Schulte Roth&Zabel

Alert

'Spoofing' Conviction Upheld: Implications for Private Fund Managers and Algorithmic Traders

August 11, 2017

On August 7, the U.S. Court of Appeals for the Seventh Circuit unanimously upheld the first-ever criminal conviction under the anti-spoofing provision of the Commodity Exchange Act.[1] In doing so, the court rejected arguments by the defendant, high-frequency commodities trader Michael Coscia, that the anti-spoofing provision is unconstitutionally vague and that the evidence was insufficient to support his conviction. As the first appellate court to address these arguments, the decision clears the path for the government to continue its efforts to pursue spoofing claims, particularly in the context of algorithmic and high-frequency trading.

This decision is an important one for private fund managers and other advisers, particularly managers that utilize algorithms or other systematic trading strategies. It makes clear that the push to pursue criminal sanctions for manipulative marketplace conduct is not limited to insider trading or to the securities markets. The *Coscia* decision also shows that courts are increasingly willing to look at the architecture of the code that generates trading instructions to divine a trader's intent. Compliance and other supervisory personnel should consider whether and how these aspects of the *Coscia* decision should be reflected in their regulatory compliance efforts.

Background

"Spoofing" generally entails efforts to affect the price of a stock or commodity through buy or sell orders that the trader has no intention of being executed. Though spoofing takes many forms,[2] it typically involves a trader:

- Placing a large order that is not intended to be executed on one side of the market, away from the market clearing price, and
- Placing a smaller order – which is intended to be executed – on the other side of the order book at a price that is advantageous to the trader, but which would not be executed absent movement in the clearing price.

The large order creates the false appearance of market demand, thus causing the market clearing price to move in the direction of the price at which the small order was placed. This results in the small order

[1] *United States v. Coscia*, No. 16-3017, 2017 WL 3381433 (7th Cir. Aug. 7, 2017).

[2] *See, e.g.*, *In re Behruz Afshar et al.*, Securities Exchange Act Release No. 76546 (Dec. 3, 2015) (spoofing related to generating liquidity rebates); Complaint, *SEC v. LEK Securities Corporation et al.*, 17 CV 1789 (S.D.N.Y. Mar. 10, 2017) (alleging a type of spoofing referred to as "layering").

on the opposite side of the market getting filled at the advantageous price. Having successfully used the larger order to shift the market price, the trader then cancels that large order.

Coscia

In Coscia's case, the government alleged that Coscia employed high-frequency trading algorithms to place large sale or buy orders that drove prices in Coscia's favor, but then canceled the orders before they could be executed. Coscia's orders created price fluctuations that lasted just long enough for him to fill a smaller order at the new price — the entire process took Coscia only a fraction of a second. The government claimed that, over a 10-week period in 2011, Coscia engaged in tens of thousands of acts of spoofing through his trading programs, earning $1.4 million in trading profits. A jury convicted Coscia of violating the anti-spoofing provision of the CEA and of committing commodities fraud, and he was subsequently sentenced to three years' imprisonment.

Coscia argued on appeal that the anti-spoofing provision should be held to be void for vagueness. That provision states that "[i]t shall be 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)."[3] Coscia claimed that this language does not give adequate notice of the proscribed conduct, as the construction of the statute signals a belief that "spoofing" is an established industry term of art when in fact it has no industry definition. The court rejected this argument, finding that the statute's parenthetical ("bidding or offering with the intent to cancel the bid or offer before execution") clearly defines spoofing, rendering any reference to an industry definition irrelevant. When it passed the anti-spoofing provision, therefore, "Congress provided the necessary definition [of spoofing] and, in doing so, put the trading community on notice."

Coscia also argued that, even if the statute gives adequate notice, it encourages arbitrary enforcement, as many high-frequency traders cancel the vast majority of their orders (98 percent) before execution. The court rejected this argument as well, finding that Coscia's "behavior clearly falls within the confines of the conduct prohibited by the statute" and that, as such, "he cannot challenge any allegedly arbitrary enforcement that could hypothetically be suffered by a theoretical legitimate trader." Furthermore, the court found, the statute does not allow for arbitrary enforcement because it only allows for prosecutors to charge a person who has "specific intent to cancel orders at the time they were placed." The court explicitly differentiated between legal trades, such as stop-loss orders and so-called fill-or-kill orders, that are "designed to be executed upon the arrival of *certain subsequent events*" (but that may be cancelled if those events fail to occur), from spoofing, where the government must prove "an intent to cancel the order *at the time it was placed*."

Typically, the most difficult challenge for the government in spoofing cases is to prove that the trader intended to cancel the orders when they were placed. Coscia argued that the government failed to prove that fact beyond a reasonable doubt in his case, but the Seventh Circuit disagreed. In finding that the evidence was sufficient to establish Coscia's intent, the court relied heavily on statistics about Coscia's order cancellation rates and how they compared to rates for other market participants. Specifically, the court cited evidence showing that: (1) Coscia's cancellations represented 96 percent of all Brent oil futures cancellations on the Intercontinental Exchange during the relevant period; (2) only 0.08 percent of Coscia's large orders on the Chicago Mercantile Exchange were filled, versus 35.61

[3] 7 U.S.C. §§ 6c(a)(5).

percent of his small orders; (3) only 0.5 percent of Coscia's large orders on the Intercontinental Exchange were filled; (4) only 0.57 percent of Coscia's large orders stayed on the market for more than one second, in contrast to 65 percent of large orders by other high-frequency traders; and (5) Coscia's order-to-trade ratio was 1,592 percent, in contrast to a range of 91 percent to 264 percent for other market participants. However, the court relied on other evidence as well, and as a result its decision may not support the proposition that a criminal conviction for spoofing can be established by statistical evidence alone.

Of particular note to private fund managers and other algorithmic or systematic traders, the court cited testimony of the architect of Coscia's algorithms that the programs were designed to avoid large orders being filled and that Coscia had asked for the program to act "like a decoy," which would be "[u]sed to pump [the] market." The programs were designed to cancel large orders (1) based on the passage of time (usually measured in milliseconds), (2) following the partial filling of the large orders, or (3) following the complete filling of the small orders – parameters that, according to the court, "suggest[], strongly, fraudulent intent." While "no single piece of evidence necessarily establishes spoofing," the court concluded, "when evaluated in its totality" the evidence allowed a rational jury to find that Coscia placed orders with the intent to cancel them before their execution.

Turning to Coscia's separate conviction for commodities fraud, the Seventh Circuit likewise rejected Coscia's argument that the evidence failed, as a matter of law, to establish that he acted with fraudulent intent. Relying on essentially the same evidence supporting the CEA conviction, the court found that the proof at trial supported the conclusion that Coscia "designed a scheme to pump and deflate the market through the placement of large orders." Coscia's scheme was therefore "deceitful," the court explained, "because, at the time he placed the large orders, he intended to cancel the orders."

Implications

For private fund managers and other advisers, *Coscia* is a reminder that criminal liability for trading activity: (1) is not limited to insider trading and (2) is not limited to trading in securities;[4] criminal liability can be implicated by manipulative activity in the securities, futures and swaps markets. While civil enforcement actions for spoofing and other manipulative activity can be brought by the SEC, the CFTC and the various securities and futures exchanges, those actions are not exclusive remedies: federal prosecutors can and will utilize their criminal enforcement powers when they deem it appropriate. Compliance and supervisory personnel should review their training materials and policies and consider how to reflect *Coscia* and the issues it raises.

Managers should also consider reviewing the extent to which their trade surveillance systems capture and retain records of unfilled and cancelled orders and evaluate how effectively their compliance tools and procedures detect evidence of spoofing.

Private fund managers and other algorithmic or systematic traders should also focus on the fact that the appeals court cited the specifications of the algorithms and code designed by and created for Coscia as evidence of manipulative intent. This aspect of the *Coscia* decision underscores the need for compliance and supervisory personnel to oversee the design and operation of algorithmic and similar automated or

[4] It is also worth noting that, even though the federal securities laws do not contain a specific anti-spoofing provision akin to the provision in the CEA, the criminal fraud statute under which Coscia was convicted (18 U.S.C. § 1348) applies equally to securities fraud and commodities fraud (although it is possible that the "vagueness" argument could be re-asserted in a securities fraud case).

systematic trading models. These personnel should consider how best to ascertain the purpose of each trading model and how to confirm that models are operating in accordance with the stated intent and purpose; in some cases, this may require compliance personnel to rely on personnel with more technical skillsets. To the extent that there is a violation, regulators will likely consider the amount of effort invested in supervising systematic trading when determining sanctions.

The *Coscia* decision likely will embolden the DOJ, SEC, CFTC and other regulators to pursue more spoofing claims, regardless of the forum in which the spoofing occurred.

Authored by Brian T. Daly, Gary Stein, Peter H. White, Jacob Preiserowicz, Jeffrey F. Robertson and Bayard P. Brown.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Schulte Roth&Zabel
New York | Washington DC | London
www.srz.com