CFTC Case Updates:

Settlement Highlights Agency's New Premium on Cooperation; 7th Circuit Upholds Criminal Spoofing Conviction

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On August 7, 2017, the Commodity Futures Trading Commission (CFTC or Commission) announced a settlement for a civil penalty of $600,000 with the Bank of Tokyo Mitsubishi UFJ, Ltd. (BTMU) for alleged spoofing violations, with Director of Enforcement James McDonald heralding BTMU's cooperation as the basis for what the agency characterized as a reduced sanction. On the same day, the 7th Circuit Court of Appeals upheld the conviction of commodity futures trader Michael Coscia[1] for violating the Commodity Exchange Act's (CEA) anti-spoofing provision, CEA Section 4c(a)(5)(C), 7 U.S.C. § 6c(a)(5)(C).[2] The Dodd-Frank Act added the anti-spoofing provision to the CEA, which prohibits engaging in any trading practice that is commonly known to the trade as "spoofing" (bidding or offering with the intent to cancel the bid or offer before execution).

CFTC Cooperation Credit

In *In re Bank of Tokyo-Mitsubishi UFJ, Ltd.*, the CFTC settled allegations that a BTMU trader had engaged in spoofing in violation of the CEA. The case is notable in that the civil penalty the parties negotiated was substantially lower than the penalty the CFTC assessed in many other recent spoofing cases, which ranged from the low millions (*see*, *e.g.*, *Panther Energy* — $1.4 million; *Oystacher* — $2.5 million) to the tens of millions (*e.g.*, *Nav Sarao* — $25.7 million).[3]

The settlement order set forth an extensive list of BTMU's cooperative efforts, including that BTMU:

- promptly suspended the trader;
- reported the conduct to the Division of Enforcement (Division);
- commenced an expansive internal review;
- provided assistance to the Division, which expedited the investigation;
- launched an overhaul of BTMU's systems and controls; and
- implemented a variety of enhancements to detect and prevent similar misconduct, including revising its policies, updating its training and implementing electronic systems to identify spoofing.

"This case shows the benefits of self-reporting and cooperation, which I anticipate being an important part of our enforcement program going forward," Mr. McDonald said, citing what he characterized as BTMU's "substantially reduced penalty." "When market participants discover wrongdoing, we want to incentivize them to voluntarily report it and to cooperate with our investigation, as the [BTMU] did here."

The emphasis on cooperation in the BTMU Order highlights a trend in the CFTC's enforcement regime. For example, on June 2, 2017, the Commission ordered that trader David Liew be permanently prohibited from trading on any exchange for engaging in manipulation, attempted manipulation and spoofing.[4] However, based on Mr. Liew's cooperation and willingness to enter into a cooperation agreement, the Commission did

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

[2] A knowing violation of CEA Section 4c(a)(5)(C) is a felony punishable by a fine of up to $1 million and not more than 10 years in prison. CEA Section 9(a)(2); 7 U.S.C. § 13(a)(2). The court also upheld Mr. Coscia's conviction for commodities fraud under 18 U.S.C. § 1348(1).

[3] *See* In re Panther Energy Trading LLC, CFTC No. 13-26, (Jul. 22, 2013) ($1.4 million civil monetary penalty); CFTC v. Nav Sarao Futures Ltd. PLC, 1:15-cv-03398, (N.D. Ill. Nov. 14, 2016) ($25.7 million civil monetary penalty); CFTC v. Oystacher, 15-cv-09196, (N.D. Ill. Dec. 20, 2016) ($2.5 million civil monetary penalty).

[4] In re Liew, CFTC No. 17-14, (Jun. 2, 2017).

not impose a civil monetary penalty. In another example, on June 29, 2017, the CFTC entered into non-prosecution agreements (NPAs) for the first time. The NPAs were entered into with three Citigroup traders who admitted to engaging in spoofing. Mr. McDonald issued a statement alongside the announcement of the agreements indicating that they "will be an important part of the Commission's cooperation program going forward." He also emphasized that "[n]on-prosecution agreements like these give the Division a powerful tool to reward extraordinary cooperation in the right cases, while providing individuals and organizations strong incentives to promptly accept responsibility for their wrongdoing and cooperate with the Division's investigation." The BTMU and Liew orders, along with the Citigroup traders' non-prosecution agreements, strongly indicate that cooperation will be a paramount consideration in future enforcement actions.

U.S. v. Coscia

The *Coscia* decision is the first appellate case to address the constitutionality of the CEA's spoofing prohibition. Mr. Coscia challenged his spoofing prosecution on the ground that CEA Section 4c(a)(5)(C) — which makes it unlawful 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)" — is unconstitutionally vague. The 7th Circuit rejected his argument. The court ruled that the anti-spoofing provision gave adequate notice of the conduct that is proscribed. It reasoned that the statute "clearly defines 'spoofing' in the parenthetical[.]" While the parenthetical refers only to "bidding or offering with the intent to cancel the bid or offer before execution," the court noted that the anti-spoofing provision is "part of a larger statutory scheme to prevent manipulation of the market" and that it is "factually accurate" to describe the provision as prohibiting "practices that artificially distort the market." The court also referred approvingly to the district court's discussion "that explains how Congress limited the [anti-spoofing] statute to manipulative cancellations."[5]

The 7th Circuit next addressed Mr. Coscia's contention that the anti-spoofing provision was vague because it encouraged arbitrary enforcement. The court ruled first that Mr. Coscia lacked standing to raise this point because his conduct "clearly falls within the confines of the conduct prohibited by the statute[.]" The court stated that the evidence was clear that Mr. Coscia intended to cancel his orders because "he commissioned a 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." According to the court, Mr. Coscia's program would place small orders on one side of the market and large orders on the other side of the market with the purpose of driving market participants to fill the small order, at which point Mr. Coscia's algorithm would cancel the large orders. The court provided an illustration of a spoofer that wanted to *buy* corn futures at $3.00 per bushel where the prevailing price was $3.05. This hypothetical spoofer would place large *sell* orders (which the spoofer intended to cancel) at $3.05, $3.04, $3.03 and so on until the market appeared saturated with sellers and other traders would fill the spoofer's small buy order at $3.00.

The court ruled in the alternative that the statute did not "permit[] arbitrary enforcement" in any event. The court explained that arbitrary enforcement is generally not a concern where the statute requires the government to prove intent and that the anti-spoofing provision was such a statute, limiting prosecution to only those persons who "a jury will find possessed the requisite specific intent to cancel orders at the time they were placed." The court elaborated that the statute's requirement that the defendant intend to cancel the order at the time it was placed "renders spoofing meaningfully different from legal trades such as 'stop-loss orders' ('an order to sell a security once it reaches a certain price') or 'fill-to-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 7th Circuit also rejected Mr. Coscia's claim that the evidence that he violated the anti-spoofing provision was insufficient. The court concluded that the question boiled down to whether "a rational trier of fact could have found that [defendant] possessed an intent to cancel the large orders at the time he placed them." In the court's view, several pieces of evidence supported such a finding, including the percentage of Mr. Coscia's cancellations compared to others in several markets and testimony suggestive of Mr. Coscia's intent to cancel.[6] All of this evidence, the court concluded,

[5] In 2013 (after Mr. Coscia's 2011 challenged trading activity), the CFTC provided an interpretation of the disruptive trading prohibitions in CEA Section 4c(a)(5), including spoofing. Interpretive Guidance and Policy Statement, 78 Fed. Reg. 31890 (May 28, 2013). In the guidance, the Commission provided what it described as "non-exclusive examples" of spoofing, one of which involves "submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards." *Id.* at 31896.

[6] Evidence the court cited included: (1) "Coscia's cancellations represented 96% of all Brent future cancellations on the Intercontinental Exchange during the two-month period in which he employed his software"; (2) "on the Chicago Mercantile Exchange, 35.61% of his small orders were filled[,]" compared to only .08 percent of his large orders; (3) the designer of Mr. Coscia's programs testified that the algorithms were "designed to avoid large orders being filled"; (4) the program designer further testified that the large orders were "'[u]sed to pump [the] market,' suggesting that they were designed to inflate prices through illusory orders"; (5) "according to one study, only .57% of Coscia's large orders were on the market for more than one second, whereas 65% of large orders entered by other high-frequency traders were open for more than a second"; and (6) an economic consultant testified that "Coscia's order-to-trade ratio was 1,592%, whereas the order-to-trade ratio for other market participants ranged from 91% to 264%."

supported the jury's verdict, because it "suggests that the large 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."

In the wake of the 7th Circuit's decision, it remains to be seen how much courts will rely on manipulation law principles in evaluating the sufficiency of evidence of a spoofing violation.[7]

[7] The standard of intent required to establish manipulative conduct or price manipulation under the CEA has also been controversial. For example, litigants have argued over the distinction between an intent to affect price versus an intent to create an artificial price. These issues have yet to be resolved by the courts. *See* Skadden's prior client alert here on this developing area of the law.

Although the 7th Circuit stated that manipulation is not an element of the spoofing offense, it also observed that the purpose of the anti-spoofing provision is to prohibit practices that "artificially distort the market," and, in determining that the evidence was sufficient to establish that Mr. Coscia intended to cancel the large orders, the court relied in part on evidence that, by placing those large orders, he was seeking to distort the market price. The *Coscia* decision was a victory for the U.S. Department of Justice, but the 7th Circuit's upholding of the spoofing prohibition also means the CFTC can continue pursuing civil violations in that jurisdiction.

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