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ALERT MEMORANDUM

Seventh Circuit Upholds First-Ever Federal Spoofing Conviction

August 10, 2017

On August 7, 2017, the U.S. Court of Appeals for the Seventh Circuit unanimously upheld Michael Coscia's conviction on spoofing and commodities fraud charges in *United States v. Coscia*, No. 16-3017 (KFR), 2017 WL 3381433 (7th Cir. Aug. 7, 2017), rejecting Coscia's constitutional challenge to the anti-spoofing statutory provision and finding Coscia's conviction adequately supported by the evidence and testimony adduced at trial.

Coscia was the first trader to be convicted under the anti-spoofing provision of the Commodity Exchange Act ("CEA"), 7 U.S.C. § 6c(a)(5). The Seventh Circuit's decision upholding Coscia's conviction marks the first time a federal appellate court has provided guidance on the scope of the anti-spoofing prohibition, and the Circuit's comprehensive rejection of Coscia's constitutional challenge fortifies the government's ability to conduct additional investigations and prosecutions in an environment of increasingly aggressive regulation of the listed futures and derivatives markets.

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Background

Beginning in 2013, Michael Coscia and his high-frequency trading firm, Panther Energy Trading LLC ("Panther Energy"), became the subject of a series of investigations and civil administrative actions by the U.S. Commodity Futures Trading Commission ("CFTC"), the U.K. Financial Conduct Authority ("FCA"), and the Chicago Mercantile Exchange Group ("CME Group") for alleged "spoofing" activities (i.e., bidding or offering with the intent to cancel the bid or offer before execution) in the futures market across a wide variety of futures contracts, including contracts on energies, metals, interest rates, agricultures, stock indices, and foreign currencies.[1] These administrative actions settled for a total of approximately $4.5 million in penalties and disgorgement.[2] The CFTC also imposed a one-year trading ban on Coscia and Panther Energy.

Coscia was accused of commissioning and then utilizing a pre-programmed computer algorithm to place and quickly cancel bids and offers in a number of futures contracts in the CME Group markets and on the ICE Futures Europe exchanges. The algorithm would first place a relatively small order at one side of the market, at Coscia's desired price. The algorithm then would rapidly place a number of large orders on the opposite side of the market at prices that gradually approached the price of Coscia's initial small order. The court found there was evidence sufficient to support the conclusion that the large orders created the illusion of market movement, leading other market participants to buy or sell the small orders placed by Coscia and his company. Significantly, the algorithm was designed to cancel the large orders before the vast majority were executed. After the small order was filled, Coscia would repeat this process in reverse allegedly to move the market again and reap a profit. The court found the evidence supported that this sophisticated process, which took less than a second to execute, "allowed Mr. Coscia to buy low and sell high in a market artificially distorted by his actions."[3] As a result of this scheme, over the course of three months in 2011 Coscia allegedly profited approximately $1.4 million.

Coscia's Trial & Conviction

On October 1, 2014, following the resolution of these civil and administrative actions, Coscia was indicted by a grand jury in the Northern District of Illinois on six counts of commodities fraud and six counts of spoofing.[4] Coscia unsuccessfully moved to dismiss the indictment. On November 3, 2015, after a seven-day trial, a jury convicted Coscia on all counts.[5]

At the closely-watched trial, the government described the trading mechanism at length and provided testimony largely tracking the conduct outlined in Coscia's settlements with the CFTC and FCA.[6]

In addition to offering testimony describing the purpose and impact of the algorithm and Coscia's trading, the government also introduced evidence regarding Coscia's intent to cancel his large orders prior to execution. At trial, Jeremiah Park, the designer of the two programs Coscia commissioned and ultimately used, testified that Coscia asked Park to create a program that would act "[l]ike a decoy" to "pump [the]

[1] Press Release, CFTC, *CFTC Orders Panther Energy Trading LLC and its Principal Michael J. Coscia to Pay $2.8 Million and Bans Them from Trading for One Year, for Spoofing in Numerous Commodity Futures Contracts* (July 22, 2013), http://www.cftc.gov/PressRoom/PressReleases/pr6649-13.

[2] The CFTC required Panther Energy and Coscia to pay a $1.4 million civil monetary penalty and disgorgement of $1.4 million in trading profits. The FCA issued a Final Notice imposing a penalty of approximately $900,000. The CME Group imposed a fine of $800,000 and ordered disgorgement of $1.3 million against Panther Energy and Coscia, with disgorgement payments by both defendants offsetting the CFTC's disgorgement order. *See id.*

[3] *United States v. Coscia*, No. 16-3017, 2017 WL 33814433, at *4 (7th Cir. Aug. 7, 2017).

[4] *See* Indictment, *United States v. Coscia*, No. 14-CR-00551 (N.D. Ill. Oct. 1, 2014), ECF No. 1.

[5] *See* Press Release, U.S. Dep't of Justice, *High-Frequency Trader Convicted of Disrupting Commodity Futures Market in First Federal Prosecution of "Spoofing"* (Nov. 3, 2015), https://www.justice.gov/usao-ndil/pr/high-frequency-trader-convicted-disrupting-commodity-futures-market-first-federal.

[6] *See Coscia*, 2017 WL 33814433 at *1-4.

market."[7] The government similarly demonstrated that Coscia's algorithm was purposely designed to enter but avoid filling or executing any of the large orders responsible for triggering favorable market moves, automatically cancelling the large orders under any conditions where they were at risk of being filled.[8]

In a rare move for a criminal case, Coscia took the stand in his own defense.[9] In addition to other testimony offered by the defense, Coscia claimed that his trading violated no market rules, pointing out that many of the orders the government alleged to be non bona-fide had, in fact, been filled and that high-frequency trading commonly involves cancelling orders.[10]

The jury returned a prompt guilty verdict on all counts.[11] Coscia filed a motion for acquittal, which the district court denied.[12] Ultimately, Coscia was sentenced to 36 months' imprisonment.[13]

"Spoofing" and Market Manipulation After Dodd-Frank

Coscia's trial and conviction represented one of the first tests of the criminal anti-spoofing provisions added to the CEA in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank"). The Dodd-Frank Act amended the CEA by explicitly adding "spoofing" to the list of prohibited transactions already detailed in the CEA, making it "unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity 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)."[14] The CFTC subsequently issued specific guidance about the market manipulation amendments in May 2013, offering examples or categories of potential spoofing behavior.[15] Knowing violation of this provision is a felony, subject to a maximum sentence of 10 years' imprisonment and a fine of the greater of $1 million or triple the monetary gain resulting from the alleged misconduct.[16]

Prior to Dodd-Frank, in order to make a case for spoofing or other market manipulation, the CEA required the CFTC to prove: (1) ability to influence price; (2) specific intent to influence the market or price; (3) the existence of an artificial price; and (4) the causation of an artificial price.[17] But the Dodd-Frank amendment relaxed these requirements in the spoofing context. Under the amended CEA, intent to cancel the bid or offer prior to execution is sufficient to establish spoofing.[18]

As expected, in the aftermath of Dodd-Frank, the CFTC began to pursue a more aggressive enforcement agenda, not only by initiating an increasing number of civil enforcement actions,[19] but also by referring selected

[7] *Id.* at *4 (alteration in original).
[8] *Id.*
[9] *Id.* at *5.
[10] Kim Janssen, *Alleged CME "Spoofer" Testifies: "I Didn't Move Any Market*," Chicago Tribune (Oct. 29, 2015, 6:14 PM), http://www.chicagotribune.com/business/ct-spoofing-trial-1030-biz-20151029-story.html.
[11] Tom Polansek, *High-Frequency Trader Convicted in First U.S. Spoofing Case*, Reuters (Nov. 4, 2015, 8:03 PM), http://www.reuters.com/article/court-spoofing-verdict-idUSL1N12Y3QE20151104.
[12] *See Coscia*, 2017 WL 33814433 at *5.
[13] *Id.*
[14] 7 U.S.C. § 6c(a)(5).
[15] *See* Antidisruptive Practices Authority, 78 Fed. Reg. 31890 (May 28, 2013).
[16] *See* 7 U.S.C. § 13(a)(2).
[17] *See In re Ind. Farm Bureau Coop. Ass'n, Inc.*, CFTC No. 75-14, 1982 WL 30249, at *5-6 (Dec. 17, 1982) ("specific intent to create an 'artificial' or 'distorted' price is a *sine qua non* of manipulation" (emphasis in original)).
[18] *See supra* at 15. Dodd-Frank also added a new anti-manipulation provision in 7 U.S.C. § 9 modeled on Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), which the CFTC has implemented through a new rule, 17 C.F.R. § 180.1, that the CFTC has indicated it intends to apply in a manner similar to Rule 10b-5 under the Exchange Act. The four-part test described above accordingly does not apply to cases brought under 17 C.F.R. § 180.1, either.
[19] *See, e.g.*, Consent Order of Permanent Inj., Civil Monetary Penalty, and Other Equitable Relief, *U.S. Commodity Futures Trading Comm'n v. Oystacher*, No. 15-cv-09196 (N.D. Ill. Dec. 20, 2016), ECF No. 287 (fining trader and trading firm $2.5 million for spoofing activities in energy and metal futures market); Order, *In re Bank of Tokyo-Mitsubishi UFJ, Ltd.*, CFTC No. 17-21

market manipulation cases like Coscia's to the Department of Justice ("DOJ") for criminal prosecution. Since 2010, federal prosecutors have charged at least two spoofing cases in addition to Coscia. The first, *United States v. Sarao*, involves Navinder Sarao, a British national accused of causing the 2010 "Flash Crash" after allegedly employing an algorithm designed to spoof the market for stock index futures.[20] Sarao's proceedings have stalled following unsuccessful efforts by the government to extradite Sarao to face charges in the United States. The second case, *United States v. Milrud*, similarly involved a Canadian day trader, Aleksandr Milrud, who in September 2015 pleaded guilty to recruiting and coordinating overseas traders placing and canceling stock orders, and then buying or selling stock at a profit following a favorable market move.[21]

The Seventh Circuit's Decision

In upholding Coscia's conviction, the Seventh Circuit made several key rulings, including rejecting Coscia's due process challenge to 7 U.S.C. § 6c(a)(5).[22]

First, the Seventh Circuit held that Section 6c(a)(5)'s anti-spoofing provision is not void for vagueness.[23] As noted above, the anti-spoofing provision reads, in relevant part:

> **(5) Disruptive practices**
>
> It 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—
>
> . . .
>
> **(C)** 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).[24]

Coscia raised a number of arguments claiming that the statute violated his right to due process, each of which was rejected by the Seventh Circuit. The court in particular emphasized that the statute's definition of spoofing "clearly proscribes the conduct" in question which defeated any claim by Coscia of inadequate notice.[25] For similar reasons, the court rejected Coscia's secondary argument that, by placing "spoofing" in quotation marks, Congress potentially modeled the amendment on the "wash sale" provision of the CEA, and therefore intended for "spoofing" to be defined by sources outside the statutory text.[26] As with Coscia's notice claim, the court once again emphasized the uniqueness of Section 6c(a)(5), noting, "the anti-spoofing provision, unlike the wash sale provision, contains a parenthetical definition, rendering any reference to an industry definition irrelevant."[27]

Coscia further claimed that the statute encourages arbitrary or *ad hoc* enforcement and prosecution by failing to provide "tangible parameters" distinguishing Coscia's purported criminal intent from that of other, legal trading strategies.[28] However, the Circuit emphatically rejected this argument as well, finding not only that Coscia's conduct fell "well within" the prohibited conduct described in the provision, but holding further that Section 6c(a)(5)'s intent requirement "renders spoofing meaningfully different from legal trades . . . because those orders are designed to be executed upon the arrival of *certain subsequent*

(Aug. 7, 2017) (fining bank $600,000 for spoofing contracts based in Treasury notes and Eurodollars).

[20] *See* Compl. for Injunctive Relief, Civil Monetary Penalties, and Other Equitable Relief, *U.S. Commodity Futures Trading Comm'n v. Nav Sarao Futures Ltd. PLC*, No. 1:15-cv-03398 (N.D. Ill. Apr. 17, 2015), ECF No. 1.

[21] *See* Ed Beeson, *Canadian High-Speed Trader Pleads Guilty In Spoofing Case*, Law360 (Sept. 14, 2015, 5:23 PM), https://www.law360.com/articles/702366/canadian-high-speed-trader-pleads-guilty-in-spoofing-case; *see also United States v. Milrud*, No. 15-cr-455 (D.N.J. Sept. 10, 2015), ECF No. 25 (entry of plea agreement).

[22] The court also considered a sentencing issue and indicated its agreement with the district court's approach in substituting gains for losses under circumstances where the victims' losses are not easily or immediately identifiable. *See Coscia*, 2017 WL 33814433 at *13-15.

[23] *See Coscia*, 2017 WL 33814433 at *5-7.

[24] 7 U.S.C. § 6c(a)(5).

[25] *Coscia*, 2017 WL 33814433 at 7.

[26] *See id.* at *6-7.

[27] *Id.* at *6.

[28] *Id*. at *8.

events. Spoofing, on the other hand, requires an intent to cancel the order *at the time it was placed* . . . [and] are never intended to be filled at all."[29] Thus, the court found that "spoofing" is "meaningfully different from legal trades such as 'stop-loss orders' ('an order to sell a security once it reaches a certain price') or 'fill-or-kill orders' ('an order that must be executed in full immediately, or the entire order is cancelled') because those orders are designed to be executed upon the arrival of *certain subsequent events.*" The court concluded that the defining feature of a spoofing trade is that "they are never intended to be filled at all."[30]

Second, the court affirmed the lower court's finding that evidence adequately supported Coscia's spoofing conviction. The court noted that a rational trier of fact "easily" could have found that Coscia intended to cancel orders prior to their execution.[31] The court appears to have been especially persuaded by Coscia's trading history, as well as additional testimony and evidence demonstrating that Coscia's trading was well outside the bounds of typical trading on the exchange.[32]

Third, the court held that the district court utilized the correct standard of materiality when—adopting the jury instruction from the Circuit's pattern jury instruction for mail and wire[33] fraud—it instructed the jury that the alleged wrongdoing had to be "capable of influencing the decision of the person to whom it is addressed."[34] Coscia, conversely, had sought a narrower instruction to the jury stating that the alleged scheme had to be "reasonably calculated to deceive persons of ordinary prudence" and carry "a substantial likelihood that a reasonable investor" would consider the deceptive conduct important in making a decision.[35]

The Seventh Circuit was unpersuaded by Coscia's claim that the provided instructions were inadequate, and noted further that even under Coscia's proposed instructions, Coscia's conduct still satisfied the materiality standard, given the testimony of actual investors at trial who testified that Coscia's trading patterns: (1) induced firms to fill orders; (2) persuaded market participants that the market was oversaturated; and (3) induced certain traders to leave the market altogether.[36]

Fourth, the court rejected Coscia's claim that his conduct was not fraudulent as a matter of law because his orders were not "fraudulent" or "illusory."[37] The court flatly rejected this distinction, observing that Coscia's argument "confuses *illusory* orders with an *illusion* of market movement."[38] The court noted that not only was the contrast between Coscia's trading patterns and those of legitimate traders striking and supportive of fraudulent intent, but that fraudulent intent could be inferred given Coscia's efforts to create a program to "facilitate[] the consummation of small orders and actively avoid[] the completion of large orders."[39]

Takeaways

Coscia is a helpful opinion for the government—not only has the criminal anti-spoofing provision survived its first constitutional challenge, but the court's opinion provides a blueprint the government can use to rebuff legal challenges to future spoofing and market manipulation prosecutions in other courts.

Many of Coscia's challenges to the CEA's anti-spoofing provision echoed commentary voiced by market participants after the initial amendment and subsequent guidance from the CFTC was released. The

[29] *Id.* at *9 (emphasis in original). The court highlighted the contrast between Coscia's trading practices and "legal trades" such as stop-loss orders (i.e., orders to sell a security once it reaches a certain price) or "fill-or-kill" orders (i.e., orders that must be executed in full immediately, or else the order is cancelled). *Id*.
[30] *Id*. at *9.
[31] *Id.* at *10.
[32] *Id.* at *9-10. For example, only 0.57% of Coscia's large orders remained on the market for longer than one second, whereas 65% of large orders entered by other high-frequency traders remained open for longer than one second. *See id.* at *9.
[33] *See* 18 U.S.C. §§ 1341, 1343.
[34] *Id.* at *12.
[35] *Coscia*, 2017 WL 33814433 at *12.
[36] *Id.* at *13.
[37] *Id.* at *10-11.
[38] *Id.* at *11 (emphasis in original).
[39] *Id.*

Court's wholesale rejection of those challenges establishes the broad scope of the anti-spoofing provision in the Seventh Circuit, which will no doubt encourage government investigators to continue seeking out appropriate cases for criminal prosecution.

The Seventh Circuit's decision also suggests that market participants seeking to justify potentially suspicious trading by gesturing to the unique nature of futures markets or high-frequency trading may not find a sympathetic audience in the courts. Nor are market participants likely to find in *Coscia* a satisfying bright line between acceptable and problematic trading strategies. For example, while the court claimed that Coscia's intent to evade execution was the key distinguishing feature between Coscia's misconduct and other traders' "legitimate" trading activities, as both parties acknowledged during oral argument, any number of acceptable trading algorithms and practices are designed to avoid execution for reasons unrelated to manipulation of the market (for example, triggering technical stop-loss levels). In Coscia's case, the court found it relevant that Coscia's algorithm was designed to affect supply and demand, and that his orders were placed "not with the intent to actually consummate the transaction, but rather to shift the market toward the artificial price at which the small orders were ultimately traded."[40] But the court's opinion provides limited guidance into whether future traders who adopt aggressive or novel trading approaches might still face criminal charges even in the absence of such evidence—or, as Judge Rovner commented at oral argument, "[be] punish[ed] . . . for being the first to build a better mousetrap[.]"[41]

A similar concern is raised by the court's emphasis on the statistical evidence provided at trial, which demonstrated that Coscia's trading was overwhelmingly an outlier among other market participants for rate of execution and order-to-trade ratio. The possibility that unusual trading statistics are now potentially indicative of misconduct will no doubt require trading firms to bulk up existing compliance programs to identify and detect potential outliers among their own trading.[42] But as with the distinction between acceptable and illegal trading strategies, the court does not provide any meaningful bright line to guide market participants. Coscia's order-to-trade ratio, for example, was 1,592%, five times greater than the highest order-to-trade ratio observed in other market participants (264%). But would an order-to-trade ratio of 500% raise similar suspicions? Or, could a jury find that it did? The court's decision provides no answer.

That and similar troubling questions are raised by *Coscia*. Despite these shortcomings, the court's decision does provide firms with a ready-made case study for future compliance trainings illustrating types of trading market participants engage in at their peril. The opinion also highlights the importance of seeking counsel's input prior to making important business or strategy decisions. Ultimately, the court's opinion suggests that even as the court laid the groundwork for

[40] *Id.* at *10. One feature of the court's decision is its potential implication that intent to have an artificial effect on supply and demand is relevant or perhaps even required to establish spoofing after Dodd-Frank, which would seem to potentially narrow the spoofing prohibition and mirror the four-part CEA test for manipulation. *See supra* at 17.

[41] *See* Jessica Corso, *7th Circ. Weighs Future of Spoofing Prosecutions*, Law360 (Nov. 10, 2016, 7:45 PM), https://www.law360.com/articles/861677/7th-circ-weighs-future-of-spoofing-prosecutions; *see also* Oral Argument, *United States v. Coscia*, No. 16-3017 (KFR) (7th Cir. Aug. 7, 2017), http://media.ca7.uscourts.gov/oralArguments/oar.jsp?caseyear=16&casenumber=3017&listCase=List+case%28s%29 (full audio of oral argument).

[42] A pending CFTC rule proposal to enhance regulation of automated trading would require certain traders to (a) implement pre-trade risk controls reasonably designed to prevent and reduce the risk of trading activity that violates the CEA or CFTC regulations (including the spoofing prohibition), among other matters, and (b) perform testing of their systems and sources reasonably designed to identify circumstances that may contribute to such violations. *See* Regulation Automated Trading, Notice of Proposed Rulemaking, 80 Fed. Reg. 78,824 (Dec. 17, 2015); *see, also* Regulation Automated Trading, Supplemental Notice of Proposed Rulemaking, 81 Fed. Reg. 85,334 (Nov. 25, 2016). Several aspects of this proposal remain under consideration by the CFTC, and it is unclear whether or to what extent the *Coscia* Court's analysis will affect how the CFTC proceeds with the rulemaking.

future prosecutions in complex and sophisticated markets, a comprehensive understanding of subtle distinctions between different trading programs and strategies will be vital for trading firms engaging in high-frequency trading seeking to avoid running afoul of the CEA.

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