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Spoofing Market Manipulation Cases Set Stage for More Enforcement

Bradley's Elisha Kobre says the Seventh Circuit has clarified questions in spoofing market manipulation cases—largely in favor of the government—paving the way for increased DOJ and CFTC enforcement.

The Seventh Circuit issued the third in a trilogy of opinions in October establishing the metes and bounds for criminal prosecutions of "spoofing"—a form of market manipulation, mostly in the commodities markets—that Congress expressly prohibited in the 2010 Dodd-Frank Act. The decisions create a roadmap for government enforcers to bring more cases.

The Department of Justice and Commodity Futures Trading Commission have in recent years brought several high-profile spoofing cases, including on Nov. 9, when a commodities trader with the investment bank Jeffries was criminally charged in a 16-count indictment in New Jersey federal court with securities and wire fraud for engaging in spoofing.

Spoofing's Rise

Spoofing is a manipulative market practice used to artificially move the market price of a stock or commodity. This artificial movement is created by placing large orders, (the "spoofing" orders), on the opposite side of the market from which the trader wants to trade a typically small order (the "trade" order).

The spoofing orders—which the trader has no intent to execute—are intended to signal to the market a large supply or demand (depending whether the orders asks or bids), resulting in price movement benefiting the trade order sitting on the opposite side of the market.

Although spoofing isn't a recent phenomenon, high-frequency trading has increased market susceptibility to spoofing by allowing computer algorithms designed to place and cancel orders in milliseconds.

Enforcement Activity

In 2014, the government brought its first federal spoofing prosecution against Michael Coscia, a trader, in the Northern District of Illinois where the Chicago Mercantile Exchange, the largest commodities exchange in the world, is located, and the Seventh Circuit affirmed the conviction in 2017.

Following the successful prosecution of Coscia, the government began bringing spoofing prosecutions in greater numbers. These prosecutions led to the Seventh Circuit's decisions in *U.S. v. Chanu* in 2022 and *U.S. v. Pacilio* in October.

In its trilogy of *Coscia*, *Chanu*, and *Pacilio*, the Seventh Circuit answered fundamental legal questions arising in spoofing prosecutions largely in favor of the government, paving the way for both the DOJ and CFTC to increase enforcement against spoofing.

Statutes Violations

Does spoofing violate commodities and wire fraud statutes? Yes, the government may prosecute spoofing not only under Dodd-Frank, but also the general fraud statutes. The principal challenge to prosecuting spoofing under the fraud statutes is that because the spoofing orders are "fully executable and subject to legitimate market risk," they can't, as a matter of law, be fraudulent.

Coscia, for example, argued that he couldn't be charged under the commodities fraud statute because his "orders were left open in the market long enough that other traders could—and often did—trade against them, leading to thousands of completed transactions" and that his "orders were not fraudulent or 'illusory' as a matter of law."

The Seventh Circuit rejected this argument, holding that it "confuses *illusory* orders with an *illusion* of market movement." In other words, although it is true that the orders weren't themselves illusory—they created an illusion of market movement because Coscia never intended to fill his large orders and thus sought to manipulate the market for his own financial gain.

Several years later in *Chanu*, the appeals court rejected an arguably stronger version of the same argument. The *Chanu* defendants argued that, while Coscia used a computer algorithm to engage in high-frequency trading, they had entered the trades manually. This distinguished the cases, they argued, because orders entered manually "were actually tradable due to the length of time they remained active prior to cancellation."

The Seventh Circuit rejected the distinction, finding computer versus manual trading to be a distinction without a difference—the orders could have been executed in both cases. The following year, *Pacilio* rejected yet another variation of the same argument.

The court also rejected an attempt in *Chanu* to distinguish the wire fraud statute charged in that case, which requires the making of a false statement or material misrepresentation, or the concealment of a material fact, from the commodities fraud charged in *Coscia*, which does not.

Proof Requirement

What evidence is sufficient to prove fraudulent intent in spoofing cases? All three cases also considered challenges to the sufficiency of evidence to prove fraudulent intent. The court set out several factors that provide a virtual checklist of evidence specific to spoofing, including:

- How large of a percentage does the trader's cancellations comprise of all cancellations of futures contracts in the relevant market? A large percentage of cancellations may reflect an intent to cancel the spoofing orders.
- What percentage of the traders' small orders are filled versus large orders? A large percentage of small orders filled and large orders not filled may reflect an intent not to execute the large orders.
- Other express evidence of an intent not to fill large orders, such as the computer programs in *Coscia*, which were designed to avoid large orders being filled.
- How long did the trader's large orders remain on the market as compared to large orders by other traders? If the defendant's large orders often remained on the order book for only short periods, that may reflect an intent that those orders not be executed.
- What is the trader's "order-to-trade ratio"? This ratio compares the trader's average order size to average trade size. A large ratio may reflect that the trader's large orders aren't executed at a rate to be expected.
- What is the trader's knowledge of Chicago Mercantile Exchange anti-spoofing rules and other compliance training? This factor is often relied upon to prove intent.

Of course, not all these pieces of evidence may be present in a given case, and the list is non-exhaustive, but it nonetheless captures what the court will be looking for to satisfy the sufficiency of the evidence standard.

Although issues will undoubtedly continue to arise in spoofing prosecutions, the Seventh Circuit's trilogy answer many of the fundamental questions—and in favor of the government. With this stage set, we can expect to see increasing enforcement activity against spoofing in the coming years.

The case is United States v. Pacilio, 7th Cir., No. 23-01530, 10/23/23.

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