

The Anti-Spoofing Provision of the Dodd –Frank Act: New White Collar Crime or ‘Spoof’ of a Law?

By Jan Paul Miller, Steve Sherman and Amina Musa

As technology has altered business practices, making them speedy and more efficient, the law has struggled to keep pace. This is particularly true in the securities industry. New technologies allow traders instant access to market information and allow the placing of hundreds of orders simultaneously. In the realm of commodity futures trading, faster and more efficient trading technology has allowed for the development of high-frequency trading, which utilizes algorithms to rapidly trade commodities. The law, however, has struggled to catch up particularly regarding a method of high-speed trading known as “spoofing.” Spoofing is a form of trading that involves the placement of non-bona fide, large-volume orders and near immediate cancelation of such orders, the goal of which is to manipulate market conditions and mislead other traders.¹ The practice is considered to be disruptive and is prohibited under the “anti-spoofing provision” of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The statute is not a model of clarity. Passed in 2010, it makes it unlawful for any person to engage in “spoofing,” which is broadly defined as “bidding or offering with the intent to cancel the bid or offer before execution.”² In addition to the imposition of civil penalties and administrative action by the Commodity Futures Trading Commission (CFTC) against violators, a knowing violation of the anti-spoofing provision is a felony.³ While the CFTC has successfully enforced civil penalties and restrictions in cases of spoofing, and did so even before the enactment of Dodd-Frank, it was not until 2013,

that the U.S. Department of Justice brought its first criminal prosecution. It did so against Michael Coscia, a high-frequency futures trader and Principal of Panther Energy Trading LLC.⁴ Coscia was charged with six counts of spoofing for conduct that had allegedly occurred in 2011.⁵ In his motion to dismiss the indictment, Coscia argued that the anti-spoofing provision of the Act was unconstitutionally vague, making the conduct defined within it indistinguishable from legitimate trade practices.⁶ The court did not accept this argument, holding the statute to be clear regarding prohibited conduct as applied to Coscia.⁷ Coscia’s

case provided one interpretation of this law in the criminal context, but subsequent cases will certainly raise other issues regarding prosecution under it. This article examines the anti-spoofing provision and its interpretation thus far by the CFTC and the court in Coscia’s case, as well as other possible applications likely to come about in the future.

I. The Anti-Spoofing Provision

A. Overview

The anti-spoofing provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act,

-
1. Deniz Aktas, *X. Spoofing*, 33 REV. BANKING & FIN. L. 89, 89 (2013).
 2. 7 U.S.C.A. § 6c(a)(5)(C).
 3. 7 U.S.C.A 13(a)(2).
 4. Gregory Scopino, *The (Questionable) Legality of High-Speed “Pinging” and “Front Running” in the Futures Markets*, 47 CONN. L. REV. 607, 653 (2015).
 5. *See United States v. Coscia*, No. 14 CR 551, 2015 WL 1805955, at *1 (N.D. Ill. Apr. 16, 2015).
 6. *Id.* at *2.
 7. *See id.* at *3.
-

Jan Paul Miller is chair of the White Collar Defense and Investigations practice at Thompson Coburn LLP. He obtained extensive trial experience during his 17 years as a United States Attorney and Assistant U.S. Attorney. Jan has experience in a wide range of white collar crime matters, including alleged fraud in the areas of health care, government contracts, banking, securities, bankruptcy, and tax.

Steven Sherman is vice chair of the White Collar Defense and Investigations practice at Thompson Coburn LLP. He has represented a wide variety of clients in white collar defense and investigations. His criminal and regulatory experience includes the representation of individuals and companies in criminal investigations.

Amina Musa is a student at Saint Louis University School of Law and summer associate at Thompson Coburn LLP. Prior to law school, she interned with the Family Court of St. Louis County in Child Protective Services. She holds a Bachelor’s Degree in Social Work from Southern Illinois University Edwardsville



signed into law in 2010 by President Obama, amended the Commodity Exchange Act's (CEA) "Prohibited Transactions" section.⁸ This statute, 7 U.S.C.A. § 6c(a)(5)(C), reads in pertinent part that "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 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)."⁹ Under 7 U.S.C.A § 13(a)(2), a knowing violation of the anti-spoofing provision is a felony, carrying a maximum sentence of 10 years' imprisonment and a fine of the greater of \$1 million or triple the violator's monetary gain resulting from the alleged conduct.¹⁰

B. What is Spoofing?

Spoofing is generally understood to be a trading strategy in which a large order is placed on one side of the market and a small order is placed on the opposite side. There is no intention to trade the larger order. The intention is that the smaller order is traded and the larger order will be canceled. Spoofing occurs in high frequency trading, but it also happens in manual trading, and even non-electronic trading. Although the anti-spoofing provision of the Dodd-Frank Act is the first legislation to define the term "spoofing," the CFTC has long regulated and sought to punish similar conduct under two other provisions of the CEA.¹¹ The first was section 4c(a)(2)(B), which held it to be unlawful to "offer to enter into, enter into, or confirm the execution of a transaction" that "is used to cause any price to be reported, registered, or recorded that is not a true and bona-fide price."¹² Further, section 9(a)(2) prohibited the delivery of "false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce."¹³ The CFTC fined and penalized traders who violated section 9(a)(2) prior to Dodd-Frank.¹⁴ So while violation of these provisions was not criminally punishable prior to Dodd-Frank,

understanding those provisions and the CFTC's prior enforcement posture does give guidance as to how to interpret the current law.

C. Purpose of the Provision

The goal of high frequency trading is to use extremely fast communication connections to create the opportunity to trade at favorable prices before the competition can make the same trade. Spoofing seeks to increase the available profits associated with high frequency trading by artificially altering the price of a given future via entering buy or sell orders that the trader has no intention of fulfilling. This induces other traders to react in response, creating a small window in the market that the trader can use to reap an excessive profit.¹⁵ CFTC enforcement director David Meister has said that spoofing will "not be tolerated" and justified enforcement of the Act in its function to "protect market participants and promote market integrity."¹⁶ With the enactment of the specific provisions in Dodd-Frank, the CFTC is now able to narrowly target the practice and its undesirable effects.

D. Civil Enforcement

The primary and most common means of enforcement of the anti-spoofing provision is the CFTC's power to pursue civil administrative enforcement actions. In 2013, the CFTC settled its first administrative action pursuant to the Act against Michael Coscia and Panther Energy LLC. The Commission found that Coscia and Panther had engaged in spoofing between the months of August and October 2011 by employing a computer algorithm to place small orders followed by larger orders that were quickly cancelled to give the impression of high buyer interest.¹⁷ The activity occurred amongst 18 futures contracts over a broad spectrum of commodities including energies, metals, interest rates, agricultures, stock indices, and foreign currencies.¹⁸ The commission found that through spoofing, Panther and Coscia reaped \$1.4 million in unlawful trading profits, which they were required to disgorge in addition to payment of \$1.4 million in civil penalties.¹⁹ The Commission also imposed a one-year trading ban on Coscia and Panther.²⁰

8. *Coscia*, 2015 WL 1805955 at *2.

9. 7 U.S.C.A. § 6c(a)(5)(C).

10. *See* 7 U.S.C.A § 13(a)(2).

11. *Aktas*, *supra* note 1 at 89.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* at 91–92.

16. *In the Matter of Panther Energy Trading LLC and Michael J. Coscia*, 2013 WL 3817473, at *7 (July 22, 2013).

17. News Release, Commodities Futures Trading Commission, 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), 2013 WL 3786696.

18. *Id.*

19. *Id.*

20. *Id.*

Since Coscia, the CFTC has pursued charges against other traders. In April 2015, the CFTC brought an action against United Kingdom resident Navinder Singh Sarao and Nav Sarao Futures Limited PLC for alleged spoofing in connection to one particular futures contract, the E-mini S&P 500.²¹ According to the CFTC, Sarao created a special algorithm referred to as “the Layering Algorithm,” which automatically and simultaneously layered multiple exceptionally large price offers that shifted to ensure a gap of three to four levels away from the best asking price.²² In addition to the Layering Algorithm, Sarao employed manual spoofing techniques and exacerbated the “Flash Crash”²³ by applying \$200 million worth of persistent

downward pressure on the E-mini S&P price.²⁴ The CFTC characterized these actions as “exceptionally large, aggressive, and persistent spoofing tactics.”²⁵ In its action, the CFTC is seeking permanent injunctive relief, disgorgement, civil monetary penalties, trading suspensions or bans, and payment of costs and fees.²⁶

Finally, in May 2015, the CFTC charged two United Arab Emirates residents, Heet Khara and Nasim Salim, for spoofing in the gold and silver futures market.²⁷ A U.S. District Judge for the Southern District of New York issued an order freezing defendants’ assets and prohibiting them from destroying documents or denying CFTC staff access to their books and record.²⁸ Between February and April 2015, defendants

allegedly spoofed the gold and silver futures market by placing large aggregate orders for contracts opposite smaller orders and immediately cancelling them once the smaller orders were executed.²⁹ As with Sarao, the CFTC seeks injunctive relief, disgorgement, civil penalties, and trading bans or suspensions.³⁰

E. Criminal Enforcement

Although Coscia’s indictment was the first criminal action pursued under the anti-spoofing provision, it has not been the only one to date. In April 2015, the Department of Justice charged Sarao with a federal criminal complaint in the Northern District of Illinois on multiple charges connected to the Flash Crash, including one count of spoofing.³¹ That case has not progressed past extradition proceedings.

II. Interpreting the Anti-Spoofing Provision

Because the anti-spoofing provision and the activities that prompted it are relatively new, a review of CFTC enforcement guidelines and the Coscia case are the primary means to determine how courts will interpret key provisions in the statute.

A. CFTC Guidelines

Although not binding upon would-be violators, prosecutors or courts, the CFTC’s published guidance clarifies some of the definitions and particularities of spoofing. In November 2010, the CFTC published an advanced notice of proposed rule-making that invited public comment on spoofing and posed specific questions as to what should or should not encompass the term and how to distinguish spoofing from legitimate trade conduct.³²

Following this, in March 2011, the Commission published a Proposed Interpretive Order regarding the Dodd-Frank Act, including comments for a roundtable discussion and proposed commission guidance.³³ The proposed guidance specified that in order to commit spoofing, a violator must act with some degree of requisite intent or scienter in that he or she intended to cancel the bid before execution;³⁴ reckless

21. See CFTC Charges U.K. Resident Navinder Singh Sarao and His Company Nav Sarao Futures Limited PLC With Price Manipulation and Spoofing, 31 No. 4 INT’L ENFORCEMENT L. REP. 144 (April 21, 2015); see also U.S. Commodity Futures Trading Commission v. Nav Sarao Futures Limited PLC and Navinder Singh Sarao, 2015 WL 1843321 (N.D.Ill.).

22. *Id.*

23. May 6, 2010 came to be known as the “Flash Crash Day,” in which the U.S. stock market had a major drop. News Release, U.S. Department of Justice, Futures Trader Charged with Illegally Manipulating Stock Market, Contributing to the May 2010 Market ‘Flash Crash’ (April 21, 2015), <<http://www.justice.gov/opa/pr/futures-trader-charged-illegally-manipulating-stock-market-contributing-may-2010-market-flash>>.

24. *Id.*

25. *Id.*

26. *Id.*

27. News Release, Commodities Futures Trading Commission, CFTC Charges United Arab Emirates Residents Heet Khara and Nasim Salim with Spoofing in the Gold and Silver Futures Market (May 5, 2015), 2015 WL 2085605.

28. *Id.*

29. *Id.*

30. *Id.*

31. See News Release, DOJ, *supra* note 33.

32. Antidistruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 67301-01 (Nov. 2, 2010).

33. Antidistruptive Practices Authority, 76 Fed. Reg. 14943-02 (March 18, 2011).

34. The intent requirement of spoofing conduct may be difficult to prove given that computer algorithms produce orders, quotes, and cancellations, and it is estimated that high-frequency traders cancel “at least 90 percent of their orders.” This raises another question as to how legitimate trade practices can be distinguished from spoofing, and how to prevent innocent high-frequency traders from being targeted by the statute. See Kluchenek & Kahn, *supra* note 13, at 126.

trading or conduct is insufficient.³⁵ Additionally, cancellation of orders as part of a “legitimate, good-faith attempt to consummate trade,” was deemed insufficient to meet the requirements for spoofing.³⁶ Finally, the Commission noted that in distinguishing between legitimate trade conduct and spoofing, it considers market context, a person’s pattern of trading activity, and “other relevant facts and circumstances” so as to not “capture legitimate trading.”³⁷

The CFTC’s final interpretive guidance in May 2013, reiterated the above and added four specific (non-exclusive) examples of conduct that constitute spoofing – adding to the three already published in 2011. These include: (i) submitting or cancelling bids or offers to overload the quotation system of a registered entity; (ii) submitting or cancelling bids or offers to delay another person’s execution of trades; (iii) submitting or cancelling multiple bids or offers to create an appearance of false market depth; and (iv) submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards.³⁸

B. Michael Coscia Case

To date, the only judicial guidance on the anti-spoofing provision occurred in Coscia’s criminal proceeding. Coscia, the principal of high-frequency futures trading firm Panther Energy Trading LLC, was indicted by a grand jury in October 2014 for alleged spoofing in violation of the anti-spoofing provision of the Dodd-Frank Act.³⁹ The indictment tracked the CFTC settlement, and alleged that in August 2011, Coscia developed and implemented a high-frequency trading strategy that allowed him to enter and cancel large-volume orders in milliseconds.⁴⁰ As with the CFTC complaint, the indictment charged that Coscia’s strategy was carried out “to create a false impression regarding the number of contracts available in the market, and to fraudulently induce other market participants to react to the deceptive market information he created.”⁴¹

Motions to dismiss indictments are not uncommon in complex criminal cases. In his motion challenging the indictment, Coscia argued the anti-spoofing provision was unconstitutionally vague because it failed to offer any ascertainable standard distinguishing spoofing from legitimate trade practices including partial fill orders (larger than necessary orders filled to ensure a sufficient quality is obtained), stop-loss orders (orders programmed to execute only when the market reaches a certain price), or “Fill or Kill” orders (orders cancelled unless they are filled immediately).⁴² Coscia further argued that there is no commonly understood meaning of the term spoofing, as evidenced by the fact that the CFTC sought comments on the nature of spoofing after passage of the provision and had difficulty agreeing upon a definition at a December 2010 roundtable discussion.⁴³ He also contended that his conduct did not fall into any of the four illustrative examples cited by the CFTC.⁴⁴

On April 16, 2015, Judge Harry D. Leinenweber denied Coscia’s motion to dismiss the indictment.⁴⁵ In

doing so, the court focused on the definition contained in section 6(a)(C)(5). Taking all allegations in the indictment as true, the court held that because the indictment specifically charged Coscia with placing orders with an intent to cancel, the conduct alleged fell outside legitimate trade practices.⁴⁶ This allegation, the court reasoned, made Coscia’s alleged conduct different than practices that might be conditional offers, contingent orders or durational orders, all of which are recognized as legitimate trade practices.⁴⁷ Notably, the court declined to opine on whether partial-fill or stop-loss orders, could, under certain circumstances, fall within the statute.⁴⁸ This is important to point out while moving forward and predicting application of the anti-spoofing provision to other traders.

III. Future Directions

A. Other Applications of the Provision

In exercising its relatively new enforcement power under the anti-spoofing provision of the Dodd-

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. News Release, U.S. Attorney’s Office, High Frequency Trader Indicted for Manipulating Commodities Futures Markets in First Federal Prosecution for Spoofing (Oct. 2, 2014), <<https://www.fbi.gov/chicago/press-releases/2014/high-frequency-trader-indicted-for-manipulating-commodities-futures-markets-in-first-federal-prosecution-for-spoofing>>.

40. *Coscia*, 2015 WL 1805955, at *1.

41. *Id.*

42. *Id.* at *2.

43. *Id.*

44. *Id.* at *3.

45. *Coscia*, 2015 WL 1805955 at *1.

46. *Id.* at *4.

47. *Id.*

48. *Id.* at *3.

Frank Act, and as demonstrated by Coscia's proceedings thus far, the Department of Justice's task of proving illegal spoofing conduct as opposed to legitimate trade practices may be challenging.

In its complaint against Sarao, the U.S. alleges that Sarao engaged in spoofing by transmitting futures contracts "he intended to cancel before execution."⁴⁹ Additionally, the government charges that Sarao contributed to the "Flash Crash" by placing multiple high-volume sell orders on the CME (to create the appearance of substantial supply and thus drive prices down) then modifying and ultimately canceling the orders before they were executed.⁵⁰ Finally, the complaint defines the "layering scheme" committed by Sarao as a "type of spoofing," explaining that the deceitful purpose of layering orders to manipulate market appearance and create artificial price movement.⁵¹

The language in the initial portion of Sarao's complaint echoes that of Coscia's regarding "intent to cancel"; therefore, the charge will likely be sustained given that this case is also brought in the Northern District of Illinois. However, the conduct involving the "layering scheme" will be a novel issue for the court to examine. The layering scheme described in the complaint notes that Sarao's conduct included trade orders that were "quickly modified or cancelled" before execution.⁵² This language, which does not explicitly describe an "intent to cancel", would seem to expand the statute to cover

orders that may not been issued with an intent to cancel. And as might be expected, Sarao has challenged the intent basis of his spoofing charge, claiming that he was engaged in a bona fide market strategy requiring constant calculations.⁵³ This, in addition to the requirement that a spoofeer create artificial movement in market prices, may be difficult for the government to meet.⁵⁴

B. Policy Implications

Both the CFTC and U.S. Department of Justice have incentives on policy grounds for prosecuting and enforcing the anti-spoofing provision of the Dodd-Frank Act. In addition to commentary by CFTC Commissioner Chilton that spoofing is intolerable, CFTC director of enforcement Aitan Goelman has stated that "protecting the integrity and stability of the U.S. futures markets is critical to ensuring a properly functioning financial system. Aggressive prosecution of spoofing is an important part of that mission."⁵⁵ The CFTC has also emphasized the fact that it plans to partner with the U.S. Department of Justice and other regulatory agencies to bring both civil and criminal proceedings to enforce the anti-spoofing provisions.⁵⁶ From the criminal perspective, the outcome of Coscia's case could potentially send a strong message that spoofing is intolerable, shifting from merely civil fines and penalties into the realm of a prosecutable white collar crime. And while the higher burden in criminal cases may to a degree dis-

suade federal prosecutors, the decision in Coscia gives the government a great deal of latitude in prosecuting complex trading schemes previously thought out of reach of United States' criminal law.

Conclusion

The passage of the anti-spoofing provision has shifted the enforcement of spoofing in two key ways: first, it gave the term "spoofing" a statutory definition; second, it provided for the possibility of criminal action against a violator. Critics of the provision argue that the law is vague, and that intent of the spoofeer is difficult to prove given the nature of the futures trading market and commonality of cancelling orders. Though civil charges have been successful under the provision, there has yet to be a completed criminal prosecution to date. Pending in the Northern District of Illinois are charges against Michael Coscia and Navinder Sarao, which, depending on their outcomes, could either create a trend of white collar criminal prosecution or prove the law to be difficult to enforce, requiring amendment with more detailed language.

□ □ □

49. Aff. in Supp. of Sarao Compl. ¶ 4(d).

50. *Id.* at ¶ 4.

51. *Id.* at ¶ 6.

52. *Id.* at ¶ 13.

53. Ronald Filler & Jerry W. Markham, *The Flash Crash Case Against Sarao—Will the CFTC Prevail?*, 35 No. 5 FUTURES & DERIVATIVES L. REP. NL 2 (June 2015).

54. *Id.*

55. See News Release, CFTC, *supra* note 30.

56. See *id.*