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Bridging the Week: November 2 - 6 and 9 2015 (Spoofing Conviction; Financial Crimes; CCOs; Tweets and Manipulation)

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Resolutions of criminal actions—including jury verdicts and pleas—highlighted developments in the financial services industry last week. Among these actions were Michael ***Coscia*** being convicted in a widely followed case involving the new ***Dodd-Frank*** provision of law prohibiting spoofing, and two former employees of the New York Federal Reserve Bank pleading guilty to criminal charges in connection with leaks of non-public information. Meanwhile, the Securities and Exchange Commission's Director of Enforcement endeavored to calm chief compliance officers by saying that the agency was not out to get them despite a number of recent SEC enforcement actions against CCOs of investment advisers. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- Jury Convicts Michael Coscia of Commodities Fraud and Spoofing (includes My View, Legal Weeds and Compliance Weeds);
- Alleged Criminal Conduct Snares Multiple Ex-Financial Services and Regulator Defendants in New York;
- SEC Enforcement Director Tells CCOs Not to Worry as Another CCO Named in an SEC Enforcement Action (includes My View);
- CME Group Proposes Changes to Transfer Trade Rules and Issues Position Limit Guidance (includes Compliance Weeds);
- Claims of Disruptive Trading, EFPs and Position Limit Violations Prompt Sanctions by CME Group;
- SEC Sues Individual for False Tweets to Manipulate Prices of Two Stocks; and more.

Jury Convicts Michael Coscia of Commodities Fraud and Spoofing:

After a seven-day trial in Chicago, Michael Coscia was convicted last week of six counts of commodities fraud and six counts of spoofing in connection with his trading activities on CME Group exchanges and ICE Futures Europe from August through October 2011. Mr. Coscia had initially been indicted for such offenses in October 2014.

According to his indictment, during the relevant time, Mr. Coscia utilized two computer-driven algorithmic trading programs that repeatedly placed small buy or sell orders in a market, followed by the rapid placement and retraction of large orders—so called "quote orders"—on the opposite side of his small orders. He supposedly did this in order to deceive the market and help ensure the execution of his small orders at favorable prices.

After the initial small orders were executed, Mr. Coscia would reverse the process—placing new small orders on the opposite side of the market as his initial filled orders and large quote orders on the opposite side of the new small orders. He allegedly traded this way in order to ensure the fills of the new small orders and profits on the overall transaction.

This case marked the first indictment and conviction under the new anti-spoofing provision of relevant law that was added as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.

Previously, the Commodity Futures Trading Commission, the UK Financial Conduct Authority and the Chicago Mercantile Exchange had all brought enforcement proceedings in July 2013 against Mr. Coscia and his trading company Panther Energy Trading LLC, and entered into simultaneous settlements with Mr. Coscia and Panther related to the same conduct, assessing aggregate sanctions in excess of approximately US $3 million and various trading prohibitions. The CME also required disgorgement of US $1.3 million of trading profits.

The jury hearing Mr. Coscia's criminal case took approximately one hour to render a decision. Sentencing is scheduled to occur on March 17, 2016. Mr. Coscia could face 25 years in prison and a US $250,000 fine for each count of commodities fraud, and 10 years in prison and a US $1 million fine for each count of spoofing.

Prior to his trial, Mr. Coscia filed a motion to dismiss his indictment as a matter of law, claiming that the federal law regarding spoofing was "hopelessly vague, and its criminal enforcement would violate [his] right to due process of law." The Court rejected this motion. (Click here for further information)

My View: As I wrote at the time of Mr. Coscia's indictment: "[w]hatever the merits of this action, a major policy concern is the chilling effect the knowledge of impending or likely criminal charges will have on persons eager to settle their exchange or government-driven civil enforcement matters and move on. Here, Mr. Coscia not only paid a substantial penalty for his actions, he disgorged most of his profits and agreed to trading prohibitions—thus substantially impacting his future livelihood. If the purposes of criminal sanctions are to act as a deterrent, punish individuals and encourage the rehabilitation of wrongdoers, it is not clear what the incremental benefit of imposing additional penalties in this criminal action may be. Moreover, it is also not clear how this effectively redundant legal proceeding (albeit a criminal action with the prospect of incarceration) … justifies the expenditure of limited tax dollars—other than to generate dramatic headlines. These musings are not to condone illicit conduct—which should be appropriately punished—but solely to ask: when is enough enough?" With Mr. Coscia's verdict now rendered, what once was just a potentially chilling effect becomes downright cold.

Legal Weeds: The relevant provision of law under which Mr. Coscia was prosecuted prohibits trading activity 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)." It may be abundantly clear what is prohibited by this provision, but by its broad sweep, the provision technically makes illegal relatively ordinary trading conduct that no one – not even the Commodity Futures Trading Commission or any exchange – would likely consider nefarious.

For example, when a trader places a stop loss order, he or she does not intend for the order to be executed, because, presumably that would mean the market is trending in a direction opposite his or her expectation. However, he or she will accept an execution if the conditions of the stop loss order are realized. The CFTC, in its May 28, 2013 *Antidisruptive Practices Authority* guidance (click here to access) seems to acknowledge this dichotomy. According to the CFTC, "a spoofing violation will not occur when the person's intent when cancelling a bid or offer before execution was to cancel such bid or offer as part of a legitimate, good-faith attempt to consummate a trade. Thus the Commission interprets the statute to mean that a legitimate, good-faith cancellation or modification of orders (e.g., partially filled orders or properly placed stop-loss orders) would not violate [the relevant statutory provision]."

CME Group, in its interpretation of its rule related to market disruption, goes even further by suggesting there is a difference between intent and hope when placing an order. According to CME, "[m]arket participants may enter stop orders as a means of minimizing potential losses with the hope that the order will not be triggered. However, it must be the intent of the market participant that the order will be executed if the specified condition is met." (Click here to access CME Group Advisory, RA-1515-5.)

Potentially, every individual that a regulator might seek to prosecute for spoofing, will likely hope that some orders might not be executed, but is likely okay for the orders to be executed if they are — i.e., if the specified market conditions are met!

Moreover, in its Advisory, CME Group also provides a number of other examples where the intent of a trader is not necessarily to have all his or her orders executed at the time of order placement, but the consequence is not deemed impermissible spoofing — e.g., placing a quantity larger than a market participant expects to trade in electronic markets subject to a pro-rata matching algorithm and placing orders at various price levels throughout an order book solely to gain queue position, and subsequently cancelling those orders as markets change.

Unfortunately, the statute prohibiting spoofing simply has it wrong. There is nothing automatically problematic about all spoofing as now defined under applicable law. Deception, to some except, is part of smart trading. No trader knowingly reveals all his or her strategy or intent as part of an order placement. As CME Group wrote in a comment letter to the CFTC about what should be deemed illegal spoofing, it is not the intent to cancel orders before execution that is necessarily problematic, it's "the intent to enter non bona fide orders for the purpose of misleading market participants <u>and</u> exploiting that deception for the spoofing entity's benefit" (emphasis added; click here to access CME letter to CFTC dated January 3, 2011). Spoofing is simply the big circle in the applicable Venn diagram; what should be prohibited is solely a smaller circle within the larger one – a subset.

Until the law is clarified to reflect what truly is problematic, it will embrace both legitimate and illegitimate activity, potentially scare away bona fide trading, and have a deleterious impact on market liquidity, as well as inadvertently to cause some market participants to run afoul of the law for ordinary order placement activity.

Compliance Weeds: In light of recent heightened attention by the Commodity Futures Trading Commission and exchanges to alleged market disruption activities by traders, it is worth recalling that the CFTC takes a broad view of a future commission merchant's duty to supervise all commodity interest accounts "carried, operated, advised or introduced" by a registrant, while the CME Group has a rule that generally states that "[i]f a clearing member has actual or constructive notice of a violation of Exchange rules in connection with the use of Globex by a non-member for which it has authorized a direct connection and the clearing member fails to take appropriate action, the clearing member may be found to have committed an act detrimental to the interest or welfare of the Exchange." ICE Futures U.S. has an equivalent rule. (Click here to access ICE Futures U.S. Rule 27.04(d).) FCMs should consider their potential obligations, if any, under these provisions to monitor for potential disruptive trading activities by clients, as well as how to respond when they may have red flags regarding such conduct.

Alleged Criminal Conduct Snares Multiple Ex-Financial Services and Regulator Defendants in New York:

Four criminal actions against individuals involved in the financial services industry were resolved in New York last week through, in one case, a jury verdict, and in the other cases, plea agreements.

Anthony Allen and Anthony Conti, residents of England, were found guilty by a jury in New York of manipulating the London InterBank Offered Rates for US dollar and Yen benchmark interest rates at various times from mid-2005 through 2011. Both individuals were previously traders for Cooperatieve Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank).

In October 2013, Rabobank itself entered into a deferred prosecution agreement with the US Department of Justice and agreed to pay sanctions of US $325 million as well as also settled civil charges with the Commodity Futures Trading Commission and the UK Financial Conduct Authority for violations related to its LIBOR submissions. The CFTC had charged that Rabobank, "through the acts of certain traders and managers located throughout the world, engaged in hundreds of manipulative acts that undermined the integrity of LIBOR and Euribor."

Mr. Allen, in addition to being a trader for Rabobank, was also its global head of liquidity and finance and the manager of the bank's money market desk in London. Sentencing is scheduled for March 10, 2016.

Separately, as expected, Rohit Bansal, a former employee of Goldman, Sachs & Co and the New York Federal Reserve Bank, and Jason Gross, a former employee of the New York Fed only, pled guilty to charges related to the unauthorized use of non-public confidential information by Mr. Bansal while employed by Goldman which he obtained from Mr. Gross. Mr. Bansal and Mr. Gross are scheduled to be sentenced in early March 2016.

Finally, Michael Oppenheim, a former employee of J.P. Morgan Securities LLC, pled guilty to embezzlement and securities fraud in connection with his theft of US $22 million from investors over a seven-year period. According to the US Attorneys Office in Manhattan, Mr. Oppenheim told his clients he would invest their money in low-risk municipal bonds and sent them fake account statements while using their funds for his personal purposes. Mr. Oppenheim is scheduled to be sentenced on February 15, 2016.

Briefly:

- **SEC Enforcement Director Tells CCOs Not to Worry as Another CCO Named in an SEC Enforcement Action**: Andrew Ceresney, Director of the Division of Enforcement of the Securities and Exchange Commission, said in a speech last week before a group of compliance professionals that concern over recent SEC enforcement cases against chief compliance officers of investment advisers is misplaced. He claimed that the actions "punish misconduct that falls outside the bounds of the work that nearly all of you do on a daily basis; do not involve the exercise of good faith judgments; and are consistent with the partnership we have developed to foster compliance with the laws." According to Mr. Ceresney, the SEC has traditionally brought only three types of cases against CCOs: (1) where CCOs are affirmatively involved in misconduct unrelated to their compliance function; (2) where CCOs obstruct or mislead Commission staff; and (3) "where the CCO has exhibited a wholesale failure to carry out his or her responsibilities." He acknowledged that it was this latter category of cases that has recently engendered criticisms—including from former commissioner Daniel Gallagher and current commissioner Luis Aguilar—in connection with actions against CCOs of certain investment advisers. However, he insisted that these types of cases were far and few between (i.e., only five enforcement actions against individuals with the title of CCO only in the past 12 years) and were justified by egregious facts. Mr. Ceresney's speech was delivered before the 2015 National Society of Compliance Professionals, National Conference. Separately last week, the SEC brought and settled an enforcement action against Fenway Partners, LLC and three of its senior officers, including the co-chief financial officer and CCO. It charged the respondents with failure to disclose conflicts of interest to a fund client and investors regarding transactions involving payments of more than US $20 million to an affiliated company for consulting services, and to one current and a number of former employees for services they rendered while still employed at Fenway Partners. The respondents agreed to pay in excess of US $10 million in aggregate to resolve this matter. This amount will be used to reimburse harmed investors.

My View: Mr. Ceresney's comments on potential CCO liability, as well as the comments of Andrew Donohue, chief of staff of the Securities and Exchange Commission, a few week's ago, are valiant efforts to at least define the very few types of fact patterns that may prompt an SEC enforcement action against a CCO. However, SEC officials must make clear that, at a minimum, the agency will not proceed against CCOs for violations of rules that do not apply to them when the language of the rule is, at best, unclear, and, more objectively, seemingly not applicable at all. Under the relevant provision of the rule under which a number of CCOs recently have been charged, it is the responsibility of an investment adviser to "adopt and implement" written policies and procedures reasonably designed to prevent law and rule violations and to review such policies and procedures at least annually for effectiveness. It is the legal requirement of CCOs solely to administer such policies and procedures. (Click here to access the relevant SEC rule—SEC Rule 275.206(4)-7). As pointed out in the separate statement of former SEC Commissioner Daniel Gallagher to the recent settlement order of Eugene Mason, the CCO of SFX Financial Advisory Management Enterprises, SEC enforcement actions imposing obligations on CCOs not explicitly required by a rule send "a troubling message that CCOs should not take ownership of their firm's compliance policies and procedures, lest they be held accountable for conduct that … is the responsibility of the adviser itself. Or worse, that CCOs should opt for less comprehensive policies and procedures with fewer specified compliance duties to avoid liability when the government plays Monday morning quarterback." (Click here for further background)

- **CME Group Proposes Changes to Transfer Trade Rules and Issues Position Limit Guidance**: CME Group proposed amendments to its rules related to transfer trades to permit futures-style options to be transferred at the original trade price or the most recent settlement price, and to authorize premium-style options to be transferred at the original trade price, the most recent settlement price or a trade price of zero. CME Group expects its new rule to be effective November 20, 2015. Separately, CME Group issued guidance on its rules related to position limits and accountability levels, as well as instructions for applying for an exemption from a position limit. Among other things, the advisory addresses the differences between position limits, position accountability levels and reporting levels; the differences between spot month, second spot month, single month and all months for purposes of position limits and accountability levels and when they go into effect; rules on holding delivery instruments; and rules on when different contracts must be aggregated into one or more base contracts to evaluate position limit compliance. This advisory is scheduled to be effective November 19, 2015.

Compliance Weeds: Beginning October 12, CME Group introduced futures-style options. The principle difference between premium-style and futures-style options is that with premium-style options, premium is calculated at the original trade price and is recognized in a settlement cycle on the day the trade first clears, while with futures-style options, initial margin is assessed against both sides from the initiation of a trade—just like with ordinary futures contracts. As long as a premium-style options contract remains open, the current market value of the option is subtracted in the case of a long option and added in the case of a short option, to determine initial margin requirements. For a futures-style option, after the initial trade event, the option is daily marked to market and variation margin is paid or collected just like with a futures contract. The first futures style options contract on CME Group involved a futures-style option on NYMEX Brent Crude Oil futures. (Click here for further details on the clearing process for futures-style options on CME Group.)

- **Claims of Disruptive Trading, EFPs and Position Limit Violations Prompt Sanctions by CME Group**: CME Group business conduct committees authorized the filing and settlement of a number of actions involving violations of prohibitions against disruptive practices and exchange requirements regarding exchange for physicals and positions limits. In two actions, Chicago Board of Trade BCCs fined Matthew Garber, an exchange member, US $60,000 in total for engaging in layering type activity involving larger size orders of Soybean futures contracts to effectuate small-sized orders on the opposite side of the market, and for entering orders in various agricultural futures during Globex pre-open sessions “that were not made in good faith for the purpose of executing bona fide transactions.” Mr. Garber agreed to the fines to settle these matters, as well as a suspension from trading CME Group products for 35 days spread over two time periods. Separately, Michigan Agricultural Commodities, Inc., a non-member, agreed to pay a fine of US $30,000 to resolve charges that it entered into eight purported EFP transactions between September 2012 and September 2013 without transferring a physical position. Finally, Quadra Commodities SA, a non-member, agreed to pay a fine of US $40,000 for holding positions in excess of spot month position limits in soybeans on June 27 and 28, 2013, and for endeavoring to resolve its position limits issues through EFPs – two of which were non-bona fide for lacking proper documentation.

- **SEC Sues Individual for False Tweets to Manipulate Prices of Two Stocks**: The Securities and Exchange Commission filed an enforcement action in a federal court in California against James Craig, a Scottish national, for using tweets to manipulate the price of two stocks. According to the SEC, on two consecutive days in January 2013, Mr. Craig disseminated “phony tweets” regarding two publicly traded companies—Audience, Inc., a technology company, and Sarepta Therapeutics, Inc., a biopharmaceutical company—from accounts designed to appear like bona fide securities research firms.

Both tweets falsely publicized detrimental news about pending regulatory issues involving the companies. In both cases, the volume of the stock increased and the price fell, and Mr. Craig tried to profit from the price decline, claimed the SEC. However, said the SEC, “[h]e waited too long each time to trade the stock” and only profited US $100 from his activity. However, “Craig’s conduct … caused harm to U.S. markets and investors by triggering significant stock price drops which undermine investor confidence,” claimed the SEC. The SEC seeks to bar Mr. Craig from future violations, and to assess a penalty and disgorgement.

And more briefly:

- **CFTC Chairman Says Agency Working to Improve Swap Data Reporting**: Timothy Massad, Chairman of the Commodity Futures Trading Commission, told an audience at the 31st FIA Futures and Options Expo in Chicago last week that the CFTC will soon issue proposals to better refine what information should be reported to swap data repositories and how it should be reported. According to Mr. Massad, there is currently a lack of standardization in how many fields of data are reported, how information is reported to SDRs and how SDRs report information to the CFTC. Mr. Massad also suggested that, sometime next year, the CFTC would make a proposal to empower SDRs to validate the completeness and accuracy of swap data it receives, and hold SDRs accountable “for the manner in which they collect, compile and report the data they receive.” Mr. Massad also indicated that CFTC staff will recommend that the Commission eliminate its *Index Investment Data* report and that dealers and traders no longer be required to provide data for this report.

- **ESMA Consults on Indirect Clearing**: The European Securities and Markets Authority issued a consultation paper to, among other things, solicit views on what type of protective accounts should be established by clearing members to afford their s0-called indirect clients the maximum protection of their cleared over-the-counter and exchange-traded derivatives while avoiding the operational burden of requiring individual segregated accounts. (Indirect clients are clients of clearing members’ direct broker or bank clients.) Comments are due by December 17, 2015.

- **Another Bank Fined for Sanctions Evasion**: Deutsche Bank AG and Deutsche Bank AG New York Branch agreed to pay US $258 million to resolve allegations by the New York State Department of Financial Services that it used “non-transparent ways” to help facilitate US dollar payments to financial institutions and other entities from Iran, Libya, Syria, Burma and the Sudan, which were subject to US economic sanctions at the time. According to NYSDFS the bank engaged in more than 27,200 prohibited transactions valued at over US $10.86 billion from at least 1999 through 2006. Five regulators, including NYDFS, settled charges last month against Credit Agricole S.A. and Credit Agricole Corporate & Investment Bank for also allegedly engaging in prohibited transactions with countries and entities subject to US financial sanctions between 2003 and 2008. (Click here for additional details)

- **Canadian Regulators Also Float Crowdfunding Proposal**: Securities regulators in five Canadian provinces issued final measures to promote capital raising through crowdfunding by authorizing a crowdfunding prospectus exemption and a registration framework for funding portals. Similar recently adopted US rules, the Canadian rules also include investment limits based on investors’ income and financial resources. The five provinces are Manitoba, New Brunswick, Nova Scotia, Ontario and Quebec. (Click here for background)

- **FCA Consults on Implementation of Market Abuse Regulation**: The UK Financial Conduct Authority is seeking comments on proposed guidance (amendments to the FCA's Handbook) regarding the European Union's Market Abuse Regulation, scheduled to be effective in Europe on July 3, 2016. The areas the FCA is seeking input on are limited because the MAR applies to the UK without the need for any implementing regulation. However, the FCA seeks input on discrete elements where it has alternative options for implementation—one involves potential delays in disclosure by an issuer of certain inside information that might be necessary to ensure investors are not misled, and one involves the public disclosure of all transactions in issuer shares or debt instruments by certain senior mangers. The FCA also seeks views on its proposed approach to amending its Handbook to conform with MAR. Comments are due by February 4, 2016. MAR—which became law in Europe in July 2014—articulates conduct that constitutes market abuse, including insider dealing and market manipulation.

- **NFA Publishes a Regulatory Guide for Forex Transactions**: The National Futures Association issued an updated regulatory guide for Forex transactions to reflect, among other things, new requirements for Forex Dealer Members pertaining to chief compliance officers and risk management programs (including customer disclosures), and new capital and security deposit requirements.

- **2015 Enforcement Results Highlighted by CFTC**: The Commodity Futures Trading Commission issued a summary of enforcement actions it commenced during fiscal year 2015 and noted that the US $3.144 billion in sanctions assessed against respondents was a record. The CFTC pointed out that its actions included a number of actions enforcing new prohibitions and requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Action, including prohibitions against spoofing, engaging in deceptive devices or contrivances, and swaps reporting and supervision obligations.

- **CPOs Are Reminded of Their Ps and Qs – and Rs Too – While CTAs Are Helped With Their PR Only**: The Division of Swap Dealer and Intermediary Oversight of the Commodity Futures Trading Commission issued *Frequently Asked Questions* regarding CFTC Forms PQR and Form PR. CPOs are required to file Form PQR each quarter to provide the National Futures Association information about their operations and the operations of pools they operate. Commodity Trading Advisers are similarly required to file Form PR each quarter similarly to provide NFA information about themselves, their trading programs, the pool assets it directs and principal-carrying broker relationships, among other information.

- **Block Trade No-Action Extended for SEFs**: The Division of Market Oversight of the Commodity Futures Trading Commission has extended the expiration date of previously granted no-action relief that permits a swap execution facility to provide use of its trading system or platform to facilitate the execution of block trades that are intended to be cleared. Under applicable rules, block trades must occur "away from" a SEF's or designated contract market's trading system or platform. The relief allows SEFs to help futures commission merchants meet their obligation to pre-screen certain swaps orders to ensure their compliance with risk-based limits. DMO's no-action relief expires on November 15, 2016.

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