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'Spoofing' Prosecutions: The DOJ's Approach

In recent years, DOJ has aggressively pursued spoofing cases under the wire fraud statute and 2020 saw significant developments in this area, including conviction after trial of two commodities traders in September 2020.

By **Jessica Masella and Jonathan Haray** | April 02, 2021

Trading in commodities or securities has come a long way from the days of Dan Ackroyd and Eddie Murphy shouting out orders for orange juice futures on the trading floor in the 1983 film "Trading Places." Few exchanges now have pit trading at all and over 90% of securities trades happen through electronic trading platforms. The beginning of electronic exchanges led to the emergence of high-frequency trading, or HFT. HFT is a subset of algorithmic trading, the use of algorithms—preprogrammed electronic instructions—to undertake nearly all parts of the trading process, with computers replacing human beings. HFT traders use these computer algorithms to place and respond to thousands of orders per minute at virtually the speed of light—milliseconds (one thousandth of a second) or even microseconds (one millionth of a second). HFT firms represent roughly 2% of trading firms but are said to account for 73% of all equity bids and orders volume. At its simplest, HFT technologies allow traders to devise arbitrage strategies which compare prices for a given security trading on different exchanges at different pricing, buying the lower and selling the higher and turning a small profit, typically less than a penny per share, but doing so thousands and thousands of times a day.

"Although high-frequency trading has legal applications, it also has increased market susceptibility to certain forms of criminal conduct." *United States v. Coscia*, 866 F.3d 782, 786 (7th Cir. 2017). Notably, the practices of certain HFT traders has brought legislative and enforcement attention to the ill-defined practice known as "spoofing." In a typical spoofing scenario, a trader who wants to buy a certain commodity or stock places an order for the amount he or she wishes to buy, at a price slightly below the current market price, while simultaneously placing *much* larger orders to sell (referred to as "spoof," "phantom," or "trick" orders)—signaling to other traders a surplus of supply and creating the illusion of downward market movement. This causes the price to drop until it reaches the level of the (smaller) buy order and it is filled. The trader then cancels the (much larger) sell orders. Once the trader acquires the commodity or stock at the price he or she wanted, he or she can then sell it at a higher price by doing the same thing in reverse, pushing the market price up. Spoofing is designed to trick other traders into buying or selling by sending a misleading signal about supply and demand. While no one questions the need for regulators to root out deceptive conduct that manipulates markets, aggressive enforcement tactics are causing great uncertainty for participants in the markets concerning their own lawful conduct.

The Commodities Exchange Act makes it unlawful for a person to engage in "trading, practice, or conduct [that] … 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)." The statute carries a maximum penalty of 10 years in prison and a $1 million fine. 7 U.S.C. §6c(a)(5). The statute applies to both HFT traders and "manual" traders, but it applies only to commodities as Dodd-Frank did not amend the securities statutes to outlaw spoofing by name in the securities market. Notwithstanding this attempt to define what is prohibited by the statute, it is widely acknowledged that that the term "spoofing" lacks a common meaning in the futures and derivatives industry, and although the CFTC has attempted to clarify Congress's language, the difference between legitimate market activity and illegal spoofing remains, in the view of many, somewhat muddled.

In guidance, the CFTC has stated that the offense of "spoofing" requires proof of an intent to cancel a placed bid or offer before its execution, and not mere recklessness. But common futures trading practices, such as partial fill orders, could readily constitute a "spoofing" violation depending on the trader's subjective state of mind. The CFTC has provided "non-exclusive examples" of what would constitute spoofing, including "submitting or cancelling multiple bids or offers to create an appearance of false market depth" and acting with the "intent to create artificial price movements upwards or downwards." 78 Fed. Reg. 31, 890, 31, 896 (May 28, 2013). Significantly, unlike traditional securities fraud offenses, the offense of spoofing requires no showing of intent to defraud investors or manipulate markets.

The SEC and DOJ have traditionally pursued spoofing cases against securities traders by treating spoofing as a manipulative practice that can violate Exchange Act §§9(a)(2) and 10(b) and §17(a) of the Securities Act. See, e.g., *SEC v. Milrud*, No. 15-cv-00237 (D.N.J. 2015). In recent years, DOJ has also aggressively pursued spoofing cases under the more expansive wire fraud statute and 2020 saw significant developments in this area, including conviction after trial of two commodities traders in September 2020. See *United States v. Bases*, 2020 WL 2557342 (N.D. Ill. May 20, 2020) (denying motion to dismiss indictment charging as wire fraud, inter alia, spoofing in the commodities market). Each of these different approaches carries different challenges for regulators and prosecutors and different risks to traders and, potentially, others who might face secondary liability.

Section 10(b) and Rule 10b-5

One can look at spoofing as a type of "open-market manipulation." Open-market manipulation involves transactions that on their face appear legitimate but are "aimed at deceiving investors as to how other market participants have valued a security." *ATSI Communications v. Shaar Fund*, Ltd., 493 F.3d 87, 100 (2nd Cir. 2007). In *ATSI*, the Second Circuit considered otherwise legal open-market securities transactions (massive short selling designed to drive down the stock price, covered by the conversion of preferred stock into common, also driving down the price). In that context, the "critical question then becomes what activity 'artificially' affects a securities price in a deceptive manner." To be actionable as a manipulative act, an otherwise legal market transaction "must be willfully combined with *something more* to create a false impression of how market participants value a security." 493 F.3d at 100-01 (emphasis added). The *ATSI* court went on to hold that the short-selling activity in that case was not manipulative because it was a commonplace open-market transaction that lacked the "something more." The short sales were real transactions that came with real risk. In that sense, they were not "artificially" affecting the security's price in a deceptive manner, although a short seller obviously hopes for the price to go down. (Other Circuits do not require "something more" and have held otherwise legal open-market trades become illegal manipulation whenever done with the intent of raising or depressing the market price. E.g., *Markowski v. SEC*, 274 F.3d 525, 528 (D.C. Cir. 2001).) At least one commentator has focused on the question of risk to opine that in at least some instances of spoofing (most likely by manual traders) the trader could argue he or she was taking on real risk because the spoof orders *are* real, at-risk orders that were capable of being filled—and in many cases are in fact filled—before the trader can cancel them, making it unclear whether courts in the Second Circuit "would find spoofing a violation of § 10(b) and Rule 10b-5." George Leonardo, "A Legislative Improvement to Anti-Spoofing Enforcement Efforts in the Securities Markets," 3 *Bus. & Fin. L. Rev.* 259, 270 (April 2020

Section 6c(a)(5)

In the commodities context, §6c(a)(5) significantly lowered the bar for successful prosecution of spoofing. Before the enactment of this stand-alone prohibition on spoofing, the CFTC generally had to prove that the defendant had the ability to influence market prices, that an artificial price existed, and that the defendant specifically intended to cause that artificial price. See, e.g., *Di Placido v. CFTC*, 364 Fed App'x 657 (2d. Cir. 2009). Under §6c(a)(5), all the CFTC or DOJ (or private claimants) need to prove is the intent to cancel the entire bid or offer. See *United States v. Coscia*, 177 F. Supp. 3d 1087, 1094 (N.D. Ill. 2016) (jury instruction that government must prove that "at the time Mr. Coscia entered the bid or offer … he intended to cancel the entire bid or offer before it was executed"). This means, among other things, that it is now substantially easier to prosecute a commodities trader than a securities trader for spoofing, because the Securities Exchange Act still requires the showing of specific intent to manipulate market prices for securities. See John Sanders, *Spoofing: A Proposal For Normalizing Divergent Securities and Commodities Futures Regimes*, 51 Wake Forest L. Rev. 517 (2016).

In the first criminal conviction under §6c(a)(5), the defendant Michael Coscia argued on appeal that the statute was vague and subject to arbitrary enforcement—noting that "high-frequency traders cancel 98% of orders before execution" and there was no way to distinguish Coscia's intent from that of other traders who cancel a high proportion of orders. *Coscia*, 866 F.3d at 793. The Seventh Circuit held that the statutory definition was not vague and that Coscia's conduct fell "well within the provision's prohibited conduct: he commissioned a [computer] program designed to pump or deflate the market through the use of large orders that were *specifically designed* to be cancelled if they ever risked actually being filled." 866 F.3d at 794. The Seventh Circuit acknowledged that a high percentage of trades get cancelled and that there are many kinds of "legal trades" that are placed as an order type that contemplates cancellation—such as a "fill or kill" order, which will be cancelled if the entire order is not filled immediately. But the Court held that those were fundamentally different because "legal trades are cancelled only following a condition subsequent" whereas

> Coscia did not place orders with the intent to cancel *under certain circumstances*—he placed orders with the present intent to *always cancel* the large orders. His purpose was not to trade on those orders, but rather to use them to shift the market up or down.

866 F.3d at 795. But what about a trader who puts orders on multiple exchanges, fully intending to cancel all of them once a trade is executed on any one of the exchanges? On what side of the line does that fall? Some have argued that this would fall within §6c(a)(5), but it is far from clear. What about a trader "pinging" the market with small "test" orders at various price levels (in an effort to detect potential large trades), immediately canceling the orders if not instantly filled?

Wire Fraud (18 U.S.C. §1343)

Until very recently, whether DOJ could prosecute spoofing as wire fraud was an untested and somewhat dubious proposition. See *United States v. Radley*, 659 F. Supp. 2d 803, 807, 805 (S.D. Tex. 2009) (traders did not commit fraud by placing multiple stacked bids to drive up prices where the bids "were actually bids, and when they were accepted, defendants actually went through with the transactions," dismissing indictment), aff'd, 632 F.3d 177 (5th Cir. 2011). Two district courts recently definitively approved that theory of prosecution, and in one of these cases the defendants were subsequently convicted by a jury. In the latter case, *United States v. Vorley*, the defendants argued that in contrast to §6c(a)(5) or §1348(1) of the commodities fraud statute, in a wire fraud case the government must prove that the alleged scheme to defraud involved a materially false representation. The government argued that the large spoof orders themselves (which the Indictment referred to as "Fraudulent Orders") communicated false information regarding supply and demand and *implied* a false representation regarding defendants' intent to trade. But, rejoined the defendants, the orders at issue were real orders, at risk of being filled (and often were), and at worse the government was alleging a failure to disclose to other commodities traders the defendants' hope that they could manually cancel those orders at just the right instant. And, of course, under the commodities laws there is no general duty to disclose information material to market price. See 17 C.F.R. §180.1(b); see also *United States v. Weimert*, 819 F.3d 351, 357 (7th Cir. 2016) (omission about a trader's negotiating positions do not violate the wire fraud statute even if they "mislead the other party about the prices and terms they are willing to accept").

Multiple financial industry advocacy groups filed amicus briefs supporting the *Vorley* defendants and voicing concerns that the government's theory, if accepted, could put at risk various common trading strategies and stressing that real orders subject to execution and market risk cannot constitute fraudulent or materially false statements. As to the allegations that the orders at issue communicated false information about supply and demand, what about the commonly used strategy of placing a Hidden Quantity Order (Iceberg Order) in which a trader (assisted by the Exchanges, which permit such orders) makes only a portion of it visible to the market; a trader looking to buy 100 lots of gold will place an order for 100, but make only an order for 10 lots visible to the market. Demand has really been increased by 100 lots, but the market is shown only an increase of 10. Is that wire fraud?

Despite all of these arguments and seemingly difficult questions, the district court showed no hesitancy in denying the motion to dismiss the Indictment. It held that the argument that defendants "could not have misled anyone about supply and demand because their orders were 'real' and 'at-risk' [was] unpersuasive," opining that the defendants confuse the question of whether they placed "*illusory* orders" (which was not alleged) with the question of whether those orders created an "*illusion* of market movement" (which was alleged). "Even 'real' and 'at-risk' orders that create an illusion of market movement can be fraudulent where they inject inaccurate information into the market." *Vorley* Order at 26. The defendants were convicted on Sept. 25, 2020. Just a few months earlier, in May 2020, a second District court followed *Vorley* in denying a motion to dismiss wire fraud charges against two other commodities traders, largely on the same grounds. *United States v. Bases*, 2020 WL 2557342 (N.D. Ill. May 20, 2020).

Much about "spoofing" and its potential to result in criminal or regulatory penalties remains unclear. Recent cases have shown prosecutors and regulators willing to pursue charges against traders, even where the traders' spoofed orders were real and could have been fulfilled in the market. It is clear that there are traps for the unwary here, especially considering that layered on top of these practices are technological advances that make placing (or cancelling) large numbers of trades in the blink of an eye not only possible, but common practice.

Jessica Masella *and* **Jonathan Haray** *are partners in DLA Piper's litigation, arbitration and investigations practice.*