreement between the courts in *Radley* and *Flotron* underscores an important question about which market participants currently have little direction: when does a trader's subjective intent not to execute an otherwise *bona fide* and executable order subject him to criminal liability for wire fraud? Unfortunately, as demonstrated by the CFTC's failure to issue definitive guidance on what constitutes spoofing, the question may not lend itself to bright-line answers.

In Flotron's case, the fact-specific nature of the spoofing inquiry ultimately inured to his benefit; following a five-day trial, a jury acquitted Flotron after only a few hours of deliberation. *See*, Peter J. Henning, "The Problem With Prosecuting 'Spoofing'," *N.Y. Times* (May 3, 2018) (https://nyti.ms/2GDwdu8). Because of the factual nature of Flotron's trades, the government struggled to establish fraudulent intent in his case. Flotron placed his orders manually, some of which he kept open for up to a minute (an eternity in the increasingly automated futures markets). This fact made it more difficult for prosecutors to show that Flotron's goal was to cancel his so-called "Spoof Orders" when there was a non-negligible chance that the orders would be filled. *See*, *id*. By contrast, the government was able to secure Michael Coscia's conviction by highlighting statistical evidence of large-scale, rapid cancellation of orders through an algorithm within milliseconds of being entered. Indeed, in affirming Coscia's conviction, the Seventh Circuit emphasized the effectiveness of his algorithm, noting that the program artificially moved the market by cancelling all but 0.08% of his orders. *Coscia*, 866 F.3d at 797 n.64. In other words, Coscia's algorithm effectively eliminated the risk of his so-called "Spoof Orders" being executed, which the jury viewed as convincing evidence of Coscia's intent to engage in spoofing. The government was unable to make the same showing as to Flotron's manual trading.

In December 2018, armed with leverage following his acquittal, Flotron reached an agreement with the CFTC to settle a related civil lawsuit in exchange for a $100,000 fine and a one-year bar from commodities trading. *See*, Dean Seal, CFTC, Ex-UBS Trader Unveil $100K Spoofing Settlement, Law360 (Dec. 21, 2018) (https://bit.ly/2RU20sL).

Bases: The Government Pursues Spoofing As Commodities Fraud *and* Wire Fraud

After the *Flotron* verdict, in July 2018, the government indicted two former Merrill Lynch precious metals traders, Edward Bases and John Pacilio, both of whom were among the individuals swept up as part of DOJ's "spoofing takedown." *See*, Indictment, *United States v. Bases*, No. 18-cr-48, ECF No. 66 (N.D. Ill. July 17, 2018). The indictment in *Bases* went a step further than *Flotron*, charging the defendants with conspiracy to commit commodities fraud *and* wire fraud, along with several substantive counts of commodities fraud and spoofing, in connection with the defendants' manual cancellation of orders of silver, gold, and platinum futures contracts. *Id*. ¶¶1-24. In the indictment, the government pointed to electronic chat logs between Bases and Pacilio in which the defendants used words like "spoof" and "push" when discussing the effects of their orders on the market. *Id*. ¶17.

In November 2018, Bases and Pacilio moved to dismiss the indictment, arguing, among other things, that spoofing cannot form the basis for a wire-fraud charge because spoofing does not involve a misrepresentation or promise. Mem. Supp. Mot. to Dismiss at 5, *Bases*, ECF No. 117. According to Bases and Pacilio, the government tacitly conceded this point in *Coscia* and *Flotron* by limiting its theory of conspiracy in those cases to commodities fraud under §1348(1), which courts have held does not require proof of a false statement. Now that the government is proceeding under statutes that plainly require proof of a false statement, the government's theory is that a trader who enters "Spoof Orders" makes an *implied* false statement to the market about: a) the trader's willingness to execute the order; and b) the existence of supply and demand in the market. Basis and Pacilio contend that this novel theory of "implied" misrepresentation runs contrary to case law holding that offers to contract or trade do not carry any such implied representations. *See*, *e.g.*, *Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, 864-65 (7th Cir. 1995). According to the defendants, the most the government has alleged in Bases is that the defendants failed to disclose the underlying motivations for their orders — something the law does not require absent a fiduciary duty, which one does not owe to a competitor in the market. *See*, *Reynolds v. East Dyer Dev. Co.*, 882 F.2d 1249, 1252 (7th Cir. 1989) (nondisclosure of material information insufficient to sustain wire-fraud charge unless defendant owed a "fiduciary duty to disclose" the information withheld).

For its part, the government responded that the defendants' alleged "Spoof Orders" made two *implicit* misrepresentations: 1) that the defendants intended to execute their trades; and 2) that there was legitimate supply and demand in the market. Gov't Opp'n at 11, *Bases*, ECF No. 135. In support of this implied-misrepresentation theory, the government cites cases in which courts have affirmed fraud convictions based on "communicative conduct" that gave an implicit misrepresentation. One such case is *United States v. Stephens*, in which the Seventh Circuit affirmed the wire-fraud conviction of a defendant who submitted reports seeking cash advances from his employer for purposes unrelated to work. The court reasoned that the false-statement prong was satisfied in that case because each report the defendant submitted "carried the implied representation that it was for purposes related to work." 421 F.3d at 507. However, *Stephens* arguably does not support the government's implied-misrepresentation theory in the spoofing context because, unlike the employee-employer relationship, spoofing cases generally involve open-market activity between competitors who owe no fiduciary duties to one another. Moreover, the concept of supply and demand is arguably irrelevant in the context of futures contracts because supply will always exist when an order is executed and two parties have reached a meeting of the minds. In view of the potentially inapt case law the government has marshaled in support of its argument, there is reason to question whether the court in *Bases* will endorse the theory that spoofing involves an implied misrepresentation sufficient to establish wire fraud.

Vorley: Government Limits Its Spoofing Prosecution Theory to Wire Fraud

The question of whether the government may use the wire-fraud statute to target spoofing is even more squarely framed in the prosecution of James Vorley and Cedric Chanu, two former Deutsche Bank precious-metals traders. *See*, *United States v. Vorley*, No. 18-cr-35, (N.D. Ill.). This is because *Vorley* is the first spoofing prosecution of its kind to proceed *solely* under the wire-fraud statute and without reference to the anti-spoofing or commodities-fraud statutes. The reason for this presumably lies with the government's need to overcome the applicable statutes of limitations for spoofing (five years) and commodities fraud (six years). *See*, 18 U.S.C. §§3282(a), 3301. Indeed, in other prosecutions involving more recent conduct (and therefore no limitations bar), the government has brought indictments only under the anti-spoofing statute. *See*, *e.g.,* Indictment, *United States v. Thakkar*, No. 18-cr-36, ECF No. 1 (N.D. Ill. Feb. 14, 2018). The government's pleading strategy in *Vorley* thus offers interesting insight into the ways in which prosecutors can dodge limitations bars through creative pleading.

The government's initial complaint in *Vorley* included claims for spoofing and commodities fraud, in addition to wire fraud, involving conduct spanning from May 2008 through March 2015. *See*, Complaint ¶5, *Vorley*, ECF No. 1. However, defense counsel presented evidence to DOJ that, in December 2011, Deutsche Bank had implemented a legal-compliance program to review and clear potential spoofing trades, including many trades made by Vorley and Chanu. In response to the defendants' presentation, the government filed an indictment paring back the end-date for the alleged conspiracy to November 2011, just before Deutsche Bank instituted its spoofing compliance program. *See*, Indictment ¶¶2, 21, 23, *Vorley*, ECF No. 12. As a result, the government's indictment alleged that Vorley's and Chanu's spoofing conduct ended more than seven years ago — well outside the limitations periods for spoofing and commodities fraud.

To get around the time bars in the spoofing and commodities-fraud statutes, the government instead asserted a single count of wire fraud, which carries a *10-year* statute of limitations in cases involving financial institutions. Specifically, under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the statute of limitations for wire fraud (but not spoofing or commodities fraud) is ten years where the wire fraud "affects a financial institution." *See*, 18 U.S.C. §3293(2). The government invoked FIRREA in the *Vorley* indictment by alleging that the defendants' fraud affected Deutsche Bank in a number of ways, including by exposing the bank to financial risk and reputational harm. *See*, Indictment ¶14, *Vorley*, ECF No. 12. This is a common tactic in wire-fraud prosecutions, and FIRREA is one of the government's favored tools for targeting decade-old conduct in situations where criminal charges would otherwise be time-barred. *See*, Robert J. Anello & Justin Roller, "Hidden 'Time' Bombs in White-Collar Criminal Matters," *Business Crimes Bulletin* (Oct. 2018) (https://bit.ly/2GC5b6j).

Although the government's tactical deployment of FIRREA allowed prosecutors to sidestep a limitations hurdle and to bring spoofing-related fraud charges against Vorley and Chanu, that pleading decision has potential consequences. In a matter of first impression, the district court in *Vorley* will now have to decide whether spoofing-related activity may be prosecuted exclusively under the wire-fraud statute and its accompanying false-statement requirement. The financial industry has responded with a resounding "no." Recently, the Bank Policy Institute, the U.S. Chamber of Commerce, and the Securities Industry and Financial Markets Association submitted an amicus brief in support of Vorley's and Chanu's pending motion to dismiss the indictment. *See*, *Amicus* Br., *Vorley*, ECF No. 96. The industry *amici* echo the defendants' position, arguing that the government's novel theory of "spoofing-as-an-implied-misrepresentation" is an overly expansive application of the wire-fraud statute, particularly when the law already contains a tailored and specific anti-spoofing provision. *Id*. at 2.

As of April 2019, the motions to dismiss filed in *Bases* and *Vorley* are fully briefed and awaiting rulings by the district court. Market participants and white-collar practitioners should pay close attention to these cases as they develop.

Analysis

The scorecard in spoofing-related prosecutions reflects mixed results. Prosecutors recently have secured a handful of guilty pleas for wire fraud and other charges from defendants snared in the government's "spoofing takedown." *See*, *United States v. Edmonds*, No. 18-cr-239 (D. Conn. Oct. 9, 2018); *United States v. Gandhi*, No. 18-cr-609 (S.D. Tex. Nov. 2, 2018); *United States v. Mohan*, No. 18-cr-610 (S.D. Tex. Nov. 6, 2018). As for those spoofing cases that have proceeded to trial, however, the government has notched one win and one loss, with the *Bases* and *Vorley* prosecutions on deck. The government's win in *Coscia* proceeded under the commodities-fraud statute — in particular, Section 1348(1), which the court in *Coscia* held does not require proof of a false statement. The conviction in *Coscia* was also aided by the unique facts of that case, which showed that the defendant had developed a restrictive algorithm that made it virtually riskless for him to enter market-disruptive orders and thereafter cancel them at a rate of more than 99%. No court since *Coscia* has been presented with a similar fact pattern involving highly effective computerized spoofing. To the contrary, the government's loss in *Flotron* involved manual (non-algorithmic) trading, with executable orders that were exposed to the real financial risk of being filled before they were cancelled.

The courts will now wrestle with the question of whether and how far to extend the wire-fraud statute in the *Bases* and *Vorley* spoofing prosecutions. Like *Flotron*, the *Bases* and *Vorley* cases involve allegations of manual spoofing that arguably are distinguishable from the high-frequency algorithmic trading at issue in *Coscia*. Moreover, the *Vorley* prosecution, which alleges only a single count of conspiracy to commit wire fraud, will test the suitability of the wire-fraud statute (and its accompanying false-statement requirement) as a standalone tool in the government's still nascent anti-spoofing efforts. How these cases progress will have critical implications for the commodities markets.

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