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Part 2 - Recent Enforcement Trends In Commodity Markets

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Last fall, Aitan Goelman – the Director of Enforcement for the ***Commodity Futures Trading Commission*** – made two interesting points that appear to be indicative of a couple of enforcement trends. Specifically, he stated that: (i) real deterrent of market manipulation requires putting people in jail; and (ii) the CFTC is going to start trying cases before Administrative Law Judges. At a minimum, these two points demonstrate the beat cop's resolve to triage all available resources in order to ensure the sanctity of the swaps and futures markets. At the outside, they define a troubling scenario in which administrative law judges with no trading experience will determine whether complex trading was or was not for legitimate purposes.

Below, we examine "spoofing" For information on administrative law judges, see the first blog post in this series.

The road to real deterrence of spoofing

One of the most recent enforcement "trends," in terms of market manipulation, relates to "spoofing." ***Spoofing*** is generally understood as putting orders on (either buy or sell) for the sole purpose of manipulating the price of a future. None of the guidance regarding alleged spoofing clearly defines what trading activity is or is not improper. Instead, whether trading activity is illegal turns on a market participant's subjective intent when placing (and later canceling) the questioned trade. As a result, initial prosecutions – the first of which is occurring now – will include novel theories and battles of experts. Such early cases will define whether new spoofing rules and laws will have true *in terrorem* impact or be a toothless tiger.

In commodity markets, spoofing has received increased scrutiny – in the form of a Market Regulation Advisory Notice from the CME Group, and a FAQ from ICE Futures U.S. – in the wake of Michael Lewis' book, *Flash Boys.* (Jan. 2015). The markets' guidance actually highlights the difficulty of separating spoofing from legitimate market activity. The CME's Advisory Notice, for example, makes it plain that the question of determining "whether the market participant's ***intent*** was to affect a price rather than to change his position" is integral to ascertaining whether trading is or is not manipulative. CME Group Adv. Not. RA1405-5 at 3.

Of course, the CFTC certainly was tuned-in to spoofing before Michael Lewis alerted the general population to high-speed traders apparently market-manipulating activity in *Flash Boys.* Indeed, Section 747 of the Dodd-Frank Act made it plain that people cannot intentionally manipulate the market by "engag[ing] in any trading, practice, or conduct … 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." 7 U.S.C. § 6c(5)(C). The CFTC also issued interpretive guidance regarding Section 747 in May 2013 (nearly ten months before *Flash Boys* was published), specifically addressing spoofing. Fed. Reg., Vol. 78, No. 102, at 31890 (May 28, 2013).

The CFTC's guidance, too, emphasizes the "know it when you see it" character of trading that is purportedly manipulative. It states, in part, "[a]s with other intent-based violations, the Commission intends to distinguish between legitimate trading and 'spoofing' by evaluating all of the facts and circumstances of each particular case, including a person's trading practices and patterns." *Id.* at 31896.

Regardless of who beat who to the punch, the Securities and Commodities Fraud Section of the United States Attorney's Office for the Northern District of Illinois brought the first ever case under Dodd-Frank's anti-spoofing provision in October 2014. *See, e.g.,* "High Frequency Trader Indicted for Manipulating Futures Market In First Federal Prosecution For Spoofing."[1] In the case, the Government alleges that Michael Coscia, the founder and principle of Panther Energy Trading, LLC, used a high-frequency algorithm to enter and then cancel large-volume orders on the CME Group and ICE Futures Europe markets in order to create the false impression of market activity. Mr. Coscia's alleged layering strategy was purportedly illegal because he entered quotes without any intent to honor them. *Id.* The trend continues as, most recently, Chicago-based 3Red Trading LLC has found itself under investigation for similar practices. *See, e.g.,* Bradley Hope, "As 'Spoof' Trading Persists, Regulators Clamp Down," *The Wall Street Journal* (Feb. 22, 2015).

Because it is an intent-based statute, "spoofing" is perhaps more difficult to prove than it may seem from *Flash Boys* or the face of the Coscia indictment. Indeed, as *The Wall Street Journal* reports – and as Coscia's lawyers are currently arguing in his case – "[s]poofing can be hard to define. There are many legitimate reasons to cancel orders. A trader might cancel after the market heads in an unexpected direction or when a news flash suggests a different trade is in order. Market-making firms continuously adjust and cancel orders as they monitor supply and demand for a particular security." *Id.* The question will be whether traders like Coscia or Igor Oystacher (the principal of 3Red Trading) can posit legitimate market reasons for placing and canceling thousands of trades each day – sometimes milliseconds after placing them.

Coscia's defense seeks to dismiss the indictment against him on the grounds that, among other things, Section 747 was unconstitutionally vague and that all of the regulatory guidance came out after his trading had occurred. *United States v. Coscia*, Case 1:14-cr-00551, Dkt. Nos. 28 & 33, *passim*. The Government, on the other hand, argues that Section 747 is not unconstitutionally vague as to ***Coscia's conduct*** because Coscia allegedly "enter[ed] large orders that he programmed to quickly cancel in order to mislead other traders and move the market in a direction favorable to him." *Id.* at Dkt. No. 31, p. 3. Again, as referenced above, Coscia's real defense (undoubtedly the Court will deny his motion to dismiss) likely will be based on some testimony that there are legitimate reasons to flash orders and cancel them – or that the practice was so commonly allowed by the exchanges that it negated any sort of fraudulent intent Coscia may have had…

Indeed, even if the United States District Court for the Northern District of Illinois deems Section 747 not to be unconstitutionally vague, the argument will still remain that these trading practices appeared to have been accepted for years. At least as it has been reported, high frequency traders have been engaging in spoofing and market accelerating-type practices for years. Many exchanges even paid traders engaging in these practices for “providing liquidity” to their markets. Certainly, until recently, no exchange appears to have claimed the practices were manipulative. And, if the government’s arguments are to be believed, clearly manipulative behavior has been deemed illegal regardless of whether spoofing was a stand-alone violation. *See Coscia,* Dkt. No. 31 at 12 (“Nonetheless, lest this Court be concerned that the commodity futures industry was unaware that defendant’s conduct was unlawful, “spoofing” conduct had been punished for a number of years under different provisions prior to the 2011 conduct alleged in the indictment.” Accordingly, exchanges could have brought cases if they believed the activity in which Coscia allegedly was engaged was, in fact, manipulative.

So, expect the *Coscia* trial and others like it to be loaded with expert testimony. Maybe even exchange enforcement and surveillance personnel will be called to testify about what they saw in trading surveillance and why they did not bring enforcement actions earlier. The trial will certainly set some parameters for market participants – and likely will help determine whether new anti-spoofing provisions have “real deterrent” effect or more guidance will be needed to give them teeth.

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[1] According to public comments by CFTC Chairman Timothy Massad, the criminal case was based on a referral by the CFTC.

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