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Spoofing Is No Joke: Prosecutors Clamp Down on High-Frequency Traders

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On November 3, 2015, an Illinois federal jury convicted Michael Coscia, a high-frequency commodities trader, of six counts of commodities fraud and six counts of spoofing—entering a buy or sell order with the intent to cancel before the order's execution.[1] Coscia's conviction was the first under the criminal anti-spoofing provisions added to the Commodity Exchange Act (CEA) by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. In the press release touting its victory, the prosecution announced: "The jury's verdict exemplifies the reason we created the Securities and Commodities Fraud Section in Chicago, which will continue to criminally prosecute these types of violations." High-frequency traders should take note that the conviction on all six counts of spoofing charged in Coscia's case may embolden prosecutors across the nation to pursue other spoofing cases with vigor. Given the real possibility of a felony indictment and conviction for spoofing—the latter of which exposes a defendant to imprisonment for up to ten years and significant monetary fines—high-frequency traders should carefully evaluate their strategies and conduct.[2]

[1] To prove commodities fraud, the government must prove four elements: (1) There was a scheme to defraud any person; (2) the defendant knowingly executed the scheme; (3) the defendant acted with the intent to defraud; and (4) the scheme was in connection with any commodity for future delivery. To prove criminal spoofing, the government must prove three elements: (1) defendant engaged in trading, practices, or conduct, that is spoofing; (2) the defendant did so knowingly; and (3) the spoofing occurred on or subject to the rules of a registered entity.

[2] In July 2013, Coscia and Panther Energy Trading LLC agreed to pay $2.8 million in civil penalties to resolve a lawsuit brought by the CFTC involving the same allegations that formed the basis for the subsequent criminal indictment. The $2.8 million was comprised of a $1.4 million penalty and $1.4 million in disgorgement. The settlement also bans Coscia and Panther Energy Trading, LLC from trading on any CFTC-registered entity for one year. U.S. Commodity Futures Trading Commission,

The Indictment

The indictment against Coscia alleged that he, a former floor trader registered with the Commodity Futures Trading Commission (CFTC), "devised, implemented, and executed a high-frequency trading strategy in which he entered large-volume orders that he intended to immediately cancel before they could be filled by other traders."[3] According to the indictment, this strategy "create[d] a false impression regarding the number of contracts available in the market" and "fraudulently induce[d] other market participants to react to the deceptive market information that he created." Coscia would then apply this strategy "in the opposite direction to immediately obtain a profit by buying future contracts at a lower price than he paid for them, or by selling contracts at a higher price than he paid for them."

To carry out this strategy, Coscia allegedly designed computer programs that would place a "ping order" for one contract "to test the market and ensure that market conditions would allow his fraudulent trading strategy to work." Coscia's trading programs would "place a 'trade order' on one side of the market, intending that the trade order be filled." On the other side of the market, Coscia would place "several layers of 'quote orders,'" to create the illusion of market interest. According to the indictment, the "quote orders" would "typically be the largest orders in the market within three ticks of the best bid or offer price, usually doubling or tripling the total quantity of contracts within the best bid or offer price." Coscia programmed his trading programs to cancel the "quote orders" "within a fraction of a second automatically" and "without regard to market conditions."

The spoofing counts alleged in the indictment focused on six of Coscia's September 2011 transactions in the gold, Euro, soybean meal, soybean oil, British point, and high-grade copper futures markets. Coscia only netted $1,070 from those six transactions. The indictment, however, alleges that Coscia made approximately $1.5 million as a result of his scheme. Each spoofing count carries a maximum sentence of 10 years imprisonment and a $1 million dollar fine. Each count of commodities fraud carries a maximum sentence of 25 years imprisonment and a $250,000 fine.

Spoofing: What Does it Mean?

The anti-spoofing provision of the CEA 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 the intent to cancel the bid or offer before execution)." Knowing violation of the anti-spoofing provision is a felony. In March 2011, the CFTC published the following proposed guidance on spoofing: "orders, modifications, or cancellations will not be classified as 'spoofing' if they were submitted as part of a legitimate, good-faith attempt to consummate a trade." The proposed guidance further stated that "the market context, the person's pattern of trading activity (including fill characteristics), and other relevant facts and circumstances" are factors relevant to distinguishing between legitimate trading and spoofing.[4] The proposed guidance provided three examples of spoofing:

1. Submitting or cancelling 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; and

3. Submitting or cancelling multiple bids or offers to create an appearance of false market depth.

Press Release, *CFTC Orders Panther Energy Trading LLC and its Principal Michael J. Coscia to Pay $2.8 Million and Bans Them from Trading for One Year, for Spoofing in Numerous Commodity Futures Contracts (July 22, 2013), available at* http://www.cftc.gov/PressRoom/PressReleases/pr6649-13.

[3] Indictment, *United States v. Coscia*, No. 14-CR-00551 (N.D. Ill. Oct. 1, 2014), ECF No. 1 at ¶¶ 1c, 3 (Count One).

[4] Id.

In May of 2013, the CFTC issued its final interpretive guidance on spoofing and added the following as a fourth example thereof: "Submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards."

In an effort to dismiss the six spoofing counts alleged in the indictment, Coscia argued that the anti-spoofing provision of the CEA was unconstitutionally vague because it prohibits a wide range of trading activity without offering any "reasonably ascertainable standard" for separating spoofing from legitimate trading practices such as partial-fill orders (orders larger than necessary to ensure that they obtain a sufficient quantity) or stop-loss orders (orders that are programmed to execute only when the market reaches a certain price).[5] In addition, Coscia argued that as of September 2011, the time of the trades at issue, the CFTC had offered only limited proposed interpretive guidance on the meaning of the term spoofing and that the lack of clear guidance was dispositive of the vagueness inquiry.[6]

Unpersuaded by Coscia's vagueness arguments, the court concluded that at the time he made the six transactions "there was some degree of consensus as to what conduct was included and excluded," namely that a "'spoofing' violation requires that a person intend to cancel a bid or offer before execution ... [L]egitimate, good-faith cancellation of partially filled orders would not violate [the statute]."[7] The court also emphasized the importance of the anti-spoofing provision's "intent to cancel" requirement, which forces the government to prove intent and knowledge, thereby undermining any argument that application of the statute is so unfair it must be invalid.[8] Accepting the allegations in the indictment as true, as the court is required to do at the motion-to-dismiss stage, the court concluded that the allegations of Coscia's intent to cancel—specifically, that he "entered large-volume orders that he intended to immediately cancel before they could be filled by other traders"—distinguished his conduct from legitimate trading practices.[9] For example, the court stated that although "fill-or-kill" orders "must be filled immediately or the entire order is cancelled ... they are not entered with the intent to cancel."[10] Likewise, the court stated that partial-fill orders are "entered with the intent to consummate a trade, not with the intent to cancel the order altogether."[11] The court denied Coscia's motion to dismiss the indictment, and the case proceeded to trial, resulting in Coscia's conviction on all counts charged in the indictment after only one hour of jury deliberations.

What Does This Mean for High-Frequency Traders?

While we do not yet know what sentence Coscia will receive for his convictions (his sentencing hearing is currently scheduled for March 17, 2016), his conviction on all six spoofing counts, by itself, is significant for several reasons.

- **Anticipated Increase in Prosecution of Spoofing Cases.** With the prosecution's victory on all six spoofing counts, further federal prosecution of spoofing cases is to be expected. In fact, British high-speed trader Navinder Singh Sarao was indicted in September 2015 in Chicago on charges of spoofing and is accused of market manipulation that contributed to the trillion-dollar 2010 U.S. flash crash. In December, the SEC filed civil charges against three Chicago traders and alleged that the trio

[5] Memorandum of Law in Support of Defendant's Motion to Dismiss, *United States v. Coscia*, No. 14-CR-00551 (N.D. Ill. Oct. 1, 2014), ECF No. 28 at 22-33.

[6] *Id.* at 30-32.

[7] Memorandum Opinion and Order, *United States v. Coscia*, No. 14-CR-00551 (N.D. Ill. Oct. 1, 2014), ECF No. 36 at 9, quoting 76 Fed. Reg. 14,947.

[8] *Id.* at 11.

[9] *Id.* at 10.

[10] *Id.* at 12

[11] Id.

"mismarked option orders to obtain execution priority and lower fees" and spoofed the market with "non-bona fide orders," which enabled them "to generate liquidity rebates from an options exchange."[12] The verdict against Coscia on all six spoofing counts and the brief jury deliberations may enhance prosecutors' resolve to bring future spoofing cases, despite the relative newness of the CEA's anti-spoofing provision. What facts may make the difference in future cases? The volume of Coscia's canceled orders, along with their size, appear to have been key to proving that Coscia was spoofing. So, too, was the evidence that the algorithm Coscia used in his trading was designed to cancel orders. Although Coscia testified at trial in his own defense (an unusual move) that he "absolutely wanted to fill every order," the jury was unpersuaded and ultimately decided that Coscia's high-speed trades and cancellations were manipulations intended to deceive and defraud other traders.[13]

- **Expanded Use of Technology to Crack Cases.** The SEC's National Exam Analytics Tool (NEAT), software developed by the Quantitative Analytics Unit, is used by the SEC to review large, complex trade blotters and match them against external events to detect front running, cross trading, insider trading, and other trading issues. In addition, the SEC has hired quantitative analysts who are capable of breaking code and reverse-engineering algorithms; these "quant" experts helped crack the Athena Capital Research case. NEAT will help the SEC detect potentially fraudulent or unusual market activity—such as spoofing—and the SEC's quantitative capabilities may help the SEC prove its cases. In addition, the close working relationship between the SEC and the Department of Justice may result in more criminal indictments based on the SEC's new tools.
- **The Importance of the CFTC's Final Interpretative Guidance.** It is likely that the legal landscape regarding spoofing will be developed through an appeal of the vagueness challenge in this case. Until the body of law interpreting the anti-spoofing provision of the CEA grows, high-frequency traders should look to the four examples set forth in the CFTC's guidance, quoted above, as a marker of what constitutes spoofing. While the four examples are not a comprehensive list of what constitutes spoofing in the context of the CEA, they are helpful reference points for evaluating high-frequency trading strategies and assessing the risk of liability under the CEA's criminal anti-spoofing provisions. High-speed traders may also want to consider this concise warning from CFTC Chair Timothy G. Massad at the FIA Expo the day after Coscia's conviction: "If they're entering a lot of orders without the intention to consummate, then they should go talk to their lawyers."[14]

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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[12] The recent case against the three Chicago traders is one of a number of spoofing cases brought by the SEC against high-frequency traders. The SEC and the CFTC continue to express interest in pursuing spoofing cases against high-frequency traders.

[13] *The New York Times*, Dealbook, Conviction Offers Guide to Future "Spoofing" Cases (Nov. 9, 2015),

[14] Id.

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