'Spoofing' – A New, Amorphous Crime with Domestic & International Implications for Traders

By Gregory Mocek & Jonathan Flynn

A RECENT CRIMINAL conviction in Illinois will likely influence and encourage future criminal and civil cases under the Commodity Exchange Act involving certain types of manual and high-frequency trading in commodity markets.

According to the lore (which may still be in the process of being written), the term 'spoof' originates in a game invented by a British comedian in the late 1800s that involves a small group of people – possibly gathered in a pub – holding coins. The person who correctly guesses the total number of coins (and successfully deceives his opponents from doing the same) wins, and keeping with tradition, buys the next round from the spoils.[3] Like a form of simplified poker, successful 'spoofers' must be able to read the faces of their opponents, while simultaneously sending out false signals to disguise the contents of their own hands.

A century later, in July of 2010, the word entered the vocabulary of the commodities and derivatives world when Congress added disruptive trading practices to the list of specific and aggressive new federal laws that prohibit particular types of trading enumerated in the Commodity Exchange Act (CEA). The prohibition was one of several amendments contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) that significantly expanded the authority of the Commodity Futures Trading Commission (CFTC) and the Department of Justice (DOJ) to prosecute manipulative, fraudulent, and disruptive conduct in the commodities and derivatives markets. Like many enforcement-related provisions of the CEA, the anti-spoofing provision can be used by the CFTC as the basis for a civil action and by the DOJ in a criminal prosecution – the primary difference being that the burden of proof is higher in criminal cases.

Under the technical definition, pursuant to CEA section 4c(a)(5), it is now unlawful for any person to engage in 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)."[4] The quotation marks surrounding 'spoofing' are a part of the statutory text and reflect the novelty and potentially ambiguous nature of this new crime. In fact, prior to implementation and soon after the anti-spoofing provision became law, many market participants and experts voiced concern about the vagueness of the statute and questioned whether, given such vagueness, the prohibition could be successfully enforced.[5] There were other more practical unanswered questions, for example:

- What is 'spoofing' and how does it differ from legitimate market activity, such as market-making or placing orders that, by definition, are not intended to be executed under certain circumstances (e.g., stop-loss orders, partial fill orders)?
- What activity is "of the character of [spoofing]" or "commonly known to the trade as [spoofing]"?
- What constitutes credible evidence of intent to cancel bids or offers before execution?
- How will a jury handle the technical details and complexities of spoofing cases?
- Can a person be found to have *intentionally* violated the anti-spoofing provision if he or she provides a plausible alternative explanation for his or her cancelled trades (e.g., I cancelled the orders because I changed my mind)?

Spoof (\spüf\), a noun or transitive verb:

1. Hoax or trick, as in a trick played on someone as a joke.[1]
2. A form of disruptive trading prohibited under the Commodity Exchange Act in which individual commodities and derivatives traders are held criminally or civilly liable for engaging in a form of deceptive trading.[2]

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A recent jury trial in Chicago made headlines as the most publicized trade practice futures trading case in recent history. The proceeding was the result of evidence that was presented in front of a grand jury and eventually made its way into the Illinois federal courthouse as ***United States of America v. Michael Coscia***, with a trader that fought diligently

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to stay out of jail for trading in a manner that the government labelled as spoofing. Given the neoteric ethos of the law and the issues it presented, the defendant was not the only one on trial. The futures industry watched closely as the viability of the new law was placed under the microscope for the first time since its enactment.

Though the CFTC previously settled several civil cases involving spoofing, including claims against Mr. Coscia and his company, Panther Energy Trading LLC, like most settlements, the orders that accompanied them provided little in the way of meaningful guidance for market participants on trading activity that is legitimate versus illegal. Similarly, guidance published by the CFTC and exchanges offered some clarity on several issues, but tended to perpetuate ambiguity on how the anti-spoofing provision would be applied in a trading environment that must have practical and clear standards. For example, the CFTC and exchanges stated that entering typical stop-loss orders would not be considered spoofing because although the trader placing the order may *hope* that it is never executed (i.e., hope that the market does not move significantly out of his or her favour), and the trader's *intent* when placing the order is to execute the trade if and when certain specified conditions are realized.[6] However, on more general issues, the guidance appears to be designed to establish a broad definition of spoofing that also includes various forms of manipulation, rather than defining specific types of conduct that is otherwise prohibited.

I. The Coscia Litigation

A. Prologue

The Coscia litigation followed an unusual course. On July 22, 2013, the CFTC and CME simultaneously announced settlements with Coscia and Panther Energy Trading in which Coscia agreed to pay $2.2 million in penalties and $1.4 million in disgorgement, in addition to a 1-year trading ban.[7]

Then, more than 14 months later, the Securities and Commodities Fraud Section of the U.S. Attorney's Office in Chicago filed criminal charges against Coscia for the same activity that was investigated and settled by the CFTC and CME.[8] Although it is increasingly common for the CFTC and DOJ to pursue parallel civil and criminal investigations based on the same underlying activity, it is still somewhat unusual for criminal authorities to resurrect, after more than a year, a matter that was presumed settled by the exchange and the federal regulator.

B. The Trial

The DOJ's indictment included six counts of spoofing and six counts of commodities fraud under 18 U.S.C. §1348.[9] The six counts of spoofing revealed the first criminal prosecution of the new anti-spoofing provision that was added to the CEA as part of the Dodd-Frank Act in 2010. The provision went into force on July 15, 2011. Despite the apparent complexity of the subject matter, both the prosecution and the defence tried to present the case as a simple question of right and wrong.

The DOJ alleged that Coscia reaped well over $1 million in illegal profits by engaging in thousands of spoof trades using a variety of different futures contracts traded on CME and ICE Futures Europe, including gold, copper, euros, British pounds, soybean oil, and soybean meal.[10] Nevertheless, the indictment itself focused on just six examples of spoofing conduct occurring between September 1 and September 28, 2011.[11] According to the testimony, Coscia's profit from these trades was only about $1,000.[12] This figure was supported by a trader at a well-known hedge fund that is a prominent supporter of high-frequency trading who testified that his firm was likely one of Coscia's victims (though he estimated that its loses were only in the area of $480).[13] Notably, during the seven-day trial, prosecutors emphasized that the dollar value associated with the six instances was irrelevant and that the jury should focus instead on the pattern of activity and the standard set by the statute.

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To support their case, the prosecution relied on testimony from the programmer that Coscia hired to develop his trading algorithm. The programmer testified that Coscia directed him to design a trading system that would "pump up the market" by placing a large volume of "quote" orders several ticks away from the best bid or offer to generate a favourable price movement.[14] A separate system would place smaller orders on the other side of the market to capitalize on the small, but generally predictable, movement in price. Once these orders were executed, the "quote" orders were cancelled, as Coscia had always allegedly intended. According to the DOJ, the system made sense because it was simple, effective, and could be repeated thousands of times.

In his defence, Coscia attempted to introduce doubt into the

prosecution's claims that his "quote" orders were nothing more than a high-tech bait-and-switch and intended to be cancelled before they could be executed. Ultimately, Coscia took the stand, testifying under oath that he intended to trade on every order that he placed.[15] Perhaps in rebuttal to other high-frequency trading firms that were his alleged victims, he added that his trading systems deceived no one.[16] On the contrary, Coscia tried to convince the jury that by creating momentarily lopsided markets, his trading actually "improved the market for everyone" by creating liquidity and promoting trading activity.[17] An expert witness for Coscia agreed, testifying that using a trading strategy of unbalanced orders was common in the market-making business. Naturally, it was reported that, Coscia seemed to grow impatient with the repeated questioning of his intent. In one such moment of apparent frustration, Coscia seemed to turn to the complexity of the market for cover, exclaiming "I'm not dealing hot dogs, I'm dealing futures!" [18]

In closing, Coscia's attorneys retreated from the technical aspects of the futures markets and attempted to reframe the debate in simpler terms with a list of 15 reasons why the jury should doubt that Coscia intended to spoof the market.[19] The list was comprised of facts that were not really in dispute, including that large orders are lawful, that Coscia executed his larger orders more often than other high-frequency traders, and that regardless of whether each order was actually executed every order that Coscia placed could have been traded against. If the jury concluded that these facts created reasonable doubt – facts that could be true in many spoofing cases – the current message to prosecutors would be that spoofing cases are nearly impossible to prosecute. Nevertheless, Coscia's jury was unconvinced.[20] The well-crafted arguments by Coscia's lawyers failed to create reasonable doubt for the 12 jurors.

C. Consequences

On November 3, 2015, after just over an hour of deliberation, the jury reduced a technical and complex case to a simple and consistent verdict – guilty on all 12 counts for spoofing and commodities fraud.[21] The case answered a number of open questions for the government. Because the Coscia trial tested some of the arguments that are central to spoofing cases, it provided a playbook for the CFTC and DOJ to follow in future cases.

Among other things, we now know:

- The government will conclude that it now can successfully prosecute criminal spoofing cases and hold individuals accountable for deceptive trading using the new, easier to prove anti-spoofing provision.
- Although it flies in the face of reasonableness, plausible alternative explanations for why a trader may have cancelled orders before execution may not provide a satisfactory defence, even in criminal cases where the burden of proof is highest.
- While it may be difficult to define activity that is "of the character of spoofing" or "commonly known to the trade as spoofing," the statute provides a core definition of spoofing using plain language – bidding or offering with the intent to cancel the bid or offer before execution – that the Chicago jury considered to be unambiguous. Some officials will now use this case as the poster child for support of the supposition that juries are capable of understanding patterns of complex trading and identifying when spoofing occurs.
- In addition to emails, instant messages, audio recordings, and historical trading data (which are often the basis for claims under the CEA), a trader's intent to engage in spoofing can arguably be inferred largely from less conventional sources, including the code used to program trading algorithms, and testimony from programmers and other non-trading personnel who may not even be familiar with the rules and practices applicable to the commodities and derivatives markets.

One additional aspect of the Coscia trial that is noteworthy involves something that was *not* argued by the prosecution. In his motion to dismiss, filed prior to trial, Coscia focused on the apparent lack of a common definition of spoofing, echoing comments made by many market participants that the anti-spoofing provision was so "hopelessly vague" that the DOJ's charges were unconstitutional.[22] Though the federal judge rejected Coscia's vagueness argument,[23] the prosecution ultimately responded by narrowing and refining its argument. Rather than addressing whether Coscia's activity was merely "of the character of" spoofing or was activity that was "commonly known to the trade" as spoofing, the government decided to argue simply that the conduct was *actual* spoofing as defined by the statute — "bidding or offering with the intent to cancel the bid or offer before execution."[24] With one exception, this rendered irrelevant, for purposes of the trial, any arguments or evidence regarding the lack of clarity behind the statute.[25]

This strategic decision by the government prosecutors is an important point because, as noted above, the CFTC and exchanges struggled publicly to provide guidance on this subject. The CFTC did not publish its final interpretive guidance regarding spoofing until May 28, 2013, and then only after an aborted attempt to draft rules on the subject that featured CFTC Commissioners commenting publicly about the vagueness of the operative language.[26] The CME published its disruptive practices rules even later on August 29, 2014.[27]

The CFTC and CME guidance was, therefore, controversial and late, arriving well after the effective date of the anti-spoofing provision and the conduct at issue in this case. By focusing instead on *actual* spoofing and the core definition provided in the statute, the DOJ eliminated from the trial a sideshow of distracting legal issues that could have undermined the simplicity and success of its argument.

Footnotes:

1. Spoof, Oxford Dictionaries, www.oxforddictionaries.com/us/definition/american_english/spoof (last visited Nov. 16, 2015).
2. This is the author's definition of 'spoofing'. For the reasons described in this article, we think that this definition is now the most important one for this little-understood term.
3. Spoof (game), WIKIPEDIA, https://en.wikipedia.org/wiki/Spoof_(game) (last visited Nov. 16, 2015).
4. CEA section 4c(a)(5)(C).
5. CFTC, Staff Roundtable on Disruptive Trading Practices (Dec. 2, 2010), www.cftc.gov/idc/groups/public/@swaps/documents/dfsubmission/dfsubmission24_120210-transcri.pdf.
6. CFTC, Q&A – Interpretive Guidance and Policy Statement on Disruptive Practices, www.cftc.gov/idc/groups/public/@newsroom/documents/file/dtpinterpretiveorder_qa.pdf; CME, CBOT, NYMEX & COMEX, CME Group RA1405-5 (Aug. 29, 2014), www.cmegroup.com/tools-information/lookups/advisories/market-regulation/files/RA1405-5.pdf.
7. In 2013, Coscia also settled related charges brought by the U.K. Financial Conduct Authority for approximately $900,000.
8. Indictment, United States v. Sarao, No. 15 CR 75 (Sept. 2, 2015).
9. Id.
10. Id.; In re Panther Energy Trading LLC, CFTC Docket No. 13-26, at 3 (July 22, 2013), available at www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfpantherorder072213.pdf; Brian Louis, Janan Hanna, Spoofing Defendant Coscia Says He Intended to Trade Orders, BLOOMBERGBUSINESS (Oct. 29, 2015 7:18 PM EDT), www.bloomberg.com/news/articles/2015-10-29/spoofing-defendant-coscia-takes-stand-as-prosecution-rests-igcm9s0g.
11. Id.
12. Brian Louis, Janan Hanna, Swift Guilty Verdict in Spoofing Trial May Fuel New Prosecution in U.S., BLOOMBERGBUSINESS (Nov. 3, 2015 10:27 PM EST), www.bloomberg.com/news/articles/2015-11-03/commodities-trader-coscia-found-guilty-in-first-spoofing-trial.
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14. Mark Melin, Coscia Guilty in Spoofing Trial As Prosecutors Look to Sarao, ValueWalk (Nov. 4, 2015 1:18 PM), www.valuewalk.com/2015/11/spoofing-coscia/.
15. Kim Janssen, Spoofing Trial Gets Testy: 'I'm not dealing hot dogs, I'm dealing futures!', CHICAGO TRIBUNE, Oct. 30, 2015, www.chicagotribune.com/business/ct-spoofing-trial-1031-biz-20151030-story.html.
16. Alleged CME 'Spoofer' Testifies: 'I didn't move any market', CHICAGO TRIBUNE, Oct. 29, 2015, www.chicagotribune.com/business/ct-spoofing-trial-1030-biz-20151029-story.html
17. Tom Polansek, 'Spoofing' defendant was biggest trader in markets, U.S. jury hears, REUTERS (Oct. 30, 2015 3:02 PM EDT), www.reuters.com/article/2015/10/30/us-court-spoofing-trader-idUSKCN0SO2K520151030#FgBJhGpZ6s9Qs5Tv.97
18. Kim Janssen, Spoofing Trial Gets Testy: 'I'm not dealing hot dogs, I'm dealing futures!', CHICAGO TRIBUNE, Oct. 30, 2015, www.chicagotribune.com/business/ct-spoofing-trial-1031-biz-20151030-story.html.
19. Jon Seidel, Brooklyn Native Found Guilty in 'Spoofing' Case in Chicago, CHICAGO SUNT-TIMES, Nov. 3, 2015, http://chicago.suntimes.com/business/7/71/1070101/brooklyn-native-found-guilty-spoofing-case-chicago
20. Brian Louis, Janan Hanna, Swift Guilty Verdict in Spoofing Trial May Fuel New Prosecution in U.S., BLOOMBERGBUSINESS (Nov. 3, 2015 10:27 PM EST), www.bloomberg.com/news/articles/2015-11-03/commodities-trader-coscia-found-guilty-in-first-spoofing-trial.
21. Philip Stafford, Lindsay Whipp, Gregory Meyer, US Trader Found Guilty in Landmark 'Spoofing' Case, CNBC (Nov. 4, 2015), www.cnbc.com/2015/11/04/.
22. See generally, Motion to Dismiss, U.S. v. Coscia, No. 14 CR 551 (Dec. 15, 2014).
23. See generally, Memorandum Opinion and Order, U.S. v. Coscia, No. 14 CR 551, (Apr. 16, 2015).
24. Government's Consolidated Motions in Limine, U.S. v. Coscia, No. 14 CR 551 (Oct. 5, 2015); CEA section 4c(a)(5).
25 The exception was that the court allowed Coscia to use other rules and regulations in the industry as evidence that his conduct was permissible; Memorandum Opinion and Order at 2-3, U.S. v. Coscia, No. 14 CR 551 (Oct. 19, 2015), however, Coscia's defense did not appear to rely heavily on such material.
26. Antidisruptive Practices Authority, 78 Fed. Reg. 31890 (May 28, 2013).
27. CME, CBOT, NYMEX & COMEX, CME Group RA1405-5 (August 29, 2014), www.cmegroup.com/tools-information/lookups/advisories/market-regulation/files/RA1405-5.pdf.
28. Id.
29. 18 U.S.C. § 1348.
30. CEA section 9(a)(2).

D. What is Next?

Coscia's sentencing hearing is scheduled for March 17, 2016.[28] Each of the six counts of commodities fraud carries a maximum sentence of 25 years in prison, plus a $250,000 fine.[29] The spoofing counts each carry a maximum sentence of 10 years in prison, plus a $1 million fine.[30]

The Coscia verdict is a cause of concern for all commodities and derivatives market participants. Spoofing creates a new source of trading risk. Given the continued spotlight on alleged misconduct involving the financial markets (and new focus on individual accountability), commodities and derivatives traders and their firms need to take this risk seriously – even though the activity may appear to be inconsequential or something that only pertains to niche algorithmic traders.

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The reality is that every trader is potentially vulnerable to a post-facto allegation that he or she intended to cancel his or her bids or offers before they were executed. This reality should continue to make corporations, algorithmic trading firms, and traders anxious over the next few years. •

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