

Department of Justice broadens aim on spoofing enforcement

By Jeffrey A. Brown, Esq., Thomas Cordova, Esq., Tanner Kroeger, Esq., and Steven Pellechi, Esq., *Dechert LLP* *

MAY 17, 2018

The U.S. Department of Justice (DOJ) and the Commodity Futures Trading Commission (CFTC), in January, announced a wave of coordinated spoofing cases that the Acting Assistant Attorney General, John P. Cronan, described as the “largest futures market criminal enforcement action in Department history.”¹

The enforcement action consisted of eight civil actions filed by the CFTC and six criminal cases brought by the DOJ.² On April 25, the first of those criminal cases to go to trial, *U.S. v. Flotron*, ended in an acquittal for defendant Andre Flotron.³

However, there is little reason to believe the acquittal will deter prosecutors from bringing spoofing actions moving forward, as the DOJ has recently been vocal about their “unwavering ... commitment to protecting the integrity of our financial markets,”⁴ while at the same time demonstrating a willingness to bring more spoofing cases with less direct — some would say weaker — evidence.

Spooing is defined in the Dodd-Frank Act as bidding or offering with the intent to cancel the bid or offer before execution.

Furthermore, the recent tag-team enforcement strategy from the CFTC and DOJ shows that the agencies are strengthening ties and suggests that the CFTC is increasingly confident in its ability to assess and refer spoofing cases for criminal prosecution.

This aggressive coordinated enforcement approach has important implications for both in-house and outside counsel.

The CFTC’s self-touted buildout of its market surveillance programs to monitor and detect archetypal spoofing patterns — coupled with the DOJ’s apparent willingness to bring criminal cases largely based on trade data alone — emphasizes the importance to market participants of having their own monitoring mechanisms and compliance programs to detect and prevent (and possibly disclose) potential violations before the regulators do.

It is also increasingly clear that once the CFTC or a self-regulatory organization (such as the CME Group) approaches a firm or

an employee about an apparent civil investigation, a criminal investigation may not be far behind.

Legal counsel with meaningful criminal experience should be consulted in order to identify and to manage the increased risk that any civil spoofing investigation will develop into a criminal action.

SPOOFING OVERVIEW

Spooing is a type of market manipulation in which a trader places orders in the market that she does not intend to actually trade, for the purpose of convincing market participants that the price of a commodity is trending either up or down, and then trading real orders designed to take advantage of that price movement.

Enforcement actions have identified a now-familiar pattern:

- A trader places large visible orders on one side of the market, without the intent of executing the orders, to create the false impression of market demand or supply;
- The trader then places smaller orders, often in the form of icebergs, on the opposite side of the market to take advantage of the market imbalance created by the large orders on the other side; and
- Once the trader’s smaller orders are executed, the trader quickly cancels the large orders.

The net result is that the spoofing trader is able to buy or sell a commodity at a better price than the natural supply and demand activity of the market would otherwise allow.

Spooing is defined in the Dodd-Frank Act as bidding or offering with the intent to cancel the bid or offer before execution.⁵

Because orders can be cancelled for many entirely legitimate reasons, and because some legal trading strategies result in a large percentage of cancelled orders,⁶ proving intent based on trading activity, viewed in isolation, is particularly challenging, especially when the burden is proof beyond a reasonable doubt.

Indeed, defendants have argued that there are many lawful trading strategies that can resemble the alleged characteristics of spoofing, making circumstantial inferences of intent particularly unreliable in this context.⁷

In light of those obvious challenges, many were surprised to see that within the DOJ's recent run of cases, more than one appeared to be based largely on circumstantial evidence.

THE DOJ IS INCREASING CRIMINAL ENFORCEMENT OF THE ANTI-SPOOFING LAWS

In the past, the DOJ primarily brought criminal spoofing cases against algorithmic traders with direct evidence of the defendant's intent to cancel orders.⁸

For example, in *U.S. v. Coscia* and *U.S. v. Sarao*, the Government had evidence of communications between the defendants and the software programmers that designed the defendants' trading algorithms in which the defendants effectively admitted their intent to spoof.⁹

This recent wave of spoofing cases likely results from improvements in the CFTC's market surveillance capabilities and its enhanced collaboration with the DOJ.

In *Sarao*, the DOJ included in the indictment quotes from emails sent by Sarao to the programmer, which aside from expressly mentioning "spoofing," made references to a "cancel if close" function that would cancel an order if the market moved toward executing a spoof order.¹⁰

In *Coscia*, which was the first criminal spoofing case to go to trial, testimony from defendant Michael Coscia's programmer revealed that Coscia's trading programs were programmed to "pump [the] market" and avoid trade execution.¹¹

Two recent cases suggest, however, that the DOJ is pursuing criminal enforcement not just against algorithmic traders in cases with strong direct evidence, but is testing the difficult waters of bringing criminal cases against manual traders with apparently little or no direct evidence of spoofing intent.

U.S. v. Flotron, which involved a manual trader and was based primarily on trading patterns and information from Flotron's former subordinates,¹² and *U.S. v. Zhao*, which according to the complaint, involves a manual trader and is based primarily on trading patterns, are two examples that may signal a markedly broader enforcement trend.¹³

U.S. v. Flotron

Flotron would appear to be the first time a criminal spoofing case involving a primarily manual trader has gone to trial.

Although defendant Andre Flotron was eventually acquitted, the case suggests a prosecutorial willingness to bring to trial cases that rely more heavily on circumstantial evidence.

Flotron was a trader at a global commodities firm, who was indicted for trades he placed for precious metal future contracts from 2008 to 2013.¹⁴

The DOJ alleged that Flotron and his co-conspirators entered large "Spoof Orders" on one side of the market to create the false appearance of substantial supply or demand, while placing "Primary Orders" on the opposite side to take advantage of artificial price movements caused by the "Spoof Orders."¹⁵

The Government further alleged that Flotron trained a subordinate how to spoof and that the trainee witnessed Flotron place orders on the market that he intended to cancel.¹⁶

At trial, the Government's case relied primarily on trade data and testimony from two former Flotron subordinates.¹⁷ The Government's proof was ultimately criticized by defense counsel as "prosecution by statistics."¹⁸

U.S. v. Zhao

Based on the DOJ complaint, *Zhao* appears to be the first criminal spoofing complaint with no reference to direct evidence of intent.

The defendant, Jiongsheng Zhao, was a commodities trader at a trading firm in Sydney, Australia, who was indicted for trades that he placed in the CME E-mini futures market from 2012 to 2016.¹⁹

The complaint describes the familiar imbalanced trading pattern, and relies on an FBI analysis of Zhao's trading patterns coupled with an expert's opinion of those patterns to allege the requisite intent.²⁰

The FBI analysis of Zhao's trading focuses on several types of statistical discrepancies between "Large-Side Orders" (alleged spoof orders) and "Small-Side Orders" to support the idea that the larger orders were never intended to be executed.²¹

Specifically, the statistics show that the alleged spoof orders were many times larger, traded less often, and were exposed to the market for a much shorter period of time than the "Small-Side Orders."²²

The *Zhao* case is stalled pending extradition proceedings in Australia,²³ but if and when the proceedings do move forward, the case will be closely watched as an additional early test of the DOJ's ability to convince a jury beyond a reasonable doubt of a trader's spoofing intent using only trading patterns and circumstantial evidence.

THIS ENFORCEMENT TREND IS LIKELY TO CONTINUE

This recent wave of spoofing cases likely results from improvements in the CFTC’s market surveillance capabilities and its enhanced collaboration with the DOJ.

In 2017, the CFTC announced that it was moving elements of its market surveillance branch from its Division of Market Oversight to its Division of Enforcement in order to increase surveillance abilities.²⁴

Furthermore, the CFTC recently formed a Spoofing Task Force, which is a coordinated effort across the enforcement division offices of Chicago, Kansas City, New York, and Washington, DC.²⁵

In addition to those organizational changes, the CFTC has undertaken a “sophisticated data analysis,” which allows the Commission to “identify trading patterns that reveal unlawful conduct,”²⁶ and has also implemented new rules directed towards incentivizing whistleblowing.²⁷

Aside from the CFTC’s upgraded spoofing enforcement tools, the head of the CFTC’s enforcement division, James McDonald, was brought over in 2017 from his previous role as an Assistant U.S. Attorney for the Southern District of New York, replacing Aitan Goelman, another former SDNY AUSA.²⁸

With another former federal prosecutor at the helm and seemingly greater coordination between the CFTC and DOJ, this trend of broadened criminal enforcement in the spoofing context shows no signs of abating.

CONCLUSION

It is no longer safe to assume that only the most egregious or obvious spoofing behavior will be considered for criminal, as opposed to civil, enforcement.

This clear raising of the stakes has obvious consequences for the individuals and institutions operating in the commodities markets.

Institutions should consider robust, up-to-the-minute compliance programs as well as implementing internal surveillance capabilities, and firms and individuals involved in civil spoofing investigations should engage counsel with the requisite criminal experience to assess how early decisions made in civil proceedings could affect future criminal liability.

NOTES

¹ U.S. Department of Justice, *Acting Assistant Attorney General John P. Cronan Announces Futures Markets Spoofing Takedown* (January 29, 2018), <https://bit.ly/2jLZKoA>

² *Id.*; Commodities Futures Trading Commission, *CFTC Files Eight Anti-Spoofing Enforcement Actions against Three Banks (Deutsche Bank, HSBC & UBS) & Six Individuals* (January 29, 2018), <https://bit.ly/219GW19>.

³ Christie Smythe, *Ex-UBS Metals Trader Beats Spoofing Conspiracy Charge*, Bloomberg (April 25, 2018), <https://bloom.bg/2wwQ8Yd>.

⁴ U.S. Department of Justice, *Acting Assistant Attorney General John P. Cronan Announces Futures Markets Spoofing Takedown* (January 29, 2018), <https://bit.ly/2jLZKoA>.

⁵ 7 U.S.C. § 6c(a)(5)(C).

⁶ Matt Levine, *Why Do High-Frequency Traders Cancel So Many Orders?*, Bloomberg (Oct. 8, 2015), <https://bloom.bg/2lelDr9>.

⁷ Memorandum of Law in Support of Defendant’s Motion to Dismiss at 17-20, *United States v. Coscia*, No. 14-cr-551, Dkt. No. 28 (N.D. Ill. Dec. 15, 2014), 2014 WL 11210343.

⁸ *United States v. Coscia*, 866 F.3d 782, 789 (7th Cir. 2017); Indictment at 4-8, *United States v. Sarao*, No. 15-cr-75, Dkt. No. 24 (N.D. Ill. Sept. 2, 2015).

⁹ *United States v. Coscia*, 866 F.3d 782, 789 (7th Cir. 2017); Indictment at 4-8, *United States v. Sarao*, No. 15-cr-75, Dkt. No. 24 (N.D. Ill. Sept. 2, 2015).

¹⁰ Indictment at 5-7, *United States v. Sarao*, No. 15-cr-75, Dkt. No. 24 (N.D. Ill. September 2, 2015).

¹¹ *United States v. Coscia*, 866 F.3d 782, at 789, 796 (7th Cir. 2017).

¹² Complaint, *United States v. Flotron*, No. 17-cr-220, Dkt. No. 1 (D. Conn. Sept. 12, 2017); Superseding Indictment, *United States v. Flotron*, No. 17-cr-220, Dkt. No. 58 (D. Conn. Jan. 30, 2018).

¹³ Complaint, *United States v. Zhao*, No. 18-cr-024, Dkt. No. 1 (N.D. Ill. Jan. 11, 2018).

¹⁴ Complaint, *United States v. Flotron*, No. 17-cr-220, Dkt. No. 1 (D. Conn. Sept. 12, 2017); Superseding Indictment, *United States v. Flotron*, No. 17-cr-220, Dkt. No. 58 (D. Conn. Jan. 30, 2018).

¹⁵ Complaint at 7, *United States v. Flotron*, No. 17-cr-220, Dkt. No. 1 (D. Conn. Sept. 12, 2017); Superseding Indictment at 5-6, *United States v. Flotron*, No. 17-cr-220, Dkt. No. 58 (D. Conn. Jan. 30, 2018).

¹⁶ Complaint at 9-10, *United States v. Flotron*, No. 17-cr-220, Dkt. No. 1 (D. Conn. Sept. 12, 2017); Superseding Indictment at 6, *United States v. Flotron*, No. 17-cr-220, Dkt. No. 58 (D. Conn. Jan. 30, 2018).

¹⁷ Christie Smythe, *Ex-UBS Metals Trader Beats Spoofing Conspiracy Charge*, Bloomberg (April 25, 2018), <https://bloom.bg/2wwQ8Yd>.

¹⁸ *Id.*

¹⁹ Complaint, *United States v. Zhao*, No. 18-cr-024, Dkt. No. 1 (N.D. Ill. Jan. 11, 2018).

²⁰ *Id.*

²¹ *Id.* at 9-10.

²² *Id.*

²³ Government’s Second Motion For An Exclusion Of Time Under The Speedy Trial Act, *U.S. v. Zhao*, 18-cr-24, Dkt. No. 12 (N.D. Ill. March 29, 2018).

²⁴ Commodities Futures Trading Commission, *CFTC: New Direction Forward* (March 15, 2017), <https://bit.ly/2KPTQzj>.

²⁵ Commodities Futures Trading Commission, *Statement of CFTC Director of Enforcement James McDonald* (Jan. 29, 2018), <https://bit.ly/2laSKMN>.

²⁶ *Id.*

²⁷ Commodities Futures Trading Commission, *CFTC Strengthens Anti-Retaliation Protections for Whistleblowers and Enhances the Award Claims Review Process* (May 22, 2017), <https://bit.ly/2wtOC93>.

²⁸ Commodities Future Trading Commission, *CFTC Acting Chairman Giancarlo Appoints James McDonald as Enforcement Director* (March 30, 2017), <https://bit.ly/2lt6EO2>.

This article appeared in the May 17, 2018, edition of Westlaw Journal Derivatives.

* © 2018 Jeffrey A. Brown, Esq., Thomas Cordova, Esq., Tanner Kroeger, Esq., and Steven Pellechi, Esq., Dechert LLP

ABOUT THE AUTHORS



(L-R) **Jeffrey A. Brown** is a litigation partner in New York at **Dechert LLP's** focusing on white collar defense, securities litigation, SEC enforcement actions, and related commercial litigation. Litigation associates **Thomas Cordova**, **Tanner Kroeger** and **Steven Pellechi** practice in the firm's New York office. This expert analysis was first published on the Dechert website. Republished with permission.

Thomson Reuters develops and delivers intelligent information and solutions for professionals, connecting and empowering global markets. We enable professionals to make the decisions that matter most, all powered by the world's most trusted news organization.