CLIENT MEMORANDUM

Spoofing Conviction Upheld: Vagueness Challenge Rejected

August 15, 2017

AUTHORS

Paul J. Pantano, Jr. | **Michael S. Schachter** | **Rita M. Molesworth** | **Elizabeth P. Gray** | **Sohair A. Aguirre** | **Neal E. Kumar**

On August 7, 2017, the Seventh Circuit Court of Appeals upheld Michael Coscia's 2015 criminal conviction for commodities fraud and violations of the Commodity Exchange Act's ("CEA") prohibition on spoofing. Coscia had appealed arguing, among other things, that the anti-spoofing provisions of the CEA are unconstitutionally vague and the evidence presented did not support a conviction for either spoofing or commodities fraud. Below, we summarize the key takeaways from the Seventh Circuit's decision rejecting Coscia's arguments.

Background Facts

Coscia used a trading program, or algorithm, to place small bids or offers and simultaneously place larger bids or offers in the opposite direction. Once the larger bids or offers moved the prices in a direction favorable to the small order, the trading program cancelled the large orders. The Seventh Circuit cited heavily to the testimony of the designer of the trading program, who stated that Coscia asked that the program act "[l]ike a decoy," which would be "[u]sed to pump the market."[1] According to the opinion, the program designer "noted that the large-volume orders were designed specifically

[1] *United States v. Coscia*, No. 16-3017 (7th Cir. 2017) ("Coscia") at 9-10.

to avoid being filled and accordingly would be cancelled in three particular circumstances: (1) based on the passage of time (usually measured in milliseconds); (2) in the event of the partial filling of the large orders; or (3) in the event of complete filling of the small orders."[2]

The Anti-Spoofing Provision of the CEA is Not Unconstitutionally Vague

The CEA proscribes "any trading, practice, or conduct 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)."[3] Coscia argued that this provision left the definition of the conduct that would be deemed spoofing unconstitutionally vague. He contended that the parenthetical following the term spoofing contained not a definition, but rather merely an illustrative example that did not provide market participants with sufficient notice as to what conduct would be deemed violative of the law.

The Seventh Circuit rejected this argument. It held that the CEA clearly defines spoofing, so the prohibited conduct is not unconstitutionally vague and Coscia had adequate notice of the prohibition. According to the Court, Congress defined spoofing in the parenthetical. The parenthetical, the Court concluded, defined spoofing as "bidding or offering with the intent to cancel the bid or offer before execution," which the Court described as "an intent to cancel the order *at the time it was placed*."[4] In light of its view that the statutory definition is clear, the Court rejected Coscia's argument that a lack of CFTC regulation or rulemaking "leaves a person of ordinary intelligence to speculate about the definition Congress intended when it placed 'spoofing' in quotation marks."

The Seventh Circuit also rejected Coscia's claim that the definition of spoofing encourages arbitrary enforcement. The Court noted that spoofing requires that a prosecutor prove specific intent, which does "much to destroy" an argument for arbitrary enforcement because "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."[5] The Court further rejected Coscia's arguments that the statutory definition could lead to arbitrary enforcement because there are no "tangible parameters" to distinguish Coscia's conduct from other traders with a high degree of cancellations.[6] The Court explained that Coscia's conduct fell "well within the provision's prohibited conduct [because] he commissioned a program designed to pump or deflate the market through the use of large orders that were *specifically designed* to be cancelled if they ever risked actually being filled."[7] The Court distinguished Coscia's trading activity from legal trades such as stop-loss orders or fill-or-kill orders

2 Coscia at 10.

3 7 U.S.C. § 6c(a)(5).

4 Coscia at 25.

5 Coscia at 23.

6 Coscia at 21.

7 Coscia at 22.

"because those orders are designed to be executed upon the arrival of *certain subsequent* events."[8] By contrast, "orders placed in a spoofing scheme are never intended to be filled at all."[9]

Evidentiary Support that Coscia Engaged in Spoofing

In rejecting Coscia's claim that there was not sufficient evidence to convict him of spoofing, the Seventh Circuit first held that "a conviction of spoofing requires that the prosecution prove beyond a reasonable doubt that Mr. Coscia knowingly entered bids or offers with the present intent to cancel the bid and offer prior to execution."[10] The Court held that the following evidence could lead a rational trier of fact to conclude that Coscia submitted his orders with the intent to cancel:

- Coscia's order cancellations comprised 96 percent of all Brent futures cancellations on the Intercontinental Exchange ("ICE") during the two months of his trading.
- On the Chicago Mercantile Exchange ("CME"), 35.61 percent of his small orders were filled in comparison to 0.08 percent of his large orders.
- Only 0.05 percent of his large orders on ICE were filled.
- The designer of the programs had testified that the programs were designed to avoid the large orders being filled.
- In a deposition taken by the Commodity Futures Trading Commission ("CFTC"), Coscia described the logic to his trading as: "The logic is I wanted to make a program with two sides. I noticed there was more trading done when one side was larger than the other, and I made a program to make a market as tight as possible with different lopsided markets. […] I watched the screen […], I noticed that when there was a larger order and smaller order, a lopsided market, there was more of a tendency for trading to occur."
- The designer of the program also testified that the "quote orders" were "[u]sed to pump the market."
- Only 0.57 percent of the larger orders were on the market more than one second as compared to 65 percent of other high-frequency traders whose large orders were open for more than one second.
- Coscia's order-to-trade ratio was 1,592 percent compared to other market participants whose order-to-trade ratios were from 91 to 264 percent.

---

8 Coscia at 24.

9 Coscia at 24.

10 Coscia at 25.

Coscia Engaged in Commodities Fraud

The Court also rejected Coscia's claim that as a matter of law Coscia did not engage in commodities fraud because all of his orders were "fully executable and subject to legitimate market risk," and therefore were not "fraudulent" or "illusory" as a matter of law.[11] The commodities fraud statute makes it a crime "to defraud any person in connection with any commodity for future delivery."[12] The Court identified the following elements of a crime under this statute: (1) fraudulent intent; (2) a scheme or artifice to defraud; and (3) a nexus with a security. The Court rejected Coscia's argument, reasoning that Coscia "confuses *illusory* orders with an *illusion* of market movement."[13] "His scheme," the Court concluded, "was deceitful because, at the time he placed large orders, he intended to cancel the orders."[14]

Lessons Learned from the Coscia Decision

This decision resolves in the government's favor a significant defense challenge to spoofing prosecutions and, as a result, will likely motivate the CFTC and criminal authorities to continue to press prosecution against spoofing activity. In addition to the legal precedent, the Court's decision provides practical data points for companies to utilize as part of a compliance program to detect potential spoofing activity of their own traders. In particular, the Court relied heavily on the circumstantial evidence presented by market regulation staff of the CME Group and ICE. This circumstantial evidence included statistical analysis of the order-to-trade ratio and the percentage of cancellations and fills for large compared to small orders. Compliance professionals will be well advised to consider the metrics described by the Court as hallmarks of illegal spoofing activity in assessing their firms' trading activity.

The decision also highlights the need to consider criminal enforcement when approaching civil investigations by financial regulators. For Coscia, settling with the CFTC not only failed to prevent criminal prosecution, his participation in the CFTC investigation provided the U.S. Department of Justice with ammunition for his ultimate conviction. Prior to his criminal trial, the CFTC took Coscia's deposition, which eventually led to his agreeing to pay a $1.4 civil monetary penalty and disgorge $1.4 million of ill-gotten gains as part of a civil settlement with the CFTC in 2013.[15] Two years later, criminal authorities relied on Coscia's CFTC deposition as evidence in his criminal prosecution of intent to spoof the market. The Seventh Circuit decision also cited to Coscia's CFTC deposition in concluding that there was sufficient evidence of intent to convict Coscia at trial. Anyone facing a CFTC or self-regulatory organization investigation into alleged spoofing activity should always be aware that a criminal investigation may also be a possibility and conduct themselves with that in mind.

---

[11] Coscia at 25, 29.

[12] 18 U.S.C. § 1348(1).

[13] Coscia at 29.

[14] *Id*.

[15] *In re Panther Energy Trading LLC and Michael J. Coscia*, CFTC Docket No. 13-26 (July 22, 2013).

If you have any questions regarding this memorandum, please contact Paul J. Pantano, Jr. (202-303-1211, ppantano@willkie.com), Michael S. Schachter (212-728-8102, mschachter@willkie.com), Rita M. Molesworth (212-728-8727, rmolesworth@willkie.com), Elizabeth P. Gray (202-303-1207, egray@willkie.com), Sohair A. Aguirre (202-303-1140, saguirre@willkie.com), Neal E. Kumar (202-303-1143, nkumar@willkie.com) or the Willkie attorney with whom you regularly work.

August 15, 2017