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Expert Analysis

'Spoofing'—the New Frontier For Criminal Prosecution?

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Even without its catchy name, the relatively new crime of "spoofing" would seem to appeal to prosecutors seeking to tap into the populist desire for prison time for perceived financial chicanery and the view that high-speed trading has rigged the markets against regular participants. Not surprisingly, therefore, the conviction last month in *United States v. Coscia*,[1] the first criminal trial on spoofing charges, has generated a good deal of attention.

Generally, spoofing is a practice, claimed to be manipulative, whereby a trader places and quickly cancels an order that the trader never intended to execute. The notion is that spoofing gives the market a false indication of genuine interest in trading at a specified price, improperly allowing the spoofer to profit on other traders' responses to this false information, often by placing a legitimate order on the other side of a large non-bona fide order. As a practical matter the conduct is focused in the realm of algorithmic trading, where computer programs are used to place and cancel orders pursuant to a defined set of instructions at extremely high speeds.

Congress expressly declared spoofing illegal in the commodities context in 2010 when it passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. The statute included no similar express prohibition in the securities context.

Dodd-Frank

Before 2010, the Commodity Futures Trading Commission (CFTC) pursued spoofing and similar practices through civil enforcement proceedings under provisions of the Commodity Exchange Act (CEA) that prohibit the manipulation of commodities or futures,[2] or the entering of non-bona fide orders.[3] Spoofing cases under these provisions were difficult to prove, however, which led Congress to amend the CEA as part of Dodd-Frank.[4]

The CEA anti-spoofing amendment broadly prohibits "any trading, practice, or conduct on or subject to the rules of a registered entity that…is, is of the character of, or is commonly known to the trade as 'spoofing' (bidding or offering with intent to cancel the bid or offer before execution)."[5] Violations of the statute may be pursued in a civil enforcement proceeding either administratively or in federal district court. For good measure, the Dodd-Frank amendment also added a criminal sanction for a "knowing" violation of the statute: up to 10 years imprisonment and a $1 million fine.

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Regulators and market participants quickly recognized significant concerns about the anti-spoofing amendment's uncertain breadth and potential application to legitimate, routine trading activity. Following the statute's adoption, it underwent approximately two-and-a-half years of debate and comment before the CFTC issued final interpretive guidance in May 2013.[6]

In that guidance, the CFTC stated that a spoofing violation does not occur when the person's intent when cancelling a bid or offer before execution is part of a legitimate, good faith attempt to consummate a trade. Instead, "a market participant [must]…act with some degree of intent, or scienter, beyond recklessness to engage in the 'spoofing' trading practices prohibited by the CEA."[7]

To distinguish between legitimate offers and spoofing, the CFTC states it will—after the fact, of course—evaluate the particular facts and circumstances of each case, including a person's trading practices and patterns and the market context of the trade orders at issue. The CFTC guidance nevertheless offers four "non-exclusive" examples of spoofing behavior: 1) submitting or canceling bids or offers to overload the quotation system of a registered entity; 2) submitting or cancelling bids or offers to delay another person's execution of trades; 3) submitting or cancelling multiple bids or offers to create an appearance of false market depth; and 4) submitting or cancelling bids or offers with the intent to create artificial price movements upwards or downwards.[8]

'United States v. Coscia'

The defendant in *United States v. Coscia*, Michael Coscia, was a trader and principal of Panther Energy Trading, LLC, a high-frequency trading firm. The CFTC first pursued a civil enforcement proceeding against Coscia and his firm for their alleged spoofing activity. In July 2013, Coscia and his firm settled that proceeding, agreeing to a cease and desist order and to pay a $1.4 million monetary penalty and a $1.4 million disgorgement.

The U.S. Attorney's Office for the Northern District of Illinois followed, obtaining Coscia's indictment on Oct. 1, 2014, on charges arising from the same alleged spoofing conduct. The indictment alleged that Coscia utilized a high-frequency trading strategy that allowed him to enter and cancel orders in a matter of milliseconds. Specifically, Coscia's computer programs were alleged to have operated as follows: on one side of the market, the programs would place a bona fide order, referred to as a "trade" order, to be filled; on the other side, the programs would place much larger volume, non-bona fide orders, referred to as "quote" orders, which were cancelled within a fraction of a second.

The "quote" orders allegedly were placed "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 that Coscia transmitted,"[9] thereby allowing him to reap greater profits on his "trade" orders. Coscia allegedly profited approximately $1.5 million from

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the scheme, which took place over approximately three months beginning in August 2011.

U.S. District Judge Harry D. Leinenweber denied Coscia's motion to dismiss the indictment on the basis that the CEA anti-spoofing provision is unconstitutionally vague. Rejecting the defendant's argument that the statute and its accompanying interpretive guidance (which was still just a proposal at the time of Coscia's conduct) failed to offer any ascertainable standard that distinguishes spoofing from legitimate trade practices such as partial-fill orders (larger than necessary orders entered to ensure a sufficient quantity is obtained) and stop-loss orders (orders that are fixed to execute only when the market reaches a certain price), the court found the statute constitutional as applied to Coscia's specific alleged conduct.

The court noted that the statute's "intent to cancel" requirement was significant and did "much to destroy any force in the argument that the application of the statute would be so unfair that it must be held invalid."[10] Judge Leinenweber also rejected Coscia's motion to dismiss the charges against him under the criminal securities and commodities fraud law first passed as part of the Sarbanes-Oxley Act of 2002, 18 U.S.C. §1348, holding that a false representation or material omission was not required under that statute.

The trial against Coscia began on Oct. 26, 2015, and lasted seven days. One of the government's key witnesses was Jeremiah Park, the computer programmer who created the trading programs at Coscia's direction. On the issue of Coscia's intent to cancel the orders before they were filled, Park explained that the programs were set to immediately cancel the large "quote" orders if they began to be filled.[11] The government also presented analysis of summary data of Coscia's trading activity, and called as witnesses other traders who asserted that they were impacted by Coscia's activity in making their own trading decisions.

Coscia, who previously had testified in the CFTC proceeding, took the stand in his own defense. The defense also offered an expert in the financial markets and an economic consultant who analyzed the data from Coscia's trading and high-frequency trading practices in general. Together with Coscia, the defense witnesses supported Coscia's main lines of defense: that all of Coscia's orders actually were available to be traded in the market, for a longer period than many others' orders, and that many such orders (though a small percentage) were in fact traded. The defense also elicited testimony that cancelling orders is commonplace in the world of high-frequency trading, that Coscia's rate of cancellation was actually lower than others' rates, and that Coscia's orders violated no market rules.

After little more than an hour of deliberations, the jury returned with a verdict of guilty on all counts.[12]

What Does 'Coscia' Portend?

Coscia is expected to appeal, and questions about the interpretation and application of the two relatively new criminal statutes at issue—the CEA's anti-spoofing amendment and 18 U.S.C. §1348—should provide fertile grounds. Because courts have recognized that alleged open market manipulative conduct like spoofing is particularly difficult to distinguish from legitimate trading strategies,[13] one hopes that prosecutors might await further guidance from the U.S. Court of Appeals for the Seventh Circuit before pursuing additional cases. Nevertheless, even prior to the verdict in *Coscia*, federal prosecutors already had charged two additional criminal spoofing cases—one in Chicago, *United States v. Sarao*,[14] arising from the well-known 2010 "flash-crash," and another in New Jersey, *United States v. Milrud*,[15] which has resulted in a guilty plea.

As mentioned above, the amendments to the CEA prohibit spoofing only in the futures and derivatives markets. No parallel provision exists under the securities statutes. To date, the Securities and Exchange Commission has attacked spoofing and similar conduct as manipulative practices in violation of the anti-fraud provisions of Section 10(b) of the Securities Exchange Act. Criminal prosecutors could do the same. They also might seek to use the provisions relied upon in *Sarao* and *Milrud*—18 U.S.C. §1343, the ever-popular wire fraud statute, and 18 U.S.C. §1348, the Sarbanes-Oxley criminal securities and commodities fraud law.

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A criminal prosecution of spoofing in the securities markets, however, would face significant legal hurdles. Prosecutions of open market manipulation have been exceedingly rare in the U.S. Court of Appeals for the Second Circuit since that court's 1991 reversal of the securities manipulation conviction in *United States v. Mulheren*.[16] Outside the classic manipulative devices of "wash sales, matched orders or rigged prices," prosecutors generally have abided by the view that Section 10(b)'s requirement that there be a deceptive communication requires that there be false statements or material omissions in order to support a criminal prosecution for manipulation.[17]

Any argument that an order made with intent to cancel before execution is equivalent to a wash trade or other classic manipulative device is subject to the response that, unlike such classic devices, an order, which by definition is open to execution under some market conditions, subjects the offeror to real market risk. Exchanges typically have no rules requiring that an order remain open for any specific period of time, and thus there is an element of fiction in the notion that any market participant could claim to be misled because an order did not do so.

Further, cases like *Coscia* illustrate why, as a matter of prosecutorial discretion, spoofing cases generally do not seem to warrant being pursued criminally. On the real world battlefield of the vast, complex and ultra-high-speed securities and commodities markets, where Coscia's trading can be considered slow and simple by today's technological standards, the line between relatively routine trading strategies and spoofing can be effectively impossible to identify. Traders cannot stay far away from that "line" without risking being seriously disadvantaged. Where more than 90 percent of all high-frequency orders are cancelled,[18] pursuing criminal charges based on an after-the-fact judgment of intent seems excessive; regulatory enforcement would appear sufficient to address the most abusive behaviors.

Conclusion

The Coscia verdict suggests that other prosecutors will consider pursuing criminal spoofing cases. Prudence dictates that they proceed with caution and restraint in this complex and evolving area.

1. 14 CR 551 (N.D. Ill.).
2. 7 U.S.C. §9 (2009) (granting CFTC authority to bring an administrative enforcement action in such cases).
3. 7 U.S.C. §6c(a)(2)(B) (2012).
4. Matthew Leising, "Market Cops Got Power to Pursue Spoofers After Years of Failure," Bloomberg (May 14, 2015).
5. 7 U.S.C. §6c(a)(5)(C) (2012).
6. On March 11, 2011, the CFTC issued a proposed interpretive order and solicited public comment. See 76 Fed. Reg. 14943 (Mar. 18, 2011). Final guidance was not issued until May 20, 2013. See 78 Fed. Reg. 31890 (May 28, 2013).
7. 78 Fed. Reg. at 31896.
8. Id.
9. Indictment, *United States v. Coscia*, 14 CR 551 at ¶ 3.
10. Memorandum Opinion and Order, *United States v. Coscia*, 14 CR 551 (April 16, 2015).
11. Transcript, *United States v. Coscia*, 14 CR 551 at p. 465 (Oct. 27, 2015).
12. Reuters, "High-Frequency Trader Convicted in First U.S. Spoofing Case" (Nov. 4, 2015).
13. See *SEC v. Masri*, 523 F.Supp.2d 361, 367 (S.D.N.Y. 2007).
14. 15 CR 75 (N.D. Ill.).
15. 15 CR 455 (D.N.J.).
16. 938 F.2d 364 (2d Cir. 1991).
17. *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977); see *United States v. Finnerty*, 533 F.3d 143, 149 (2d Cir. 2008). There is Second Circuit authority, however, holding that no false representation or material omission is required for criminal liability for securities fraud under 18 U.S.C. §1348. See *United States v. Mahaffy*, 693 F.3d 113, 125 (2d Cir. 2012). The Coscia court relied upon this authority in rejecting Coscia's motion to dismiss. See *United States v. Mahaffy*, 693 F.3d 113, 125 (2d Cir. 2012).
18. Peter J. Henning, "Conviction Offers Guide to Future 'Spoofing' Cases," The New York Times (Nov. 9, 2015).

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