

# Clients & Friends Memo

## First Criminal Prosecution for Spoofing: High Frequency Trading Firm Owner Indicted in Northern District of Illinois

October 7, 2014

On October 2, 2014, the U.S. Attorney for the Northern District of Illinois announced the indictment of Michael Coscia, the owner of Panther Energy Trading (“**Panther**”), for six counts of commodities fraud and six counts of spoofing.<sup>1</sup> This indictment represents the first ever criminal case to use the anti-manipulation authority provided in the Dodd-Frank Act to charge spoofing in the context of commodities transactions, and is one of the first major cases announced by the newly-formed Securities and Commodities Fraud section of the U.S. Attorney’s office for the Northern District of Illinois. These criminal charges come more than one year after the July 2013 announcement of several civil actions brought by the Commodity Futures Trading Commission (“**CFTC**”), the CME Group (“**CME**”), and the UK Financial Conduct Authority (“**FCA**”) in which Coscia and Panther agreed to pay significant fines and penalties and to disgorge the profits gained as a result of this trading activity.

The indictment is important for several reasons:

- It pushes the boundary of criminal prosecution of conduct that the CFTC previously pursued;
- It demonstrates the willingness of the Northern District of Illinois to break new ground in its investigation and prosecution of securities and commodities fraud cases, and perhaps signals an attempt to carve out a pre-eminent law enforcement role in the Commodities Markets, much like the Southern District of New York does in securities cases;
- It reminds market participants that multiple regulatory bodies are potentially interested in pursuing claims for the same conduct; and
- The use of the criminal code to charge the conduct at issue as commodities fraud results in more than double the maximum imprisonment term (25 years) compared to the criminal spoofing charge under the Commodity Exchange Act (“**CEA**”), which results in a maximum 10 year term.

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<sup>1</sup> Section 4(c)(a)(5)(C) of the CEA makes it unlawful “to engage in any trading, practice, or conduct on or subject to the rules of a registered entity 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).”

## Background

The indictment alleges that Coscia perpetrated the fraud during the fall of 2011 when he designed a trading program that used an algorithm to submit bids and offers that were cancelled before execution. The alleged unlawful conduct affected contracts traded on the CME's Globex and ICE Futures Europe. As part of an investigation and settlement of conduct by the CME, the exchange noted that during the time period at issue, the algorithm entered over 400,000 large orders on Globex and cancelled those orders over 98% of the time.

On July 22, 2013, the CME settled a disciplinary action against Panther and Coscia that resulted in the imposition of fines totaling \$800,000 and an order of disgorgement of \$1.3 million in profits.<sup>2</sup> The CME placed a six-month trading ban on Coscia.

Similarly, the CFTC previously filed and settled a civil action against Panther and Coscia for spoofing in connection with trading futures contracts in various commodities including energy products, metals, interest rates, agricultural products, stock indices, and foreign currencies and futures contracts including Light Sweet Crude Oil, Natural Gas, Corn, Soybean, Soybean Oil, Soybean Meal, and Wheat contracts. Also on July 22, 2013, Panther and Coscia settled the CFTC claims for \$2.8 million, comprised of a \$1.4 million civil monetary penalty and \$1.4 million in disgorged profits. Simultaneously the FCA imposed a fine on Coscia as an individual for \$903,000 (£597,000) concerning allegations of market abuse on ICE Futures Europe for the same conduct.

## Potential Legal Challenges to the Indictment

Based on what appear to be the same facts as those in the settled CME, CFTC, and FCA actions, the indictment charges Coscia individually with criminal violations of the CEA and federal anti-fraud statutes. The indictment raises interesting legal issues, and the progress of the case should be of great interest to market participants – especially since spoofing has never before been alleged to be criminal behavior under the CEA.

### *Can Spoofing Be Charged Alone or Must It Accompany a Charge of Fraud or False Reporting/Manipulation?*

The allegations in the indictment seem to indicate that the same conduct constitutes both commodity fraud and criminal spoofing, which raises the question of whether spoofing can be a standalone charge. It appears that the prosecutors' theory is that spoofing creates a fraud on the market by misrepresenting to market participants the volume of bids and offers in the market. If prosecutors believe that spoofing is a form of fraud, but different in some way, in kind or degree,

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<sup>2</sup> The disgorgement ordered by the CME Group offset the CFTC's disgorgement order.

from fraud charged under the CEA, we might expect to see more indictments that allege commodities fraud – with its 25 year maximum prison term – in addition to spoofing charges in the future.

### *What Defines Criminal Spoofing?*

To date, regulators have provided market participants with minimal guidance around the definition of spoofing, and it is unclear of what elements the criminal offense of spoofing consists.<sup>3</sup> Indeed, the spoofing counts in the Coscia indictment have very minimal facts and seem to use the same facts that serve as the basis for the fraud charges (although the spoofing charges do not specifically incorporate by reference all facts included in the fraud charges). This raises the question of a potentially multiplicitous<sup>4</sup> indictment that could be subject to constitutional challenge.

Despite the lack of definitive guidance from the regulators, the Coscia indictment suggests that the following is market activity that could raise red flags to regulators and prosecutors:

- Programming algorithms to seek out optimal market conditions for cancelling orders before execution to benefit positions (e.g., price stability, low volume at the best prices, and a narrow bid-ask spread)
- Designing programs to place several layers of large “quote orders” (those not intended to be executed) very near the best bid or offer (usually within three ticks) to “create the illusion of market interest”
- Trading programs that automatically cancel all quote orders immediately if any quote order is even partially filled for the purpose of provoking other traders to react to “false price and volume information” by using quote orders that appear “to represent a substantial change in the market”

### *Effect on Civil Actions*

This case presents an unusual scenario in the investigation and prosecution of commodities cases. As noted above, it follows by more than one year several civil settlements between regulators and Coscia. It is unclear why the Department of Justice filed criminal charges at this particular time or whether prosecutors and law enforcement had any involvement in the civil cases. Regardless of the history of this case, it will be necessary going forward for parties to civil settlements with the

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<sup>3</sup> Antidisruptive Practices Authority, Interpretive Guidance and Policy Statement, 78 Fed. Reg. 31,890 (May 28, 2013); Antidisruptive Practices Authority, Proposed Interpretive Order, 76 Fed. Reg. 14,943 (Mar. 18, 2011).

<sup>4</sup> A multiplicitous indictment is one in which a single offense is charged in several counts thereby raising significant double jeopardy concerns. See 1 C. Wright, Federal Practice and Procedure, § 142 at 469 (1982).

regulators to proceed with care to anticipate and attempt to negotiate global settlements at the outset. All regulatory investigations and settlement proceedings, whether with the CFTC or an exchange, should be diligently defended, regardless of the apparent severity of the allegation.

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