THE LAW SURROUNDING SPOOFING IN THE DERIVATIVES AND SECURITIES MARKETS

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I. OVERVIEW

a. "Spoofing" is generally understood as a pattern in which a trader places and quickly cancels an order that was never intended to be executed. Such an order can cause prices to move up or down, because it alters the appearance of supply or demand, and many traders base their strategies on their perception of supply and demand at various price levels. For example, certain market participants (including computerized trading algorithms) may buy when buy orders outnumber sell orders and sell when sell orders outnumber buy orders.

   i. A spoofer will sometimes place a smaller, genuine order on the opposite side of the market from a large, non-bona fide order (that is, a genuine order to buy opposite from a large non-bona fide sell order, or vice-versa) in order to take advantage of distortions that large orders can produce in the market.[1]

   ii. Closely related to spoofing is "layering," which is best understood as a specific form of spoofing. With layering, the trader places a series of non-bona fide orders increasingly far from the prevailing best price (that is, orders to sell at increasingly higher prices than the prevailing lowest asking price, or orders to buy at increasingly lower prices than the prevailing highest bid price) in order to give the false appearance of market depth. A series of sell orders above the prevailing ask may give the appearance that the price is going to fall, thus causing others in the market to lower their asks, and allowing the trader to buy a security or futures contract at a lower price than would have otherwise been possible. If the trader also (for example) sold the instrument short before beginning the layering sequence, he could capture profit from the fall in price he caused.

b. U.S. regulators have long asserted that spoofing undermines the integrity of markets. But with the rise of automated trading systems, spoofing has become subject to enhanced scrutiny—and additional legal prohibitions.

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[1] For a description of the mechanics of spoofing, *see, e.g.*, Matt Levine, *Why is Spoofing Bad?*, BLOOMBERGVIEW (Apr. 22, 2015), http://www.bloombergview.com/articles/2015-04-22/why-is-spoofing-bad-; Matt Levine, *Prosecutors Catch a Spoofing Panther*, BLOOMBERGVIEW (Oct. 2, 2014), http://www.bloombergview.com/articles/2014-10-02/prosecutors-catch-a-spoofing-panther. *See also* Bradley Hope, *As 'Spoof' Trading Persists, Regulators Clamp Down*, WALL ST. J. (Feb. 22, 2015).

c. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) outlawed spoofing by name on futures and derivatives exchanges, greatly enhancing the ability of the Commodity Futures Trading Commission (CFTC) and Department of Justice (DOJ) to bring cases against alleged spoofers.

d. The first criminal spoofing trial, against Michael Coscia, ended on November 3, 2015 with a verdict of guilty on all counts (see Part V(a)(iii) below) – a result that is sure to embolden prosecutors and regulators.

II. ANTI-SPOOFING EFFORTS IN THE FUTURES MARKETS BEFORE DODD-FRANK

a. Even before Dodd-Frank, government agencies sought to target spoofing. For pre-Dodd-Frank conduct in the futures markets, the CFTC and DOJ have relied on Commodity Exchange Act (CEA) provisions that generically prohibited manipulative or deceptive practices—in particular, Sections 6(c) and 9(a)(2) of the CEA.

    i. Pre-Dodd-Frank, Section 6(c) of the CEA gave the CFTC authority to bring an administrative enforcement action against traders who "manipulat[ed] or attempt[ed] to manipulate . . . the market price" of a commodity or future. *See* CEA § 6(c) (2009 version), 7 U.S.C. § 9 (2009). Dodd-Frank made significant changes to Section 6(c). New Section 6(c) is discussed in Part III below.

    ii. Section 9(a)(2), a criminal prohibition the substance of which was also civilly enforceable by the CFTC, *see* CEA § 6c (2009), 7 U.S.C. § 13a-1 (2009)), made it unlawful to "manipulate or attempt to manipulate the price" of a commodity or future. *See* CEA § 9(a)(2) (2009 version), 7 U.S.C. § 13(a)(2) (2009).

    iii. Pre-Dodd-Frank, it was extremely difficult for the CFTC to prove manipulation when it was put to the test – which is reportedly what led to the inclusion in the legislation of a prohibition on spoofing (along with other specified practices) by name.[2] Between the CFTC's creation in 1975 and the passage of Dodd-Frank in 2010, the agency is believed to have successfully litigated only one contested market manipulation case to final judgment.[3] (The case is *Anthony J. DiPlacido*, CFTC Docket No. 01-23, 2008 WL 4831204 (Nov. 5, 2008), which was affirmed on liability, *DiPlacido v. CFTC*, 364 Fed. Appx. 657 (2d Cir. 2009).)

[2] Matthew Leising, *Market Cops Got Power To Pursue Spoofers After Years of Failure*, BLOOMBERG (May 14, 2015), http://www.bloomberg.com/news/articles/2015-05-14/market-cops-got-power-to-pursue-spoofers-after-years-of-failure.

[3] *E.g.*, Matthew F. Kluchenek & Jacob L. Kahn, *Deterring Disruption in the Derivatives Markets*, 3 HARV. BUS. L. REV. ONLINE 120, 126 (2013), http://www.hblr.org/?p=3159; *see also* Jerry W. Markham, *Manipulation of Commodity Futures Prices – The Unprosecutable Crime*, 8 YALE J. REG. 281 (1991).

1. To prove manipulation under the CEA, the Government had to show (1) that the accused had the ability to influence market prices; (2) that she specifically intended to do so; (3) that artificial prices existed; and (4) that the accused caused the artificial prices. *See, e.g.*, *In re Amaranth Natural Gas Commodities Litig.*, 730 F.3d 170, 173 (2d Cir. 2013).

2. To prove attempted manipulation under the CEA, the Government had to show that a trader had "an intent to affect the market price of a commodity and [engaged in] some overt act in furtherance of that intent." *CFTC v. Bradley*, 408 F. Supp. 2d 1214, 1219 (N.D. Ok. 2005).

b. In addition, the CFTC has used Section 4c(a)(2)(B) of the CEA to target pre-Dodd-Frank conduct that consisted of entering non-bona fide orders. *See, e.g.*, *In re Gelber Group*, CFTC Docket No. 13-15 (Feb. 8, 2013); *In re Bunge Global Markets*, CFTC Docket No. 11-10 (Mar. 22, 2011).

   i. Section 4c(a)(2)(B) makes it unlawful under certain circumstances to offer to enter into, to enter into, or to confirm a futures "transaction" that causes a price to be reported, registered, or recorded that is not true and *bona fide*. *See* CEA § 4c(a)(2)(B), 7 U.S.C. § 6c(a)(2)(B) (2012).

   ii. However, it is not clear that an unexecuted order counts as a "transaction" under Section 4c(a)(2)(B). *See* Kluchenek & Kahn, *supra* note 3, at 131.

   iii. Section 4c(a)(2)(B) is still available, but the CFTC has not, to our knowledge, relied on it in spoofing-related cases where the relevant conduct occurred after Dodd-Frank took effect.

c. Before Dodd-Frank, the DOJ could proceed under additional statutes contained in the federal criminal code: the general mail fraud (18 U.S.C. § 1341) and wire fraud (18 U.S.C. § 1343) statutes, and the commodities fraud (18 U.S.C. § 1348) statute.[4] Those statutes and their continuing applicability in spoofing cases are discussed in Part III below.

III. SPOOFING IN FUTURES AND DERIVATIVES AFTER DODD-FRANK

a. Dodd-Frank amended the CEA in several ways potentially relevant to a spoofing case. Most obviously, new Section 4c(a)(5) of the CEA explicitly forbids spoofing, in addition to two other specified "disruptive practices." The prohibition applies on regulated exchanges for trading futures and

[4] Prior to the 2009 passage of the Fraud Enforcement and Recovery Act, 18 U.S.C. § 1348 only covered securities fraud. It now covers both commodity fraud and securities fraud. *See* 18 U.S.C. § 1348 (2012).

other derivatives. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 747, 124 Stat. 1376, 1739 (2010).

i. In particular, new Section 4c(a)(5)(C) prohibits “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).” 7 U.S.C. § 6c(a)(5)(C) (2012).

   1. Section 4c(a)(5)(C) is the first U.S. statutory provision to specifically prohibit spoofing in commodity markets.

   2. According to Guidance released by the CFTC in 2013 (“Guidance”), the spoofing prohibition applies to activity on all registered trading facilities, including in pre-open periods and during exchange-controlled trading halts. It does not cover block trades, bilaterally negotiated swap transactions, exchanges for related positions, or non-executable market communications such as requests for quotes. It applies regardless of a trading platform’s order book functionality. CFTC, *Antidisruptive Practices Authority*, 78 Fed. Reg. 31890, 31892, 31896 (May 28, 2013).

   3. In the Guidance, the CFTC clarified that it “does not interpret reckless trading, practices, or conduct as constituting a ‘spoofing’ violation”, nor does it interpret the prohibition as “reaching accidental or negligent trading, practices, or conduct.” Rather, the agency must prove that the trader *intended* to cancel his bid before execution. *Id.* at 31896 & n.74. But the CFTC does not need to prove that the trader intended to move the market. *Id.* at 31892.

   4. The CFTC noted that “a spoofing violation will not occur when the person’s intent when cancelling a bid or offer before execution was to cancel such bid or offer as part of a legitimate, good-faith attempt to consummate a trade.” A partial fill may, but will not necessarily, qualify as spoofing. The CFTC promised, in distinguishing between spoofing and legitimate activity, to evaluate “the market context, the person’s pattern of trading activity (including fill characteristics), and other relevant facts and circumstances.” *Id.* at 31896.

   5. Presumably to distinguish Section 4c(a)(5) from the CEA’s anti-manipulation provisions, the CFTC stated that the prohibitions in Section 4c(a)(5) are “distinct statutory

provisions from the anti-manipulation provisions in [new CEA § 6(c)]; the Commission does not interpret the CEA section 4c(a)(5) violations as including any manipulative intent requirement." *Id*. at 31892.

6. The CFTC made a point of saying that a violation of Section 4c(a)(5)(C) does not "requir[e] a pattern of activity"; rather, "even a single instance of trading activity" can be a violation if it is coupled with the prohibited intent. *Id*. at 31896.

7. The CFTC also noted that "[a]s with other intent-based violations," it intends to discern intent from "all of the facts and circumstances of each particular case, including a person's trading practices and patterns." As a practical matter, the CFTC will seek direct evidence from contemporaneous communications (*e.g.*, emails, instant messages) as well as algorithmic code to the extent relevant. The CFTC will also look for circumstantial evidence in the trading data – the number of orders submitted, duration of the orders before cancellation, relationship between cancelled and executed orders, and so on.

8. Finally, the CFTC provided "four non-exclusive examples of possible situations" constituting spoofing. 78 Fed. Reg. at 31896. Most recent cases seem to belong to the third and / or fourth of these categories:

    a. "Submitting or cancelling bids or offers to overload the quotation system of a registered entity"

    b. "Submitting or cancelling bids or offers to delay another person's execution of trades"

    c. "Submitting or cancelling multiple bids or offers to create an appearance of false market depth"

    d. "Submitting or cancelling bids or offers with intent to create artificial price movements upwards or downwards"

ii. As with other provisions of the CEA, the CFTC can bring administrative proceedings or district court cases for alleged violations of Section 4c(a)(5)(C).

1. A person[5] who is found liable for spoofing in an administrative proceeding can be barred from trading on an exchange, have his CFTC registration suspended or revoked, and be forced to pay a penalty and restitution. The penalty may not exceed the greater of $140,000 or triple the monetary gain to the person for each violation. A violator may also be ordered to cease and desist. *See* CEA §§ 6(c)(4), 6(c)(10), 6(d), 7 U.S.C. §§ 9(4), 9(10), 13b (2012).

2. A person found liable for spoofing in federal district court can be subject to an injunction, and forced to pay disgorgement, restitution, and a penalty. The penalty may not exceed the greater of $140,000 or triple the monetary gain to the person for each violation. *See* CEA § 6c, 7 U.S.C. § 13a-1 (2012); 17 C.F.R. § 143.8 (2012) (adjusting statutory penalty amount for inflation).

3. In addition, the DOJ can bring criminal charges against a defendant who "knowingly" violates Section 4c(a)(5)(C). *See* CEA § 9(a)(2), 7 U.S.C. § 13(a)(2) (2012). If criminally convicted of spoofing, a defendant can face up to $1 million in fines and 10 years in prison per count. *See* CEA § 9(a)(2), 7 U.S.C. § 13(a)(2) (2012).

b. Dodd-Frank also amended the general prohibition against manipulation contained in Section 6(c) of the CEA. *See* 7 U.S.C. § 9 (2012). The new Section 6(c) includes a general securities-style antifraud / anti-manipulation provision in CEA § 6(c)(1), 7 U.S.C. § 9(1) (2012), in addition to Section 6(c)'s pre-existing anti-manipulation prohibition, which is now found in CEA § 6(c)(3), 7 U.S.C. § 9(3) (2012). Post Dodd-Frank, the CFTC has invoked these provisions in two cases that involved allegations of spoofing. *See CFTC v. Nav Sarao Ltd. PLC, et al.*, No. 15 Civ. 3398 (N.D. Ill. April 17, 2015); *CFTC v. Igor B. Oystacher, et al.*, No. 15 Civ. 9196 (N.D. Ill. Oct. 19, 2015).

i. Under Section 6(c)(1), it is now "unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with any swap, or a contract of sale of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate . . ." *See* CEA § 6(c)(1), 7 U.S.C. § 9 (2012).

[5] The enforcement provisions described here and elsewhere in this outline do not necessarily apply to a "registered entity" (a category that includes regulated exchanges, trading facilities, and data repositories), which is subject to separate statutory provisions and potentially different penalties.

1. This provision was modeled on Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”), but with an added prohibition on attempt (which does not exist in the securities statutes).

2. To implement new CEA § 6(c)(1), the CFTC promulgated Rule 180.1, which prohibits material misstatements and fraudulent conduct in connection with swaps and futures. *See* 17 C.F.R. § 180.1. The language of Rule 180.1 was consciously modeled on, and closely tracks, that of SEC Rule 10b-5 (again, with an added prohibition on attempt). *See* CFTC, *Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices*, 76 Fed. Reg. 41398 (July 14, 2011) (adopting release for Rules 180.1 and 180.2).

3. The CFTC has said that it “will be guided, but not controlled, by the substantial body of judicial precedent applying the comparable language of SEC Rule 10b-5.” *Id*. at 41399. This may mean that the case law on manipulation under Section 10(b) and Rule 10b-5 (some of which is discussed in Part IV(a) below) is also applicable to the CEA’s counterpart statute and rule.

4. At the same time, Congress and the CFTC have sought to separate the new securities-style antifraud prohibitions in Section 6(c)(1) and Rule 180.1, on the one hand, from, on the other, the pre-existing statutes and traditional case law on CEA manipulation. CEA § 6(c)(1)(B) and Rule 180.1(c) each provide that “nothing in [CEA § 6(c)] shall affect, or be construed to affect, the applicability of [CEA § 9(a)(2), 7 U.S.C. § 13(a)(2) (2012)].” *See also* Part III(b)(ii) below (discussing CEA § 6(c)(3) and CFTC Rule 180.2).

5. Rule 180.1 by its terms prohibits only “intentional[]” or “reckless[]” conduct. The CFTC has explained that, “[c]onsistent with long-standing precedent under the commodities and securities laws, the [CFTC] defines recklessness as an act or omission that departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she was doing.” 76 Fed. Reg. at 41404 (internal quotation marks and citations omitted).

6. Section 6(c)(1) and Rule 180.1 contain a type of prohibition not present in the Exchange Act and SEC Rule 10b-5: they classify as unlawful manipulation for purposes of CEA

§ 6(c)(1) "delivering, or causing to be delivered . . . a false or misleading or inaccurate report concerning . . . market information or conditions that affect or tend to affect the price of any commodity in interstate commerce," with knowledge or reckless disregard of the report's being false, misleading, or inaccurate. CEA § 6(c)(1)(A), 7 U.S.C. § 9(1)(A) (2012); 17 C.F.R. § 180.1(a)(4).

ii. New Section 6(c)(3) makes it "unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of" a swap, commodity, or future. *See* CEA § 6(c)(3), 7 U.S.C. § 9(3) (2012). This provision stems from a prohibition contained in pre-Dodd-Frank Section 6(c).

1. The CFTC has promulgated Rule 180.2, which substantially verbatim tracks CEA § 6(c)(3). *See* 17 C.F.R. § 180.2; 76 Fed. Reg. 41398 (July 14, 2011) (CFTC adopting release).

2. According to the CFTC, Section 6(c)(3) and Rule 180.2 incorporate the old four-part price manipulation test from cases that arose under Sections 6(c) and 9(a)(2). In other words, the Government still must show "(1) that the accused had the ability to influence market prices; (2) that the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) that artificial prices existed; and (4) that the accused caused the artificial prices." 76 Fed. Reg. at 41407.

3. In adopting Rule 180.2, the CFTC made sure to clarify that, unlike with Rule 180.1, a violation of Rule 180.2 requires that a person "act with the requisite specific intent" – recklessness is not enough for traditional price manipulation. *Id.* at 41407.

4. Section 6(c)(3), unlike its predecessor in old Section 6(c) and the similar provision in Section 9(a)(2), has the words "directly or indirectly," potentially making CEA § 6(c)(3) further-reaching than CEA § 9(a)(2).

iii. As with other provisions of the CEA, the CFTC can bring an administrative proceeding or a federal district court case for alleged violations of Section 6(c).[6]

[6] For simplicity, this section presupposes that all violations of Sections 6(c)(1) and 6(c)(3) would be classified as "manipulation" (or attempted manipulation) subject to the heightened penalty regime. However, it may be that there is conduct (such as a pure material misstatement, with no attempt to manipulate prices, *see* 17 C.F.R. § 180.1(a)(2)) that would violate Section 6(c)(1) and Rule 180.1 but would not properly qualify as "manipulation" for purposes of the enhanced penalty provisions. For comparison, the case law on Securities Exchange Act Section 10(b) distinguishes fairly clearly between market manipulation, on the one hand, and misstatements, on the other.

1. A defendant who is found liable for manipulation or attempted manipulation in an administrative proceeding can be barred from trading on an exchange, have his CFTC registration suspended or revoked, and be forced to pay a penalty and restitution. The penalty may not exceed the greater of $1 million (as opposed to the $140,000 per-violation penalty that applies to a violation of the specific prohibition on spoofing in CEA § 4c(a)(5)(C)) or triple the monetary gain to the person for each violation. A violator may also be ordered to cease and desist. *See* CEA §§ 6(c)(4), 6(c)(10), 6(d), 7 U.S.C. §§ 9(4), 9(10), 13b (2012).

2. A defendant who is found liable for manipulation or attempted manipulation in district court can be subject to an injunction, and forced to pay disgorgement, restitution, and a penalty. The penalty may not exceed the greater of $1,025,000 (again, compare to the $140,000 per-violation amount for a violation of the anti-spoofing provision) or triple the monetary gain to the person for each violation. *See* CEA § 6c, 7 U.S.C. § 13a-1 (2012); 17 C.F.R. § 143.8 (2012) (adjusting statutory penalty amounts for inflation).

c. The CEA's other anti-manipulation provision, Section 9(a)(2), remains in force, although Dodd-Frank upped the per-occurrence penalty for a violation to $1,000,000. *See* 7 U.S.C. § 13(a)(2) (2012).

   i. As noted above, to prove manipulation under Section 9(a)(2), the Government must show (1) that the accused had the ability to influence market prices; (2) that she specifically intended to do so; (3) that artificial prices existed; and (4) that the accused caused the artificial prices. See Part II(a)(iii)(1) above.

   ii. To prove attempted manipulation under Section 9(a)(2), the Government still must show (1) an intent to affect the market price and (2) some overt act in furtherance of that intent. See Part II(a)(iii)(2) above.

   iii. The CFTC can bring an administrative proceeding or a federal district court case for an alleged violation of Section 9(a)(2). As a practical matter, in a non-criminal case, a violation of Section 9(a)(2) subjects a person to the same remedies as does a violation of Section 6(c)(1) or Section 6(c)(3) (assuming it is based on manipulation, see footnote 6 above). CEA § 6(c)(10)(C)(ii), 7 U.S.C. § 9(10)(C)(ii) (2012); CEA § 6c(d)(1)(B), 7 U.S.C. § 13a-1(d)(1)(B) (2012). Those remedies are discussed in Part III(b)(iii) above.

iv. The DOJ can bring criminal charges for manipulation under Section 9(a)(2). The same four-part test that applies in civil cases applies in criminal cases as well. *E.g.*, *United States v. Reliant Energy Servs.*, 420 F. Supp. 2d 1043, 1056 (N.D. Cal. 2006). If convicted under Section 9(a)(2) of criminal manipulation, a defendant can be required to pay up to $1 million in fines and serve up to 10 years in prison per count. *See* 7 U.S.C. § 13(a)(2) (2012).

d. The mail, wire, and commodities fraud statutes are still in play in criminal spoofing cases. *See United States v. Sarao*, Case No. 15-cr-00075 (N.D. Ill. Feb. 11, 2015); *United States v. Milrud*, Crim No. 15-455 (D.N.J. Jan. 12, 2015).

IV. SPOOFING IN THE SECURITIES MARKETS

a. Unlike the CEA, the securities statutes do not outlaw spoofing by name. Instead, the Securities and Exchange Commission (SEC) has taken aim at spoofing and layering by characterizing it as a manipulative practice.

b. The SEC's spoofing cases sometimes invoke the antifraud and anti-manipulation prohibitions of Exchange Act Section 10(b) (15 U.S.C. § 78j) and Rule 10b-5 (17 C.F.R. 210.10b-5), as well as Section 17(a) of the Securities Act, 15 U.S.C. § 77q(a).

i. Section 10(b) of the Exchange Act prohibits "manipulative or deceptive device[s] or contrivance[s]" in violation of SEC rules such as Rule 10b-5. The Supreme Court has said that "manipulation" is "'virtually a term of art when used in connection with securities markets.' The term refers generally to practices, such as wash sales, matched orders, or rigged prices, *that are intended to mislead investors by artificially affecting market activity*," *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977) (citation omitted) (emphasis added), and "connotes intentional or willful conduct *designed to deceive or defraud investors by controlling or artificially affecting the price of securities*." *Ernst & Ernst v Hochfelder*, 425 US 185, 199 (1976) (emphasis added).

ii. The Second Circuit has elaborated: "Case law in this circuit and elsewhere has required a showing that an alleged manipulator engaged in market activity aimed at deceiving investors as to how other market participants have valued a security. The gravamen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators. In identifying activity that is outside the natural interplay of supply and demand, courts generally ask whether a transaction sends a

false pricing signal to the market." *Wilson v. Merrill Lynch & Co.*, 671 F.3d 120, 130 (2011) (citations and internal quotation marks omitted); *see also GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 205 (3d Cir. 2001) (concluding that a "Section 10(b) plaintiff [must] establish that the alleged manipulator injected 'inaccurate information' into the market or created a false impression of market activity.").

iii. To the extent that spoofing can be characterized as artificially affecting the price of a security, sending a false pricing signal, or deceiving market participants about the natural interplay of supply and demand, it could be a violation of Section 10(b) and Rule 10b-5. (The SEC's modern spoofing cases – discussed below in Part V(c) – have all been settled without having been tested in litigation.)

c. Most of the SEC's spoofing cases have also invoked Exchange Act Section 9(a)(2), 15 U.S.C. § 78i (2015), which in its current form[7] makes it unlawful "[t]o effect . . . a series of transactions . . . creating actual or apparent active trading in [a security], or raising or depressing the price [of a security], for the purpose of inducing the purchase or sale of such security by others." This provision, which appears in the Exchange Act section on "Manipulation of Security Prices," was probably designed to target practices like wash sales, in which consummated trades have historically been used to mislead other market participants. The SEC apparently takes the position that in spoofing cases, cancelled – that is to say, unconsummated – orders can be a "transaction" that "creat[es] actual or apparent active trading." *See* pages 10-11 of the Order in *Biremis Corp., et al.*, Exchange Act Release No. 68456 (SEC Dec. 18, 2012), discussed in Part V(c) below.

d. The SEC has also accused broker-dealers whose accounts were used by others who engaged in spoofing or layering of violating the Market Access Rule (SEC Rule 15c3-5, 17 C.F.R. § 240.15c3-5) and other supervisory requirements.

e. The Financial Industry Regulatory Authority (FINRA) has brought enforcement actions against spoofing and layering. These have typically alleged violations of just and equitable principles of trade (FINRA Rule 2010 / NASD Rule 2110), market access deficiencies (Exchange Act § 15(c)(3) and Rule 15c3-5 thereunder), and/or supervisory failures (FINRA Rule 3110 / NASD Rule 3010). Cases brought by FINRA are discussed in Part V(d) below.

[7] Before Dodd Frank, this provision applied only to securities registered on a national securities exchange, and to security-based swap agreements. 15 U.S.C. § 78i (2009).The amended version applies to "any security other than a government security" as well as to security-based swap agreements.

V. SPOOFING CASES

a. Criminal Cases

i. *United States v. Sarao*, Case No. 15-cr-00075 (N.D. Ill.) (complaint filed Feb. 11, 2015)

1. Navinder Singh Sarao is alleged to have engaged in "layering" involving the E-Mini S&P 500 futures contracts. Sarao, apparently with the assistance of a computer program, allegedly placed large orders that he did not intend to execute in order to move the market and thereby capture profit from his genuine positions. Sarao also allegedly took steps to minimize the chances that his non-bona fide orders would be executed, such as keeping his orders in the "middle of the book" – that is, several increments higher (lower) than the prevailing lowest ask (highest bid). The Government has asserted that Sarao's trading contributed to the May 6, 2010 "Flash Crash."

2. The Government charged Sarao with committing wire fraud in violation of 18 U.S.C. § 1343; commodities fraud in violation of 18 U.S.C. § 1348; spoofing in violation of CEA §§ 4c(a)(5)(C) and 9(a)(2), 7 U.S.C. §§ 6c(a)(5)(C) and 13(a)(2); and commodities manipulation in violation of CEA § 9(a)(2), 7 U.S.C. § 13(a)(2).

3. The Government is currently seeking to extradite Sarao from England. On March 23, 2016, an English judge ruled that Sarao should be extradited to the United States. As of this writing, Sarao was seeking to appeal the extradition order.

4. The CFTC has also brought a civil case against Sarao. *See CFTC v. Nav Sarao Ltd. PLC, et al.*, No. 15-civ-03398 (N.D. Ill.) (discussed below).

ii. *United States v. Milrud*, Crim. No. 15-455 (D.N.J.) (complaint filed Jan. 12, 2015)

1. The Government accused Aleksandr Milrud, a stock trader, of recruiting large numbers of overseas traders to engage in layering of stocks on his behalf. Milrud allegedly directed his overseas traders to cover up their spoofing and Milrud's involvement in it by using multiple trading accounts and working through third parties.

2. The Government initially charged Milrud via complaint with wire fraud (18 U.S.C. § 1343) and conspiracy to commit securities fraud (18 U.S.C. § 371).

3. In September 2015, the Government filed an information, and Milrud agreed to plead guilty to conspiracy to commit securities fraud. In December 2015, the court entered a forfeiture judgment of $285,000 against Milrud.

iii. *United States v. Coscia*, Case No. 14-cr-00551 (N.D. Ill.) (indictment filed Oct. 1, 2014)

1. Michael Coscia, the manager and owner of Panther Energy Trading LLC, is alleged to have used an algorithm to place and then rapidly cancel large orders for futures contracts, allowing him to buy lower (or sell higher) than was possible before the orders were entered. Coscia allegedly then reversed the strategy, selling contracts for a price higher than the price at which he bought them, or buying back contracts at a price higher than the price at which he sold them. The Government alleges that Coscia placed the large orders in an effort to confuse other market participants and induce them to react to his deceptive information.

2. Coscia was indicted on six counts of commodities fraud in violation of 18 U.S.C. § 1348 and six counts of spoofing in violation of 7 U.S.C. §§ 6c(a)(5)(C) and 13(a)(2). This was the first criminal indictment for spoofing.

3. On November 3, 2015, a jury returned a verdict of guilty on all counts. Coscia's sentencing is currently scheduled for July 13, 2016.

4. Coscia's case is so far the only one in which a court has had occasion to make rulings regarding the scope and legitimacy of the spoofing prohibition, and of the evidence relevant to establishing or negating a violation. See discussion of Coscia's vagueness challenge to Section 4c(a)(5)(C) in Part VI(d) below and of an evidentiary ruling in Part VI(b)(vi).

5. The CFTC also brought a civil case against Coscia and Panther for spoofing. *See In re Panther Energy Trading LLC, et al.*, CFTC Docket No. 13-26 (July 22, 2013) (also discussed below).

b. CFTC Cases

i. *CFTC v. Igor B. Oystacher and 3 Red Trading LLC*, No. 15-cv-9196 (N.D. Ill.) (complaint filed Oct. 19, 2015)

1. The CFTC has accused trader and his wholly owned firm of using large, non-bona fide orders to create a false picture of the order book and thereby induce the execution of the defendants' smaller orders on the other side of the market. The CFTC challenges order activity relating to various commodity futures (including for copper, crude oil, natural gas, and the volatility index (VIX)) on at least 51 days from December 2011 to January 2014. The CFTC's complaint does not indicate whether the orders were placed and cancelled manually or algorithmically.

2. The charges were brought under Section 4c(a)(5)(C) of the CEA as well as Section 6(c)(1) and Rule 180.1.

3. The month after filing, the CFTC sought a preliminary injunction on the ground that violative conduct had continued and was continuing after the Complaint was filed. A hearing concluded on May 12, 2016 with the judge taking the CFTC's application under advisement.

4. According to news reports, Oystacher is also the subject of a federal criminal inquiry. Matthew Leising, *The Man Accused of Spoofing Some of the World's Biggest Futures Exchanges*, BLOOMBERG (Oct. 19, 2015), http://www.bloomberg.com/news/articles/2015-10-19/before-u-s-called-igor-oystacher-a-spoofer-he-was-known-as-990.

ii. *CFTC v. Heet Khara and Nasim Salim*, No. 15-civ-03497 (S.D.N.Y.) (complaint filed May 5, 2015)

1. The two defendants are in the United Arab Emirates but traded gold and silver futures in the U.S. On several occasions in early 2015, the defendants allegedly entered small orders on one side of the market as well as a series of larger, layered orders on the opposite side of the market. Once their small orders were filled, the traders cancelled their large orders. The CFTC alleges that the defendants never intended to fill their large orders.

2. The charges were brought under Section 4c(a)(5)(C) of the CEA.

3. Both defendants eventually settled with the CFTC on a neither-admit-nor-deny basis.[8] On March 31, 2016, the Southern District of New York entered a consent order pursuant to which Khara and Salim would each pay a civil monetary penalty of, respectively, $1,380,000 and $1,310,000, and were subject to broad injunctions against trading commodities.

iii. *CFTC v. Nav Sarao Futures Ltd. PLC et al.*, No. 15-civ-03398 (N.D. Ill.) (complaint filed April 17, 2015)

1. Navinder Singh Sarao (who was also charged criminally, see discussion above) and his wholly-owned trading entity allegedly used an automated layering algorithm as well as manual techniques to reap $40 million in profits.

2. CFTC charges were brought under (i) Section 4c(a)(5)(C); (ii) Sections 6(c)(3) and 9(a)(2) and Rule 180.2; and (iii) Section 6(c)(1) and Rule 180.1.

3. Some of the conduct occurred before August 15, 2011, when amended CEA §§ 6(c)(1) and 6(c)(3) (and Rules 180.1 and 180.2) took effect. The pre-Dodd Frank conduct is alleged to have violated CEA §§ 6(c) and 9(a)(2).

4. Discovery in the civil matter has been stayed in light of the parallel criminal proceedings.

iv. *In re Panther Energy Trading LLC, et al.*, CFTC Docket No. 13-26 (July 22, 2013)

1. Michael Coscia (who has since been indicted and convicted, see above), the manager and owner of Panther Energy Trading LLC, used an algorithm to place orders and then cancel them before they could be executed. Panther used the technique in trading a wide variety of futures contracts.

2. This was the first case brought under CEA § 4c(a)(5)(C).

3. The respondents settled on a neither-admit-nor-deny basis, paying a $1.4 million civil penalty on top of a $1.4 million

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[8] In a settlement on a neither-admit-nor-deny basis, the defendant (known as a respondent in agency proceedings) consents to the *issuance* of an order by the regulator, or the entry of a judgment by a court, that imposes sanctions and often contains findings by the regulator, including findings that the defendant/respondent has violated the law. The defendant/respondent expressly does not admit or deny the findings, despite consenting to their public dissemination. In addition, SEC and CFTC rules prohibit a defendant/respondent who enters into a neither-admit-nor-deny settlement from publicly denying or even factually undermining the agency's findings.

disgorgement obligation, and agreeing to be barred from futures trading for one year.

v. *CFTC v. Moncada*, Civil Action No. 12-cv-8791 (S.D.N.Y.) (complaint filed Dec. 4, 2012)

1. Eric Moncada entered and then canceled numerous orders for a wheat futures contract. The CFTC alleged that Moncada never intended to fill those orders and that he placed them for the purpose of misleading other market participants and thereby manipulating the market. The alleged violations occurred in 2009, before the enactment of Dodd-Frank.

2. The charges were brought under Sections 6(c) and 9(a)(2) of the pre-Dodd Frank CEA. Moncada was also charged with engaging in fictitious sales in violation of Section 4c(a) of the pre-Dodd Frank CEA.

3. After litigating for a time, the CFTC and Moncada settled the manipulation charges on a neither-admit-nor-deny basis. Moncada agreed to pay a $1.56 million fine and to be subject to a one-year trading ban and a five-year prohibition on trading wheat futures.

vi. *In re Gelber Group*, CFTC Docket No. 13-15 (Feb. 8, 2013)

1. A Gelber Group trader[9] entered orders for NASDAQ E-mini 100 futures contracts during pre-opening sessions, then withdrew his orders before the market opened. The CFTC alleged that the trader had no intention of filling his orders and that the orders caused price fluctuations in the market for NASDAQ E-mini 100 futures. Later, two Gelber traders engaged in wash trades in certain futures contracts, allegedly in order to inflate Gelber's volume, which enabled Gelber to obtain rebates through an exchange program that rewarded trade volume. The alleged violations occurred in 2009 and 2010, before Dodd-Frank took effect.

2. The charges were brought under former Sections 4c(a)(2)(A), 4c(a)(2)(B), and 9(a)(2) of the CEA.

3. The Gelber Group paid a $750,000 fine on a neither-admit-nor-deny basis.

[9] Possibly Igor Oystacher, who worked at Gelber during the time period at issue. *See, e.g.*, Matthew Leising, *The Man Accused of Spoofing Some of the World's Biggest Futures Exchanges*, BLOOMBERG (Oct. 19, 2015), http://www.bloomberg.com/news/articles/2015-10-19/before-u-s-called-igor-oystacher-a-spoofer-he-was-known-as-990; Bradley Hope, *As 'Spoof' Trading Persists, Regulators Clamp Down*, WALL ST. J. (Feb. 22, 2015).

vii. *In re Bunge Global Markets*, CFTC Docket No. 11-10 (Mar. 22, 2011)

1. Bunge traders entered orders for soybean futures contracts during pre-opening sessions, then withdrew their orders before the market opened. The CFTC alleged that the traders entered the orders to gauge the depth of support for soybean futures at different price levels and had no intention of allowing the orders to be executed. The orders allegedly had a major effect on the Indicative Opening Price (IOP) for soybeans futures. The conduct at issue occurred in 2009, before the enactment of Dodd-Frank.

2. The charges were brought under Sections 4c(a)(2)(B) and 9(a)(2) of the pre-Dodd Frank CEA.

3. Bunge paid a $550,000 fine on a neither-admit-nor-deny basis.

viii. *In re UBS AG and UBS Securities Japan Co., Ltd.*, CFTC Docket No. 13-09 (Dec. 19, 2012)

1. The CFTC alleged that UBS engaged in a variety of misconduct with the aim of manipulating LIBOR rates. Some of the alleged manipulation was said to constitute spoofing: in particular, according to the CFTC, a UBS trader asked brokers to make false bids and offers on cash trades in the market to skew market perception of cash rates. (See pp. 26-27 of Order.) The alleged violations occurred before Dodd-Frank took effect.

2. The charges were brought under Sections 6(c), 6(d), and 9(a)(2) of the pre-Dodd Frank CEA.

3. On a neither-admit-nor-deny basis, UBS paid a $700 million fine and agreed to develop more comprehensive monitoring and auditing systems.

ix. *In re RP Martin Holdings Limited and Martin Brokers (UK) Ltd.*, CFTC Docket No. 14-16 (May 15, 2014)

1. This was another case arising out of the global investigation into alleged LIBOR manipulation. RP Martin's Yen brokers allegedly offered false bids to their clients, many of which were Yen submitters, creating the false impression that banks were willing to trade Yen at a particular price. The CFTC alleges that the RP Martin brokers did this in order to manipulate Yen LIBOR rates in ways that benefited a UBS

trader who was paying the RP Martin brokers to offer false bids. The alleged violations occurred before the enactment of Dodd-Frank.

2. The charges were brought under Sections 6(c), 6(d), and 9(a)(2) of the pre-Dodd Frank CEA.

3. Respondents agreed, on a neither-admit-nor-deny basis, to pay a $1.2 million civil penalty and to strengthen their internal controls, policies and procedures.

x. Pending Investigations

1. The CFTC is reportedly investigating Chicago-based high-frequency trading firm Allston Trading LLC for alleged spoofing. *See* Matthew Leising & Silla Brush, *Allston Said to Face CFTC Probe Into Alleged Manipulation*, BLOOMBERG (Mar. 31, 2015), http://www.bloomberg.com/news/articles/2015-03-31/allston-said-to-face-cftc-investigation-for-alleged-manipulation.

c. SEC Cases

i. *Behruz Afshar, et al.,* Securities Act Release No. 9983 (SEC Dec. 3, 2015)

1. SEC instituted administrative proceedings against twin brothers, their friend, and two limited liability companies owned by the brothers.

2. The SEC has alleged that Respondents, among other things, engaged in a scheme to take advantage of the PHLX exchange's "maker-taker" model. The SEC alleged that Respondents placed large All-Or-Nothing (AON) orders and then placed smaller displayed orders for the same option series and price on the opposite side. The SEC alleges that Respondents did not intend to execute the smaller orders, but instead, placed the orders to alter the best bid or offer so that other market participants would submit orders at the new best bid or offer that would execute against the Respondents' AON orders. After the AON orders were executed, the Respondents cancelled their open smaller orders. The Respondents, according to the SEC, received "maker" rebates for adding liquidity (because the large AON orders pre-existed the other market participants' induced orders) but were not penalized for cancelling the smaller orders.

3. The spoofing charges were brought under Section 17(a) of the Securities Act and Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b-5 thereunder.

4. The case had been headed for an administrative trial, but settled on June 13, 2016 on a neither-admit-nor-deny basis. The consent decree imposed industry bans, total disgorgement of $1,573,237, and total civil money penalties of $325,000.

ii. *Briargate Trading, LLC*, *et al.*, Securities Act Release No. 9959 (SEC Oct. 8, 2015)

1. SEC alleged that proprietary trading firm and trader used large non-bona fide pre-open orders to affect NYSE's pre-open imbalance messages. The published imbalances in turn impacted the opening price at other exchanges where the respondents had bona fide orders on the other side of the market.

2. Settled charges brought under Section 17(a) of the Securities Act, Exchange Act Section 10(b) and Rule 10b-5, and Exchange Act Section 9(a)(2).

3. Respondents consented on a neither-admit-nor-deny basis to $525,000 disgorgement plus prejudgment interest and a combined $500,000 in civil penalties.

iii. *SEC v. Aleksandr Milrud*, No. 15-cv-00237 (KM) (D.N.J.) (complaint filed Jan. 13, 2015)

1. SEC charged Milrud with directing overseas traders to engage in a layering scheme.

2. SEC accused Milrud, on various theories of primary and derivative or secondary liability, of violating Section 17(a) of the Securities Act, Exchange Act Section 10(b) and Rule 10b-5, and Exchange Act Section 9(a)(2).

3. A parallel criminal case in which Milrud recently pled guilty is discussed above. The SEC case has been stayed during the pendency of the criminal proceedings.

iv. *Wedbush Securities Inc., et al.*, Exchange Act Release No. 72340 (SEC June 6, 2014) (charging order), Exchange Act Release Nos. 73652-54 (SEC Nov. 20, 2014) (settlement orders)

1. SEC charged Wedbush and two executives with violating the Market Access Rule (SEC Rule 15c3-5, 17 C.F.R. § 240.15c3-5) by failing to implement proper controls and procedures to prevent, among other things, illegal layering.

2. The Market Access Rule requires a broker-dealer that gives customers access to exchanges and other trading venues to establish controls and procedures designed to ensure that customers comply with relevant regulatory requirements. The system of controls and procedures must be under the exclusive control of the broker-dealer.

3. Wedbush provided “sponsored” market access, allowing customers “to send orders that bypassed Wedbush’s trading system and were routed directly to exchanges and other trading venues.” *Wedbush Securities* Order (Nov. 20, 2014), at 4. These customers in turn each had hundreds or thousands of traders. *Id*. The customers used proprietary trading platforms or ones leased from third-party vendors, known as service bureaus.

4. Wedbush, among other failures, received reports of layering activity in one of its customer accounts, but did not take appropriate measures to stop it. *Id*. at 12-13. Wedbush did not review for layering, and failed to file required suspicious activity reports relating to layering. *Id*. at 13.

5. Wedbush eventually consented to a $2.5 million penalty and a series of remedial undertakings. The executives each consented to $25,000 disgorgement plus prejudgment interest and a $25,000 penalty. Wedbush admitted facts in connection with its settlement.

v. *Visionary Trading LLC, et al.*, Exchange Act Release No. 71871 (SEC April 4, 2014)

1. SEC charged trader with layering in violation of Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b-5, along with other charges against trader and related persons.

2. Trader consented on a neither-admit-nor-deny basis to an industry bar and to payment of $1,103,000 disgorgement plus prejudgment interest and a $785,000 penalty.

vi. *Biremis Corp., et al.*, Exchange Act Release No. 68456 (SEC Dec. 18, 2012)

1. SEC accused broker-dealer and its two co-founders with failing to reasonably supervise a force of overseas day traders that engaged in layering in violation of Section 9(a)(2) of the Exchange Act.

2. On a neither-admit-nor-deny basis, SEC revoked broker-dealer's registration, barred the two individuals from the securities markets, and fined the co-founders $250,000 each.

vii. *Hold Brothers On-Line Investment Services, LLC, et al.*, Exchange Act Release No. 67924 (SEC Sept. 25, 2012)

1. SEC alleged that accounts at broker-dealer and under the control of its co-founder were used by overseas traders for layering, and that broker-dealer failed to properly police this activity.

2. SEC accused broker-dealer and related entities and individuals of violating Section 9(a)(2) of the Exchange Act on various theories of primary and secondary liability.

3. Broker-dealer agreed to pay approximately $638,000 in disgorgement and a penalty of approximately $1.9 million; related entity agreed to $1.258 million in disgorgement. Individuals each consented to various industry bars and a $75,000 penalty. Settlements were on a neither-admit-nor-deny basis.

4. Broker-dealer defaulted on most of the payment obligation, prompting the SEC to file an action in federal court to enforce the settlement decree. *SEC v. Hold Brothers On-Line Investment Services, LLC*, No. 14 Civ. 7286 (D.N.J. Sept. 21, 2014).

viii. *SEC v. Alexander M. Pomper*, SEC Lit. Release No. 17221 (Nov. 5, 2001), SEC Lit. Release No. 17479 (April 19, 2002)

1. SEC filed a federal-court action accusing trader of spoofing by using phantom limit orders to affect the National Best Bid and Offer prices for thinly traded securities.

2. Charges were filed under Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5.

3. Trader eventually agreed, on a neither-admit-nor-deny basis, to pay $9,800 in disgorgement and prejudgment interest and a $15,000 civil penalty.

d. Financial Industry Regulatory Authority (FINRA) Cases[10]

i. *Marcus C. Rodriguez*, Letter of Acceptance, Waiver and Consent, No. 2013037932401 (Feb. 24, 2016) (president, compliance officer, and principal fined $50,000 and barred from associating with a FINRA member firm for, among other things, alleged supervisory failures that allowed layering and spoofing, in violation of NASD Rule 3010 and FINRA Rule 2010). Rodriguez was also the subject of another enforcement action for previous conduct at another employer.

ii. *Electronic Transaction Clearing, Inc.*, FINRA Disciplinary Proceeding, No. 2010025475601 (Feb. 19, 2016) (brokerage firm censured and fined $875,000 pursuant to a settlement for allegedly failing to police spoofing and other forms of manipulative trading in violation of NASD Rule 3010, FINRA Rules 2010 and 3110, Exchange Act § 15(c)(3), and Exchange Act Rule 15c3-5).

iii. *Great Point Capital LLC, et al.*, FINRA Disciplinary Proceeding, No. 2008014822702 (Dec. 11, 2015) (brokerage firm censured, fined $1,100,000, and ordered to retain an Independent Consultant, with executive jointly liable for $50,000 of the fine and barred from association with a FINRA member, pursuant to a settlement for allegedly failing to police layering, in violation of NASD Rules 3010 and 2110, and FINRA Rule 2010, among other violations).

iv. *Wedbush Securities Inc.*, FINRA Disciplinary Proceeding, No. 2009020634401 (Dec. 1, 2015) (brokerage firm fined a total of $1,800,000 in the concurrent settlements of several Disciplinary Proceedings, including one that alleged failure to police spoofing and other forms of manipulative trading, in violation of NASD Rules 3010, 2110, and 3011, FINRA Rules 3310 and 2010, Exchange Act § 15(c)(3), and Exchange Act Rule 15c3-5).

v. *Lightspeed Trading, LLC*, FINRA Letter of Acceptance, Waiver and Consent, No. 2010023935005 (Feb. 13, 2015) (brokerage firm fined $250,000 for allegedly failing to police spoofing, in violation of NASD Rules 3010 and 2110, and FINRA Rule 2010, among other violations).

vi. *Transcend Capital, LLC*, FINRA Letter of Acceptance, Waiver and Consent, No. 2011029039801 (Dec. 17, 2013) (brokerage firm fined $200,000 for allegedly failing to police spoofing and other

[10] FINRA has brought many cases involving allegations of spoofing and layering, or brokerage firms' failure to police the same. This section has most of the cases filed since 2005 but is not necessarily comprehensive. Note that each FINRA proceeding referenced in this section represents a settlement in which the respondent consented to the entry of FINRA's findings without admitting or denying the allegations or findings. See footnote 8 above.

forms of manipulative trading, in violation of NASD Rule 3010, FINRA Rules 2010 and 3310, and Exchange Act Rule 15c3-5).

vii. *Newedge USA, LLC*, FINRA Letter of Acceptance, Waiver and Consent, No. 20090186944 (July 10, 2013) (brokerage firm fined $9.5 million for allegedly failing to police spoofing, in violation of NASD Rules 3010 and 2110, and FINRA Rule 2010, among other violations).

viii. *Title Securities, Inc.*, FINRA Letter of Acceptance, Waiver and Consent, No. 2010022913901 (Sept. 26, 2012) (brokerage firm fined $150,000 for allegedly failing to police spoofing and other forms of manipulative trading, in violation of NASD Rule 3011 and FINRA Rules 3310 and 2010).

ix. *Hold Brothers On-Line Investment Services, LLC*, FINRA Letter of Acceptance, Waiver and Consent, No. 2010023771001 (Sept. 25, 2012) (brokerage firm fined $5.9 million for allegedly failing to police spoofing, in violation of Exchange Act § 9(a)(1)-(2), NASD Rules 3010, 3310, IM-3310, 3320 and FINRA Rules 2010, 2020, 5210, 5210.01, and 5520, among other violations).

x. *Biremis Corp.*, FINRA Letter of Acceptance, Waiver and Consent, No. 2010021162202 (July 30, 2012) (brokerage firm expelled from FINRA, and executive barred from association with any member firm, for allegedly failing to police layering, in violation of NASD Rules 2110 and 3010, and FINRA Rule 2010, among other violations).

xi. *Todd M. Fernbach*, FINRA Letter of Acceptance, Waiver and Consent, No. 2009021082506 (June 18, 2012) (compliance officer fined $10,000 and suspended for 90 days for allegedly failing to police layering, in violation of NASD Rules 3011 and 2110, and FINRA Rule 2010, among other violations).

xii. *Robert T. Bunda*, FINRA Letter of Acceptance, Waiver and Consent, No. 2006005157101 (May 26, 2011) (trader suspended for 16 months and ordered to pay $175,000 fine and $171,740 in restitution, for alleged spoofing and other forms of manipulative trading, in violation of NASD Rules 2110, 2120, 3310, and IM-3310, among other violations).

xiii. *Trillium Brokerage Services, LLC*, FINRA Letter of Acceptance, Waiver and Consent, No. 2007007678201 (August 5, 2010) (brokerage firm, compliance officer, trading supervisor, and nine traders ordered to pay a total of $2.27 million in fines and disgorgement, in addition to individual suspensions, based on

alleged layering in proprietary accounts and supervisory failures, in violation of NASD Rules 2110, 2120, 3310, IM-3310, and 3010).

e. Exchange Cases

i. In the wake of Dodd-Frank, the futures exchanges have adopted rules that specifically prohibit spoofing as a supplement to their pre-existing prohibitions on manipulative and dishonest practices.

ii. The CME Group Exchanges' new Rule 575 (which took effect in September of 2014) prohibits "Disruptive Practices" and provides in part: "All orders must be entered for the purpose of executing bona fide transactions. . . . No person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution." *See also* CME Rules 432.B.2., 432.H., 432.Q., 432.T. (general prohibitions on dishonest and manipulative conduct, and conduct inconsistent with just and equitable principles of trade).

iii. ICE Futures U.S. ("ICE") now has a rule, Rule 4.02(l), that makes it a violation to "engage in any . . . manipulative or disruptive trading practices prohibited by the [CEA] or by [CFTC regulation], including . . . entering an order or market message . . . with . . . [t]he intent to cancel the order before execution, or modify the order to avoid execution." *See also* ICE Rules 4.02(a), 4.04 (general prohibitions on price manipulation and conduct inconsistent with just and equitable principles of trade).

iv. Under CME Rule 575 and ICE Rule 4.02(l), entering an order either with intent to cancel it before execution, or with "reckless disregard" for the order's adverse impact on the market, may be enough to constitute a violation.

v. The CME has brought at least four cases under its new anti-spoofing rule. ICE has brought at least one case under its new anti-spoofing rule. Disciplinary cases include:[11]

1. *William Chan*, COMEX File No. 14-0059-BC, NYMEX File No. 14-0059-BC (June. 9, 2016) (trader fined a total of $45,000 in companion cases and suspended from accessing CME Group trading venues for 15 business days for alleged violations of Exchange Rule 575.A; trader neither admitted nor denied the violations).

2. *Joshua Bailer*, NYMEX File No. 15-0073-BC (May 26, 2016) (trader fined $35,000 and suspended from accessing CME

[11] This section and the next provide recent examples but are not intended as a comprehensive listing.

Group trading venues for 10 business days for alleged violations of Exchange Rule 575.A; trader neither admitted nor denied the violations).

3. *Heet Khara*, *Nasim Salim*, COMEX File Nos. 15-0103-BC-1, 15-0103-BC-2 (Apr. 28, 2016) (traders fined respectively, $90,000 and $100,000 and barred from applying for Membership at any CME Group Exchange and from accessing CME Group trading venues for alleged violations of Exchange Rule 575.A, among other violations; traders neither admitted nor denied the violations).

4. *James Shrewsbury*, ICE File No. 2015-045 (Mar. 11, 2016) (trader fined $139,850, including $69,850 disgorgement, and suspended from accessing all electronic trading and clearing platforms owned or controlled by ICE Futures U.S. for 10 business days for possible violations of ICE Rule 4.02(l), including its anti-spoofing prohibition; trader neither admitted nor denied the violations).

vi. Disciplinary cases brought by exchanges under more general prohibitions on manipulative or dishonest practices include:

1. *David Kotz*, NYMEX File No. 14-9933-BC (Apr. 28, 2016) (trader fined $200,000 and suspended from accessing any CME Group trading venue for 15 business days; trader neither admitted nor denied the violations).

2. *Matthew Garber*, CBOT File No. 12-8862-BC (Nov. 6, 2015), CBOT File No. 11-8570-BC (Nov. 6, 2015) (trader fined in two separate cases a total of $60,000 and suspended from accessing CME Group trading venues for a total of 35 business days; trader neither admitted nor denied the violations).

3. *Nitin Gupta*, COMEX File No. 13-9391-BC (Oct. 12, 2015) (trader fined $100,000 and banned from trading on any CME Group exchange).

4. *James Groth*, CBOT File No. 11-8463-BC (July 20, 2015) (trader fined $55,000 and suspended from trading on any CME Group exchange for 10 business days; trader neither admitted nor denied the violations).

5. *Igor Oystacher*, ICE File No. 2013-009 (June 5, 2015) (trader fined $125,000; trader neither admitted nor denied the findings).

6. *Igor Oystacher*, COMEX File No. 11-08380-BC & NYMEX File No. 10-07963-BC (Nov. 28, 2014) (trader fined $150,000 and suspended from trading on any CME Group exchange for one month; trader neither admitted nor denied the violations).

VI. RECURRING ISSUES

a. Section 4c(a)(5)(C) of the CEA prohibits spoofing as well as activity that is "of the character" of spoofing. The statute defines "spoofing" but does not spell out what conduct may be "of the character of spoofing." The outer boundaries of that conduct remain unclear. The CFTC has said that the four types of behavior listed in the 2013 Guidance, *see* Part III(a)(i)(8) above, are not exclusive. *See* Antidisruptive Practices Authority, 78 Fed. Reg. at 31896. Although a number of cases have been filed, only one court (the Northern District of Illinois, in Michael Coscia's criminal case) has made any significant legal pronouncements regarding the statute. *See* Parts VI(b)(vi) and VI(d) below.

b. Many spoofing cases involve some form of high-frequency trading. For a trader's behavior to qualify as spoofing, she must place her bids with the intent of cancelling them before they are filled. But there are plenty of legitimate reasons to cancel orders soon after placing them. In a world where 90 percent or more of all high-frequency trading bids are cancelled, it can be difficult to distinguish spoofing behavior from legitimate, "good-faith" trading. This leads to problems of proof.

    i. In cases involving algorithmic trading, the CFTC has sought to use the contents of the algorithms themselves as evidence of intent.

    ii. In cases involving manual trading, emails, instant messages, and phone recordings may help to establish intent, but such evidence will not always be available.

    iii. Accordingly, there are likely to be cases in which the only evidence is circumstantial—namely, the trading data itself—which could present challenges for government agencies seeking to prove forbidden intent.

    iv. In certain markets, traders are likely to offer a series of legitimate reasons for rapidly cancelling orders, including rapid changes in market conditions. Manual traders may argue that at the time they placed an order, they specifically intended that it be executed immediately or not at all—as with a "fill or kill" or "immediate or cancel" order. Such an order would be exposed for less time than a manual trader would have to react to market conditions—but that

would not necessarily mean that the trader's intent was to cancel. The intent in such a situation would rather be to get a fill immediately upon placing the order, or not at all. Traders may also say that they are using their subsequently cancelled orders to gather information. That is, the trader may say that he wished to observe how other market participants would respond to the order – would the order be filled or not, and at what price? – which is not the same thing as placing an order with the sole intent to cancel it.

v. The government, if put to its proof, may need to demonstrate forbidden intent on an order-by-order basis. This evidentiary challenge is further enhanced when, as will often be the case, challenged orders have been culled from a much larger universe of trading data.

vi. In the Coscia criminal case, the District Court allowed the defendant to use the existence of certain market rules, and his compliance with them, as evidence of his good faith and to negate prohibited intent. Coscia was permitted to introduce evidence that the exchanges he traded on, among other things: allowed orders to be placed simultaneously on both sides of the market; did not require orders to be kept open for any minimum length of time before being cancelled; had maximum order-cancellation rates that Coscia was shy of reaching; had position limits (*i.e.*, limits on the number of open contracts that a trader may hold at a given time) that Coscia did not breach; and allowed "laddered" and "ping" orders. *See* Memorandum Opinion and Order, *United States v. Coscia*, 14 CR 551 (N.D. Ill. Oct. 19, 2015), pages 2-3; Defendant's Response to the Government's Consolidated Motions in Limine, *United States v. Coscia*, 14 CR. 551 (N.D. Ill. Oct. 12, 2015), pages 1-5.

c. Related to the points above, the CEA's statutory definition ("bidding or offering with the intent to cancel the bid or offer before execution") arguably leaves additional room for interpretation and argument in that it could encompass legitimate and common practices.

i. For instance, many traders hedge with the use of stop loss and other types of orders that are put in place as a precaution but that the trader hopes and expects to unwind without execution.

ii. Moreover, there is an argument that any order genuinely exposed to the market (and thus to a risk of execution) is inherently legitimate. In this way of thinking, spoof orders are unlike (for example) wash sales or other classic market manipulation techniques that create the illusion but not the reality of a change of ownership. That the spoofing trader intended to cancel his orders

does not change the fact that his orders each represented actual – and potentially actionable – market activity.

d. Constitutional challenges.

   i. "A fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required." *F.C.C. v. Fox Television Stations*, 132 S. Ct. 2307, 2317 (2012). In other words, vague criminal laws offend due process. Criminal spoofing defendant Michael Coscia has argued that the definition in Section 4c(a)(5)(C) is void for vagueness, that it covers legitimate market activity, and that at the time of his conduct Coscia lacked adequate notice of the difference between forbidden spoofing and permissible trading strategies. Oystacher and 3 Red Trading LLC, as well as Navinder Sarao, have made similar assertions in their Answers to the CFTC's Complaints.

   ii. In April 2015, a District Judge rejected Coscia's vagueness claims. *See United States v. Michael Coscia*, No. 14-cr-00551, 2015 U.S. Dist. LEXIS 50344 (N.D. Ill., April 16, 2015). Still, Coscia is likely to appeal, and Oystacher, Sarao, or other future spoofing defendants may press a version of this argument.[12] The *Coscia* court held that the statute was not void for vagueness *as applied* to the (relatively egregious) allegations against Coscia. The ruling, therefore, even if upheld on appeal, may not foreclose vagueness challenges where the allegations are less egregious and can be characterized as extending to arguably legitimate practices.

e. To what extent is spoofing actionable under the CEA's amended general anti-manipulation prohibition, Section 6(c)?

   i. *CFTC v. Nav Sarao Futures Ltd. PLC* and *CFTC v. Igor B. Oystacher* appear to be the only post-Dodd Frank spoofing cases that the CFTC has charged under Section 6(c) as well as Section 4c(a)(5)(C). Those cases are pending.

   ii. As discussed above (*see* Part III(b)(ii)), CEA § 6(c)(3), 7 U.S.C. § 9(3) (2012) likely requires "intent to cause artificial prices," *Amaranth*, 730 F.3d at 173, 183. In all probability, an intent to cause artificial prices will be harder to demonstrate than that an order was placed with the intent to cancel it. *See* Part II(a)(iii) above.

[12] *See also* Gary DeWaal, *Coscia files motion to dismiss criminal spoofing indictment*, Lexology (Dec. 21, 2014), http://www.lexology.com/library/detail.aspx?g=6a310a42-c501-4e4e-8c76-242e10589c6c (arguing that the statutory definition of spoofing is problematic because it encompasses both legitimate and illegitimate trading activity).

iii. The CFTC may take the position that, because a Section 6(c)(1)/Rule 180.1 violation can be established by recklessness, the agency faces a relaxed intent standard under these provisions as compared with the anti-spoofing prohibition or with CEA § 6(c)(3), 7 U.S.C. § 9(3) (2012).

1. However, as noted above (*see* Part III(b)(i)), Section 6(c)(1) and Rule 180.1 were modeled on Exchange Act Section 10(b) and Rule 10b-5, and the courts interpreting those provisions generally define market manipulation as "practices . . . that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977). Accordingly, those targeted by a CFTC or DOJ spoofing probe may argue that the agency, even under Section 6(c)(1), must show "artificial[] . . . market activity." And, as noted above, an accused spoofer will often have a potentially plausible explanation for his cancelled orders that has nothing to do with artificial activity. For the government, therefore, proving "manipulation" may not be much different from proving specific intent to create artificial conditions.

2. Beyond that, even to show "recklessness," the government as a practical matter may need to prove that an order was not bona fide.

   a. The CFTC's definition of recklessness draws on the case law defining recklessness in the context of Section 10(b) / Rule 10b-5. *See* 76 Fed. Reg. at 41404 & n.87; *see also CFTC v. Equity Financial Group LLC*, 572 F.3d 150, 160 n.17 (3d Cir. 2009). The type of recklessness required for a Section 10(b) / Rule 10b-5 violation is not far from full-blown intent. *E.g.*, *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1992) ("The kind of recklessness required [under Section 10(b)], however, is not merely a heightened form of ordinary negligence; it is an 'extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or so obvious that the actor must have been aware of it.'"); *see also* 76 Fed. Reg. at 41404 ("Consistent with long-standing precedent under the commodities and securities laws, the [CFTC] defines recklessness as an act or omission that 'departs so far from the standards of ordinary care that it is very difficult to believe the actor was not aware of what he or she

was doing.'" (citing *Drexel Burnham Lambert Inc. v. CFTC*, 850 F.2d 742, 748 (D.C. Cir. 1988))).

b. A "danger of misleading buyers" by definition can exist only where an order is not bona fide – if it were bona fide, no one can have been misled by it. Similarly, showing that the actor must have been "aware of what he or she was doing" necessarily implies that the actor was "doing" something wrong – which is impossible if the order was placed with bona fide intent to have it filled.

f. Is there a private right of action for spoofing?

i. In at least two recent civil suits, plaintiffs have asserted causes of action for spoofing under CEA § 4c(a)(5)(C). *See* Complaint, *HTG Capital Partners, LLC v. John Doe(s)*, No. 15-cv-2129 (N.D. Ill.); Complaint, *Mark Mendelson v. Allston Trading LLC and John Does Nos. 1-10*, No. 15-cv-4580 (N.D. Ill). Both cases also include certain claims under CEA § 6(c), 7 U.S.C. § 9 (2012).

ii. The CEA authorizes a private suit where a person has been harmed through a violation of the CEA that constitutes "the use or employment of, or an attempt to use or employ, . . . any manipulative device or contrivance in contravention of" CFTC-promulgated rules or "a manipulation of the price" of a commodity, future, or swap. *See* CEA § 22(a)(1)(D), 7 U.S.C. § 25(a)(1)(D) (2012). In the *Mendelson* case, a defendant moved to dismiss, arguing that the private right of action authorized by the CEA does not extend to a violation of CEA § 4c(a)(5)(C), or to an asserted violation of CEA § 6(c) that was simply a recasting of the spoofing allegations. *See* Allston Trading LLC's Motion to Dismiss, *Mendelson*, No. 15-cv-4580 (July 22, 2015).

iii. The *Mendelson* plaintiff voluntarily dismissed his case before the Court could rule on the question of a private right of action for spoofing. In February 2016, the district court in *HTG Capital Partners* granted defendants' motion to compel arbitration because CBOT Rule 600.A requires arbitration of disputes among members, and dismissed the action without prejudice under the Federal Arbitration Act.

iv. If the issue comes up again, it may tie into larger questions about the extent to which spoofing can be characterized as "manipulation."

v. In the securities arena, the private right of action under SEC Rule 10b-5 should be available to a plaintiff alleging harm from alleged manipulation, provided the plaintiff can satisfy the various damages, causation, and reliance requirements. *See, e.g.*, *Fezzani v. Bear, Stearns & Co.*, 716 F.3d 18, 22-23 (2d Cir. 2013).

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