

7th Circ. Spoofing Decision Buoy Gov't Crackdown

By Tom Zanki

Law360, New York (August 8, 2017, 8:39 PM EDT) -- The Seventh Circuit's unanimous decision Monday to uphold the conviction of Michael Coscia for a market manipulation tactic known as "spoofing" is a landmark ruling that removes questions about the constitutionality of the law banning such conduct, strengthening government efforts to crack down on the practice, experts said Tuesday.

By affirming Coscia's conviction, the Seventh Circuit became the first federal appellate court to provide guidance on the crime, which is a violation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The post-financial crisis law seeks to deter traders from manipulating the market with large orders meant to be canceled and then capitalizing on the ensuing price fluctuation.

Coscia had argued that the statute outlawing spoofing was unconstitutionally vague and could criminalize any high-frequency trader's activity, an argument rejected by the three-member appellate panel. The Seventh Circuit determined that the law's language is clear and that the evidence presented to an Illinois federal jury at his 2015 trial was enough to convict.

"The short takeaway is that it was a complete win for the government," said Covington & Burling LLP attorney Anne M. Termine, a former U.S. Commodities Futures Trading Commission chief trial attorney. "There wasn't a single portion of Coscia's argument that the court accepted."

Barnes & Thornburg LLP partner Vincent "Trace" Schmeltz said the court's endorsement of the clarity of Dodd-Frank's definition of spoofing — bidding or offering with the intent to cancel the bid or offer before execution — and its relevance to this case was a critical point that threw cold water on attempts to void the law on vagueness grounds.

"That takes a significant arrow out of the quiver of anyone defending these kinds of cases," said Schmeltz, co-chair of Barnes & Thornburg's financial and regulatory litigation group.

Renato Mariotti, the prosecutor who tried the original case in 2015 that produced Coscia's conviction, said he was surprised the Seventh Circuit went so far as to attack the constitutional challenge by stating the statute is clear about what constitutes spoofing. And he anticipates more charges going forward.

"What I would expect is courts will not stop regulators and criminal authorities from going after this conduct," said Mariotti, a former assistant U.S. attorney and now a partner at Thompson Coburn LLP. "There won't be a ton of criminal cases because there never are, but there will be a lot of cases from CME Group and the CFTC."

Coscia, who is currently serving a three-year sentence in a New Jersey federal prison, is the first person to be charged and convicted of spoofing. An Illinois federal jury found Coscia, founder of New Jersey-based Panther Energy Trading LLC, guilty of six counts of commodities fraud and six counts of spoofing in November 2015. He was sentenced in July 2016.

Morgan Lewis & Bockius LLP partner and former federal prosecutor David Miller said any questions about high-frequency trading cases being too complex for juries should be put to rest, noting that the conviction and the Seventh Circuit's subsequent rejection of appeal "shows that these cases can be prosecuted."

"And I would expect the DOJ on the criminal end and CFTC on the civil end may be emboldened to bring more spoofing cases as a result," Miller said.

Prosecutors during trial had said that Coscia used a pair of computer algorithms to mislead other Chicago Mercantile Exchange traders dealing in futures contracts for commodities like gold, soybean oil and high-grade copper.

The algorithms placed large selling or buying bids that drove prices up or down in Coscia's favor, but then yanked the bids before anyone could actually fulfill them, the government contended. Coscia netted \$1.4 million in profits over a period of about three months in 2011 by using the bids to create price fluctuations for seconds or less — just long enough for him to successfully fill a smaller order at the new price, prosecutors said.

Coscia steadily argued that prosecutors had not proven he intended to manipulate the market. His orders were real and executable, he said during trial and on appeal, and many traders completed transactions against his offered prices. Plus, cancellations of orders are more than commonplace, he argued.

But during oral arguments, Circuit Judge Kenneth F. Ripple pointed to testimony from the designer of Coscia's algorithms as critical to showing the trader's intention. The designer, Jeremiah Park, told the jury that Coscia asked for an algorithm that would "act like a decoy" and would have orders automatically cancel in certain circumstances.

Attorneys said use of the word "decoy" likely served as crystallizing points for the jury, providing a clear-cut example of wrongful intent that is easier to grasp than algorithmic complexities. Schmeltz said the prosecutors' argument that Coscia was pulling the schoolyard bully trick of yanking his hand away before a peer could shake it also effectively illustrated that point.

"Once someone has put their thoughts in writing, there is no legitimate debate about it," Schmeltz said.

Schmeltz said he believes the punishment of Coscia will likely deter others in the market from similar activity, especially now that it is evident exchanges are monitoring this conduct and working with regulators, which in turn are cooperating with government prosecutors.

And while there may be more prosecutions now that the Seventh Circuit has issued its ruling, he also expects more plea deals in spoofing cases going forward.

"The impact of a decision like this is that people are less emboldened to go to trial," Schmeltz said.

Ermine said that establishing intent of wrongdoing is still a difficult challenge for prosecutors, noting that the

government had solid facts in this case. But she agreed that the government will have an increased willingness to investigate cases with an eye toward litigation, which could prompt more settlements.

“Now the DOJ has a good, solid high-profile case under their belt,” Ermine said.

--Additional reporting by Diana Novak Jones. Editing by Philip Shea and Edrienne Su.

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