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The Spoofing Statute Is Here To Stay

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On Aug. 7, 2017, the United States Court of Appeals for the Seventh Circuit held, in the first criminal prosecution under the spoofing statute, that the statute was not unconstitutionally void for vagueness, that the evidence at trial was sufficient to sustain trader Michael Coscia's convictions for spoofing and fraud, and that the trial court did not err in computing Coscia's sentencing guideline range. Previously we have written about the spoofing statute and charges in this case,[1] and about Coscia's motion to dismiss the case before trial and the trial court's ruling on that motion.[2] In this article, we briefly discuss the trial, the parties' arguments before the Seventh Circuit, examine the court's recent opinion, and present takeaways for traders and those responsible for their conduct. It is now clear that the spoofing statute is here to stay, and that spoofing can be considered not only a regulatory violation, but, under certain circumstances, can be considered a criminal fraud.

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Coscia's Trial and Post-Trial Proceedings

Coscia's trial began on Oct. 26, 2015. The government's witnesses included employees of CME Group, ICE Futures Europe, traders from several firms, Coscia's former computer programmer, an FBI agent and an expert witness. Defense witnesses included an expert and Coscia himself. Counsel for both Coscia and the government presented persuasive and well-organized cases to the jury but, on Nov. 3, the seventh day of trial, the jury convicted him of all 12 counts after deliberating for about one hour.

On Dec. 18, 2015, Coscia moved for a judgment of acquittal and for a new trial, renewing both his constitutional challenge to the spoofing provision and his objection to the government's allegation that his conduct was fraudulent.[3] Regarding his fraud challenge, he argued that the government did not prove at trial that there was anything "false" or "deceptive" about any of his orders.[4] Indeed, he argued that the evidence at trial showed that he placed real orders, that he did not mislead other traders about any aspect of his orders (such as volume or price), and that the orders were in the market for a very long time by high-frequency trading standards — plenty of time for other algorithms to trade them. He also argued that the government had switched its fraud theory from the one charged in the indictment to arguing at trial that he committed fraud simply by inducing other market participants to trade with him which, he argued, relieved the government of its burden to establish either that there

was any fraud, or that he intended to deceive other market participants about a material matter, both of which are statutory requirements.[5]

On April 6, 2016 Judge Harry Leinenweber denied Coscia's motion, ruling that the government had introduced ample evidence from which a reasonable jury could find intent to deceive — namely, the substantial evidence suggesting that Coscia never intended to fill large orders and thus sought to manipulate the market for his own financial gain.[6] The judge also rejected Coscia's argument that the government offered no proof that his deception related to a material matter: "Drumming up interest on one side of the commodities market through the placement of large (though illusory) quote orders seems obviously material to other market participants' investment decisions."[7]

Prosecutors recommended that Judge Leinenweber sentence Coscia to 70 to 87 months' imprisonment,[8] while the defense recommended a sentence of probation.[9] On July 13, 2016, after hearing from both sides, the judge sentenced Coscia to three years in prison, a sentence that was approximately half of the low end of the sentencing guideline range urged by the government.[10] Coscia appealed his conviction and sentence to the Seventh Circuit.[11]

Coscia's Arguments on Appeal

Coscia advanced three arguments on appeal. First, he claimed that the district court erred in concluding that the evidence was sufficient to prove that his trading activity constituted a fraudulent scheme, because no rational juror could have concluded beyond a reasonable doubt that his orders were reasonably calculated to deceive market participants of ordinary prudence; rather, his orders were real, executable orders that were not deceptive as a matter of law.[12]

Second, he argued that the spoofing conviction must be reversed because the spoofing statute was impermissibly vague as applied in his case.[13] This vagueness, he claimed, was evidenced by the district court's allegedly differing interpretations of the anti-spoofing provision in the jury charge and the post-trial order, by the widespread industry confusion over what constituted "spoofing," and by the lack of final and publicly available guidance from the U.S. Commodity Futures Trading Commission prior to his commission of the offense conduct. As a result, he contended that due process rights were violated because he was not afforded fair notice of what conduct was prohibited in 2011.[14]

Finally, he argued that even if his commodity fraud and spoofing convictions were not error, the Seventh Circuit should vacate his sentence because the district court erroneously applied the amount of his financial gain as the measure of loss under the sentencing guidelines, inflating the range of sentencing from 12-18 months to 70-87 months.[15] He claimed this error resulted from insufficient proof that he caused any actual losses and a corresponding failure to establish that his gain would be a reasonable proxy for actual victim loss.[16]

The Government's Arguments on Appeal

On appeal, the government argued that the jury's verdict was supported by substantial evidence:

Defendant entered and cancelled the large-volume orders intending that the orders would not be traded. He placed the orders for a purpose other than to fill them. They were bait or, in defendant's own words, decoys. This constitutes spoofing: He placed the orders with the intent to cancel them. It also constitutes commodities fraud: He schemed to deceive other traders about market supply and demand, to create the illusion of significant market activity at increasing or decreasing prices, and, ultimately, to

fill his small orders — buying low and selling high — at prices that had not existed in the order book when he placed those orders.[17]

The government also argued that Coscia had fair notice that his conduct violated the spoofing statute; that the statute itself contains a definition of spoofing — bidding or offering with the intent to cancel the bid or offer before execution; and that the definition was provided to the jury, which found that Coscia engaged in the proscribed conduct.[18]

Regarding Coscia's sentencing challenge, the government contended that the district court properly used Coscia's gain as a proxy for loss because the district court found that the actual loss could not reasonably be determined due to the sheer volume of Coscia's trading data and the complex task of estimating loss to other traders.[19] Nevertheless, the government explained the trial testimony established that Coscia's fraud caused losses to other traders, ranging from $480 to the low hundreds of thousands of dollars.[20]

The Seventh Circuit's Ruling

On Aug. 7, 2017, the Seventh Circuit affirmed Coscia's convictions, holding: (1) the spoofing statute is not unconstitutionally vague because it provides clear notice of the proscribed conduct and does not allow for arbitrary enforcement; (2) Coscia's spoofing and commodities fraud convictions were supported by sufficient evidence to support the jury's verdict; and (3) the district court did not err in applying a 14-point sentencing enhancement measured by Coscia's trading gains.[21]

The court found that Coscia's vagueness challenge failed because the statute clearly defines the term spoofing as "bidding or offering with the intent to cancel the bid or offer before execution," which provides adequate notice of the proscribed conduct.[22] Furthermore, because Coscia's actions — the use of large orders *specifically designed* to be canceled if they ever risked actually being filled — fell within the proscribed conduct, the court noted that "he cannot challenge any allegedly arbitrary enforcement that could hypothetically be suffered by a theoretical legitimate trader."[23] Nevertheless, even if Coscia could challenge the statute based on allegedly arbitrary enforcement, this challenge would fail because the spoofing provision "does not vest virtually complete discretion in the hands of the police," but instead "imposes clear restrictions on whom a prosecutor [or CFTC enforcement attorney] can charge with spoofing; prosecutors can charge only a person whom they believe a jury will find possessed the requisite specific intent to cancel orders at the time they were placed."[24]

Regarding the sufficiency of the evidence to support Coscia's fraud convictions, the court noted the cumulative trial evidence allowed a rational trier of fact to determine that: (1) Coscia entered the majority of his orders with the intent to cancel them before their execution; and (2) Coscia designed a trading scheme to deceive other traders by using large orders to inflate or deflate market prices, while simultaneously structuring that scheme to avoid filling the large orders.[25] Coscia persisted in his pretrial argument that his orders were not, as a matter of law, fraudulent because they were "fully executable and subject to market risk."[26] The court rejected that argument and found that, "His scheme was deceitful because, at the time he placed the large orders, he intended to cancel the orders. … and thus sought to manipulate the market for his own financial gain."[27] The court found that evidence of Coscia's fraudulent intent was "substantial" and pointed to the testimony of Coscia's computer programmer, Jeremiah Park, who testified that the objective of Coscia's trading program was to "pump the market" and "act like a decoy" and therefore "create the *illusion* of market movement."[28] "With Park, Mr. Coscia *designed* a system that used large orders to inflate or deflate prices, *while also structuring the system to avoid the filling of large orders*."[29] It is significant that the

court held that false representations or material omissions are not required for conviction under 18 U.S.C. § 1348.[30]

Finally, the court held that the district court did not err in applying the sentencing enhancement based on Coscia's trading gains because it was reasonable to use that figure as a proxy for loss given the "insurmountable logistical burden" on the government to prove the loss to other traders.[31] Coscia's trading scheme was "complex, involving thousands of anonymous trades executed across multiple exchanges with numerous counterparties," which would have required "hours of labor ... to collect, collate, and analyze the relevant trading logs," the type of logistical burden that the gain-for-loss approach was designed to alleviate.[32]

The Takeaways

The Coscia case is all about intent — intent to cancel orders before execution and intent to defraud. The court observed: "Recognizing that 'it is usually difficult or impossible to provide direct evidence of a defendant's mental state,' we allow for criminal intent to be proven through circumstantial evidence."[33] "As in all cases based upon circumstantial evidence, no single piece of evidence necessarily establishes spoofing. Nonetheless, when evaluated in its totality, the cumulative evidence certainly allowed a rational trier of fact to determine that Mr. Coscia entered his orders with the intent to cancel them before execution."[34]

Traders would do well to keep in mind the different pieces of evidence that the government used to assemble the puzzle for the jury, and which were noted by the Seventh Circuit:

- ***Trading Code.*** "The primary items of evidence in support of [Coscia's intent to cancel large orders before execution] were the two programs that Mr. Coscia had commissioned to facilitate his trading scheme: Flash Trader and Quote Trader."[35]

- ***Testimony of Code Developers.*** "[T]he designer of the programs … testified that the programs were designed to avoid large orders being filled [and that] the 'quote orders' were 'used to pump the market' suggesting that they were designed to inflate prices through illusory orders."[36]

- ***Statements to Regulators.*** Coscia testified about his trading strategy both to the CFTC and before the jury at trial.

- ***Order Duration.*** "... only 0.57% of Coscia's large orders were on the market for more than one second, whereas 65% of large orders entered by other high-frequency traders were open for more than one second."[37]

- ***Order-to-Trade Ratio.*** One witness testified that, "… Coscia's order-to-trade ratio was 1,592% whereas the order-to-trade ratio for other market participants ranged from 91% to 264%. As explained at trial, these figures 'mean[] that Michael Coscia's average order [was] much larger than his average trade."[38] Another witness testified that, "Mr. Coscia placed 24,814 large orders between August and October 2011, although he only traded on 0.5% of those orders. During this same period he placed 6,782 small orders on the Intercontinental Exchange and approximately 52% of those orders were filled."[39]

We doubt that any one of these pieces of evidence would be sufficient to establish spoofing. For example, there are many good reasons why short-lived orders are perfectly legitimate. And it would be myopic to try to establish spoofing liability solely on the basis of order-to-trade ratio, or any other statistical measure.

While the Coscia case is significant for its holdings concerning spoofing, there are even more significant implications to its holdings concerning fraud. The Seventh Circuit has now joined three federal judges in the Northern District of Illinois in holding that a trader can commit manipulation or fraud — even criminal fraud — against anonymous market participants simply by the way the trader enters orders in an open and liquid futures market even without making false statements or material omissions.[40] How will a trader know where the regulator draws the line? *Is* there a line?

It is now a fact of life that standard setters and rule enforcers expect traders to be aware of concerns around spoofing, and expect firms to take steps to detect and prevent spoofing in their own operations. There is now a regulatory dragnet set for spoofers. But if trading strategies are carefully conceived, properly vetted, well-documented and faithfully monitored, traders may be able to avoid unwarranted investigations, alleviate regulatory concerns that may arise, and should be able to fully and confidently participate in the financial markets.

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[1] Clifford C. Histed, A Look At The 1st Criminal 'Spoofing' Prosecution: Part 1, Law360, April 20, 2015, https://www.law360.com/articles/645167/a-look-at-the-1st-criminal-spoofing-prosecution-part-1.

[2] Clifford C. Histed, A Look At The 1st Criminal 'Spoofing' Prosecution: Part 2, Law360, April 21, 2015, https://www.law360.com/articles/645567/a-look-at-the-1st-criminal-spoofing-prosecution-part-2.

[3] United States v. Coscia, Case No. 14 CR 551 (N.D. Ill.), Dkt. No. 97.

[4] Id. at 3.

[5] Id. at 3–4.

[6] United States v. Coscia, 177 F.Supp.3d 1087, 1091 (N.D. Ill. 2016).

[7] Id. at 1091.

[8] Id., Dkt. No. 157 at 1.

[9] Id., Dkt. No. 156 at 1–2.

[10] Id., Dkt. No. 159, 160; see also Department of Justice, U.S. Attorney's Office for the Northern District of Illinois's Release, "High-Frequency Trader Sentenced to Three Years in Prison for Disrupting Futures Market in First Federal Prosecution of 'Spoofing,'" found at https://www.justice.gov/usao-ndil/pr/high-frequency-trader-sentenced-three-years-prison-disrupting-futures-market-first. Coscia is currently incarcerated at a federal correctional facility in New Jersey, about 120 miles from his home.

[11] United States v. Coscia, Case No. 14 CR 551 (N.D. Ill.), Dkt. No. 163.

[12] United States v. Coscia, Case No. 16-3017, (7th Cir.), Dkt. No. 18 at 25, 31.

[13] Id. at 25.

[14] Id. at 25, 38–39.

[15] Id. at 26.

[16] Id.

[17] Id., Dkt. No. 29 at 26–27.

[18] Id. at 27.

[19] Id. at 28.

[20] Id.

[21] United States of America v. Michael Coscia, Case No. 16-3017, United States Court of Appeals for the Seventh Circuit, Dkt. No. 36 at 2–3.

[22] Id. at 18, 20.

[23] Id. at 22. (emphasis in original)

[24] Id. at 23.

[25] Id. at 25-27, 29–30.

[26] Id. at 28.

[27] Id. at 29.

[28] Id. at 29. (emphasis in original)

[29] Id. at 29-30. (emphasis in original)

[30] Id. at 28.

[31] Id. at 39.

[32] Id.

[33] Id. at 25, quoting United States v. Morris, 576 F.3d 661, 674 (7th Cir. 2009).

[34] Id. at 27.

[35] Id. at 9.

[36] Id. at 26.

[37] Id. at 26.

[38] Id. at 26.

[39] Id. at 11.

[40] See United States v. Coscia, 100 F.Supp.3d at 660; U.S. Commodity Futures Trading Commission v. Kraft Foods Group, Inc. and Mondelez Global LLC, 153 F.Supp.3d 996, 1015 (N.D. Ill. 2015) ("Thus, Kraft, through its activities in the market, conveyed a false sense of demand, and the resulting prices in the market (both of cash wheat and of wheat futures) were based not solely on the actual supply and demand in the market, but rather were influenced by Kraft's false signals of demand."); Harry Ploss et al. v. Kraft Foods Group Inc., 197 F.Supp.1037, 1055 (N.D. Ill. 2016) ("For example, [b]ecause every transaction signals that the buyer and seller have legitimate economic motives for the transaction, if either party lacks that motivation, the signal is inaccurate, and using that false signal to manipulate commodity pricing can qualify as manipulation. … so the Court holds that an explicit misrepresentation is not required for a [Commodity Exchange Act] manipulation claim, which may be based on market activity that sends a false pricing signal to the market.") (internal citations omitted).

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