Bloomberg Law

Securities Regulation & Law Report™

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United States v. Coscia: First Spoofing Conviction Leaves Hard Questions for Another Day

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On August 7, 2017, the United States Court of Appeals for the Seventh Circuit affirmed the conviction and sentencing of Michael Coscia. Coscia, a futures trader, was the first person criminally prosecuted under the provision of the Commodity Exchange Act (CEA) prohibiting conduct known as "spoofing." His appeal challenged the constitutionality of this anti-"spoofing" provision, which has been criticized as vague and as potentially criminalizing common, previously uncontroversial trading practices. Commentators have suggested that the government's victory in *Coscia* will embolden regulators to pursue spoofing claims, and that seems inevitably true. Even so, *Coscia* takes an important step toward limiting potentially arbitrary enforcement actions by acknowledging the challenge of proving specific intent in spoofing cases. Although some industry groups may remain disappointed by the lack of clear regulatory guidance regarding acceptable trade practices, the holding of *Coscia* is far narrower than some have suggested, and the specific-intent requirement the decision imposes could meaningfully shape the development of the law in future spoofing cases.

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Dodd-Frank and the Indeterminate Prohibition of Disruptive Trading

Despite regulators' significant recent interest in "spoofing," there is little consensus as to how exactly that term should be understood. Spoofing is part of a broader category of activity labeled "disruptive trading," a term first codified in 2010, when the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 4c of the CEA to forbid three categories of practices deemed to be "disruptive of fair and equitable trading." Disruptive trading includes trading that "violates bids and offers," trading that "demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period," and trading that "is, is of the character of, or is com-

monly known to the trade as, 'spoofing' (biding or offering with the intent to cancel the bid or offer before execution).'' 7 U.S.C. § 6c(a)(5).

Some forms of what is now known as ''disruptive'' trading, such as wash trades, ''banging the close,'' and quote stuffing (entering and cancelling orders to slow down quoting networks, allowing market participants to take advantage of resulting disruptions in information flow) received regulatory attention and industry commentary and were generally understood even before Dodd-Frank. The same was not true of ''spoofing,'' a term Dodd-Frank did little to clarify. To begin with, although the statute appeared to assume the existence of a general industry understanding of the word ''spoofing,'' that assumption was false: as many commentators pointed out in the wake of Dodd-Frank, there was no commonly understood meaning of ''spoofing'' in the trade. The statute also left ambiguous whether the parenthetical phrase—''(bidding or offering with the intent to cancel the bid or offer before execution)''—was the definition of spoofing or merely an example of it. Finally, even if the parenthetical phrase was meant to define the word ''spoofing,'' the statute appeared to suggest that some undefined category of trading could be ''of the character of'' or ''commonly known as'' spoofing without actually *being* spoofing—and that such trading, whatever it might be, could be illegal (and even criminal).

Enforcement Activity Further Muddles the Landscape

The enactment of a statutory provision expressly prohibiting disruptive trading unleashed a flurry of regulatory enforcement activity. Since 2010, the Commodity Futures Trading Commission and the Department of Justice have aggressively investigated and litigated trade practice cases not only invoking their traditional anti-fraud and anti-manipulation authorities, but also under the new anti-disruptive trading provision. This activity has targeted both direct market participants and the futures commission merchants (FCMs) that provide them services. The futures exchanges, which have been criticized by the CFTC for failing to do more to police disruptive trading, have also promulgated and enforced new rules prohibiting certain practices. This burst in enforcement activity has provided some clarity regarding the types of activities that may be prohibited: unquestionably, market participants cannot enter orders with the intent to cancel the orders before execution. Often, however, the same trading conduct can be perceived as legal or illegal (or even criminal), depending on the mental state of the market participant. On the issue of how to prove intent, regulators have raised as many questions as they have answered.

For example, the Chicago Mercantile Exchange (CME)'s guidance interpreting its anti-disruptive trading Rule 575 provides a series of examples of conduct that can be permissible or forbidden, depending on the trader's intent. Market participants can make two-sided markets with unequal quantities (e.g., resting orders for 100 contracts on the bid and 10 contracts on the offer) if the orders are entered ''for the purpose of executing bona fide transactions.'' If either order is entered recklessly, however, the trader has violated the CME's rule. Similarly, a trader can modify or cancel an order due to a perceived change in market conditions, but the CME may view the same modification or cancellation as evidence of an intent not to execute the order, depending on its consideration of a ''variety of factors.''

Other scenarios have proven even more baffling. The CFTC and the CME, for example, have pursued enforcement inquiries involving so-called ''flip'' orders. The CME generally describes these orders as aggressive orders to buy (or sell) that a market participant enters at a price where it was previously resting passive orders to sell (or buy). For example, a market participant may change its bias, ''flipping'' from offering to bidding at the same price. The CME has explained that this activity is acceptable because ''there are many variables that can cause a market participant to change his perspective of the market,'' but that it can also be disruptive in violation of exchange rules because it may suggest that the orders that were cancelled may never have been intended to be executed in the first place. Whether a flip order will be deemed disruptive depends, among other things, on ''whether the flip involved the cancellation of a large sized order(s) relative to the existing bid or offer depth.'' Thus, the CME will consider the relative size of resting passive orders that are cancelled by an aggressive ''flip'' order in determining whether the flip order was disruptive.

The CME's focus on the percentage of contracts in a price queue cancelled by an aggressive ''flip'' order, however, can lead to perverse results. Often, a group of market participants resting passive orders at the same price will perceive, nearly simultaneously, that they have misread the market. Typically, this occurs when the participants observe a large trade in the direction opposite their position. A market participant's rational response in that scenario would be to cancel its resting orders and enter orders in the opposite direction, following the trend of the large trade it detected in the market. If all the participants at a price have the same reaction, they will be racing each other to cancel their orders. The slowest participant will inevitably end up cancelling a large percentage of the orders in the queue, because the other orders at that price will already have been cancelled. The CME's queue-percentage test means, then, that the slowest participant may be accused of disruptive trading simply because it lost the race to exit a price. The regulatory uncertainty regarding this type of scenario may lead market participants to be less willing to change their biases in response to evolving market conditions, chilling legitimate trading and impairing the market's ability to absorb the latest available information.

The Seventh Circuit Picks Low-Hanging Fruit

Coscia arose against the backdrop of a series of ongoing skirmishes between regulators and market participants trying to understand the law governing such scenarios. Coscia challenged the anti-spoofing statute in part on the grounds that it was unconstitutionally vague and failed to provide sufficient guidance about where to draw the line between permissible and illegal activity. Brief of Defendant-Appellant Michael Coscia at 35-51, *United States v. Coscia*, No. 16-3017 (7th Cir. Sept. 6, 2016), ECF No. 18. Coscia's constitutional claim, however, was ''as-applied''—he argued that the

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anti-spoofing statute did not provide fair notice that his specific trading activity was illegal. *Id*. at 35. To support his claim, he pointed out that traders routinely enter ''stop-loss'' orders they hope will never be executed (because execution would mean that the market had turned against them), or ''fill-or-kill'' orders they know will not be executed unless certain conditions are satisfied, which no regulator considers unlawful. *Id*. at 6-8, 39-40. The difference between entering an order a trader *hopes or believes* will not be executed and an order a trader *intends* not to be executed, Coscia claimed, was too opaque to satisfy the Fifth Amendment's requirement that criminal laws provide fair notice of the conduct they prohibit. *Id*. at 47-48.

The Seventh Circuit answered that argument by concluding that Coscia, despite framing his argument as an as-applied challenge, was largely relying on hypotheticals that were not applicable to his particular case, violating the general rule that a party who ''engages in some conduct that is clearly proscribed cannot complain of the vagueness of the law as applied to the conduct of others.'' *United States v. Coscia*, No. 16-3017 (7th Cir. Aug. 7, 2017), ECF No. 36 at 21. The court first noted that the parenthetical phrase ''bidding or offering with the intent to cancel the bid or offer before execution'' is the definition of spoofing, rather than merely an example of it. *Id*. at 17-18. It then interpreted the evidence to have shown that Coscia, who had entered large orders on one side of the market opposite small orders on the other, had ''*specifically designed*'' those large orders to ''be cancelled if they ever risked actually being filled.'' *Id*. at 22. The court noted that Coscia's trading program would ''cancel the large orders (1) after the passage of time, (2) if the small orders were filled, or (3) if a single large order was filled.'' *Id*. The court also emphasized the testimony of Coscia's programmer, who explained that the objective of Coscia's trading program was ''to pump [the] market'' and act ''[l]ike a decoy.'' *Id*. at 29. Thus, unlike scenarios involving stop-loss or fill-or-kill orders, the court concluded that there was no circumstance in which Coscia intended to receive an execution on his large orders. *Id*. at 24 & n.45.

That conclusion was reinforced by statistical analysis confirming that Coscia virtually never received executions on his large orders. The evidence showed that only 0.08% of Coscia's large orders on the CME, and 0.5% of his large orders on the Intercontinental Exchange, were executed. *Id*. at 26. Although low fill rates do not necessarily demonstrate that a trader is not providing meaningful liquidity, and the court did not pause to consider how many contracts Coscia bought or sold, the court did note that Coscia's ''average order [was] much larger than his average trade.'' *Id*. Coscia's large orders were also relatively short-lived: 0.57% of his large orders were exposed for more than one second, as compared to 65% of the large orders entered by other market participants. *Id*. The statistical evidence introduced by the government made Coscia's trading look so far outside the norm that the court found that a rational jury ''easily could have found that, at the time he placed his orders, Mr. Coscia had the 'intent to cancel before execution.' '' *Id*. at 27.

How Ambitious Will Regulators Be in Choosing the Next Coscia?

Understood in context, the holding of *Coscia* is narrow, and preserves courts' ability to limit prosecutors' and regulators' authority to label trading they do not like as ''spoofing'' by requiring rigorous proof of specific intent. Although the pattern of activity identified in the case—consistently resting large orders ''specifically designed to be cancelled'' opposite small orders and automatically cancelling the large orders after receiving executions on the small orders—will obviously remain a regulatory concern, the industry has already digested the specific facts of *Coscia*, and responsible compliance officers have long since cracked down on that kind of activity. Looking forward, the most important question is not whether the spoofing statute is constitutional as applied to facts as blatant as those in *Coscia*, but instead how far regulators will be permitted to push their authority in cases where the evidence is far less clear. If regulators attempt to prosecute spoofing cases without the kind of overwhelming evidence of orders ''specifically designed to be cancelled'' present in *Coscia*, or if they seek to prosecute conduct ''of the character of'' or ''commonly known to the trade as'' spoofing, they will need to persuade courts that they have a principled basis on which to distinguish criminal conduct from legitimate market activity. On that point, *Coscia* is simply the start of a debate, not its conclusion.