

X. *Spoofing*

A. Introduction

Spoofing is a type of market manipulation that “involves placing certain non-bona fide order(s) . . . with the intention of triggering another market participant(s) to [place orders], followed by canceling the non-bona fide order, and entering an order on the opposite side of the market.”¹ This conduct creates artificial market conditions that benefit the individual spoofer’s interests, while harming other market participants.² In 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), which lists spoofing among its prohibited transactions.³ Although other provisions of the Commodities Exchange Act (“CEA”) penalized spoofing, the Dodd-Frank Act was the first time Congress specifically addressed spoofing.⁴

This article examines how the United States government regulates spoofing. Part B highlights the relevance of spoofing to current financial conditions as well as recent developments. Part C reviews the history of government regulation of spoofing. Part D explains the impact of spoofing on the market. Part E describes how the Dodd-Frank Act addresses spoofing, and Part F explores the Dodd-Frank’s impact. Finally, Parts G and H analyze whether the penalty for spoofing is adequate, and why regulators impose such lenient penalties.

¹ News Release, FINRA, FINRA Joins Exchanges and the SEC in Fining Hold Brothers More Than \$5.9 Million for Manipulative Trading, Anti-Money Laundering, and Other Violations (Sept. 5, 2012), http://www.finra.org/Newsroom/NewsReleases/2012/P178687?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+FINRANews+%28FINRA+Nsews%29.

² Alex Lincoln-Antoniou & Mauro Wolfe, *HFT Spoof That Wasn’t Funny*, COMPLIANCE MONITOR, Sept. 2013, at 1, available at http://www.duanemorris.com/articles/static/wolfe_compliancemonitor_0913.pdf.

³ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376, 1913 (codified at 12 U.S.C. § 5301 (2012)).

⁴ Mathew Kluchenek & Jacob L. Kahn, *Deterring Disruption in the Derivatives Markets: A Review of the CFTC’s New Authority Over Disruptive Trading Practices*, 3 HARV. BUS L. REV. ONLINE 120, 126 (2013), http://www.hblr.org/wp-content/uploads/2013/03/Kluchenek_Deterring-Disruption.pdf.

B. Relevance to Current Financial Conditions and Recent Developments

Since the enactment of the Dodd-Frank Act, regulators have begun to fine trading firms for their involvement in spoofing.⁵ Key examples include enforcement actions against Panther Energy Trading (“Panther”), Biremis Corporation (“Biremis”), and Hold Brothers On-line Investment Services, LLC (“Hold Brothers”).⁶

Most recently, in July 2013, the Commodity Futures Trading Commission (“CFTC”) fined Panther \$2.8 million for spoofing.⁷ Furthermore, the CFTC issued a one-year trading ban to Panther and its owner, Michael Coscia.⁸ This was the first time the CFTC enforced the Dodd-Frank Act’s spoofing rules.⁹ Also, the Chicago Mercantile Exchange and foreign regulators imposed penalties on Coscia and Panther.¹⁰

Previously, the Securities Exchange Commission (“SEC”) withdrew the trading license from Biremis, based on spoofing by the firm’s day traders in December 2012.¹¹ Furthermore, the SEC issued the owners of Biremis a fine of \$250,000 and permanently banned them from trading.¹²

In September 2012, the Financial Industry Regulatory Authority (“FINRA”), some exchanges, and the SEC penalized Hold Brothers for various violations, including spoofing.¹³ Hold Brothers, like Biremis, allowed overseas day-trading without proper supervision.¹⁴ The SEC also permanently banned three senior managers of Hold Brothers from the industry.¹⁵

⁵ See Nathaniel Popper, *New Powers Invoked to Curb a High-Speed Trading Feint*, N.Y. TIMES (Jul. 22, 2013, 12:19 PM), <http://dealbook.nytimes.com/2013/07/22/high-speed-trading-firm-is-fined-and-barred/>.

⁶ *Id.*; David Barboza, *S.E.C. Moves Against Day-Trading Broker*, N.Y. TIMES (Dec. 19, 2012, 8:09 AM), <http://dealbook.nytimes.com/2012/12/19/s-e-c-moves-against-day-trading-broker/>; News Release, FINRA, *supra* note 1.

⁷ Popper, *supra* note 5.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ Barboza, *supra* note 6.

¹² *Id.*

¹³ News Release, FINRA, *supra* note 1.

¹⁴ *Id.*

¹⁵ *Id.*

C. History of Spoofing

Prior to the Dodd-Frank Act, the CFTC penalized spoofing through two CEA provisions.¹⁶ For example, the CFTC charged Bunge Global Markets (“BGM”) and Gelber Group with violating sections 4c(a)(2)(B) and 9(a)(2) of the CEA.¹⁷ Under section 4c(a)(2)(B), it is unlawful to “offer to enter into, enter into, or confirm the execution of a transaction” that “is used to cause any price to be reported, registered, or recorded that is not a true and bona-fide price.”¹⁸ Section 9(a)(2) prohibits “caus[ing] to be delivered for transmission . . . false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of any commodity in interstate commerce.”¹⁹ In March 2009, two traders for BGM entered orders for Chicago Board of Trade soybean futures to “determin[e] the depth of support for soybean futures at certain price levels before the market opened.”²⁰ BGM’s traders, who never intended to complete the orders, cancelled the orders before the market opened.²¹ By submitting bids they intended to cancel, BGM’s traders artificially altered the Indicative Opening Price (“IOP”)—the expected trade price of a given future—causing the publication of an artificially altered IOP.²² Thus, while regulators could not enforce rules against spoofing itself, they could enforce rules against some of the detrimental effects of spoofing by enforcing violations of sections 4c(a)(2)(B) and 9(a)(2) of the CEA.²³

D. Spoofing’s Impact on the Market

Traders spoof for financial gain by artificially altering the value of certain futures to induce other market participants to react in

¹⁶ Kluchenek & Kahn, *supra* note 4, at 130.

¹⁷ *Id.* at n.53 (citing Gelber Group, LLC, CFTC Docket No. 13-15 (Feb. 8, 2013); Bunge Global Markets, Inc., CFTC Docket No. 11-10 (Mar. 22, 2011)).

¹⁸ *Id.* at 131 n.60 (citing 7 U.S.C. § 6c(a)(2)(B) (2012)).

¹⁹ *Id.* at 131 n.61 (citing § 13(a)(2)).

²⁰ Bunge Global Markets, Inc., CFTC Docket No. 11-10 (Mar. 22, 2011), at 1.

²¹ *Id.*

²² *Id.* at 3.

²³ Kluchenek & Kahn, *supra* note 4, at 130.

a way that is beneficial for the spoofing trader.²⁴ The ultimate outcome of spoofing is increased market instability.²⁵ Since the IOP is based on pre-opening orders, bids placed before the market opens can significantly impact the bids others place once the market opens.²⁶ Market participants expect the IOP to reflect the actual demand for given futures, since they cannot know what orders are placed for a given future, or with what intent.²⁷ If the IOP is artificially altered, market participants would rely on inaccurate information, possibly to their detriment.²⁸

For example, Panther placed a small bona-fide sell order, and subsequently made many large non-bona-fide buy orders at increasingly higher prices.²⁹ The large buy orders reflected (false) considerable buying interest, in turn signifying that prices would likely increase.³⁰ This increased the probability of market participants filling Panther's small sell order.³¹ After participants filled Panther's small sell order,³² Panther cancelled the large buy

²⁴ See *supra* note 1 and accompanying text.

²⁵ Lincoln-Antoniou & Wolfe, *supra* note 2, at 2.

²⁶ Kluchenek & Kahn, *supra* note 4, at 130.

²⁷ *Id.* at 130–31.

²⁸ See Bunge Global Markets, Inc., CFTC Docket No. 11-10 (Mar. 22, 2011), at 4. For example, if trader A places a buy order for 2,000 futures contracts at consecutively higher prices, the increased pressure to buy will induce trader B (and others) to place a buy order for those futures contracts at the newly raised price, under the assumption that the value of the futures contract will continue to increase and that trader B will be able to sell the futures contracts for a higher price. When trader A “spoofs” and cancels the 2,000 buy orders, the IOP goes down below trader B's buy order price. Now, when trader B sells, he has lost the difference in value between the buy order placed before trader A's 2,000 futures contracts were cancelled, and the new value.

²⁹ Kate Micik, *Spoofing Leads to Ban, But Is It Long Enough?*, MARKET MATTERS BLOG (Jul. 22, 2013, 11:50 AM), <http://www.dtnprogressivefarmer.com/dtnag/view/blog/getBlog.do;jsessionid=EAAD6A99E472386E540B6D890C6BD7DE.agfreejvm1?blogHandle=gainmarkets&blogEntryId=8a82c0bc3e43976e01400749f7721175>.

³⁰ Panther Energy Trading LLC., CFTC Docket No. 13-26 (July 22, 2013), at 3.

³¹ *Id.*

³² For example, if trader A puts in a buy order for a future at \$50 and trader B agrees to sell for \$50, the sale is made and the order is filled. *Fill Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/f/fill.asp> (last visited Oct. 7, 2013).

orders, and the spoof started anew in reverse—Panther placed a small buy order followed by several large sell orders.³³ Consequently, Panther benefitted from executing the small orders many times over the time period in question.³⁴ Panther profited roughly \$1.4 million from the aforementioned spoofing transactions.³⁵ The Panther incident represents a paradigmatic example of how spoofing creates market instability through artificially altering the marketplace.

E. Current Regulation That Affects Spoofing

“Title VII of the Dodd-Frank Act amended the [CEA] to establish a comprehensive new regulatory framework for swaps and security based swaps.”³⁶ Section 747 of the Dodd-Frank Act amends section 4c(a) of the CEA, entitled “Prohibited Transactions,” to add a new section entitled “Disruptive Practices.”³⁷ New CEA section 4c(a)(5) makes it “unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that – (C) is, is of the character of, or is commonly known to the trade as, ‘spoofing.’”³⁸

Dodd-Frank Act section 747 also amends CEA section 4c(a) by granting the CFTC authority to promulgate such “rules and regulations as, in the judgment of the Commission, are reasonably necessary to prohibit the trading practices [enumerated therein] and any other trading practice that is disruptive of fair and equitable trading.”³⁹ Subsequently, the CFTC issued an Advance Notice of Proposed Rulemaking asking for public comment on section 747 of

³³ Panther Energy Trading LLC, *supra* note 30.

³⁴ *Id.*

³⁵ David S. Mitchell et al., Fried Frank Harris Shriver & Jacobson, *United States: CFTC Update: Commodity Futures Trading Commission Assesses Penalty In First “Spoofing” Case*, MONDAQ (last updated Aug. 12, 2013), <http://www.mondaq.com/unitedstates/x/257180/Commodities+Derivatives+Stock+Exchanges/CFTC+Update+Commodity+Futures+Trading+Commission+Assesses+Penalty+In+First+Spoofing+Case>.

³⁶ Antidistruptive Practices Authority, 76 Fed. Reg. 14,943, 14,944 (Mar. 18, 2011).

³⁷ See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 747, 124 Stat. 1376, 1739 (codified as amended at 7 U.S.C. §4c(a)(5)(C) (2012)).

³⁸ *Id.*

³⁹ *Id.*

the Dodd-Frank Act.⁴⁰ After receiving and considering comments, the CFTC issued an interpretive guidance and policy statement to “provide market participants and the public with guidance on the scope and application of the statutory prohibitions set forth in CEA section 4c(a)(5).”⁴¹

F. The Regulations’ Effect on the Future of Spoofing

With respect to section 4c(a)(5)(C) of the CEA, the CFTC’s interpretive guidance states that a market participant must act with “scienter” to violate the spoofing provision.⁴² “Reckless trading, practices, or conduct” do not violate section 4c(a)(5)(C).⁴³ Furthermore, there is no spoofing when “the person’s intent was to cancel such bid or offer as part of a legitimate, good-faith attempt to consummate a trade.”⁴⁴ Therefore, orders that are legitimate, good-faith cancellations do not violate section 4c(a)(5)(C).⁴⁵

Still, just one faulty trade can violate section 4c(a)(5)(C) if the actor possesses the requisite scienter.⁴⁶ This means that high-frequency traders, who cancel approximately 90 percent of their orders, may be at risk for heightened scrutiny.⁴⁷ Indeed, Panther was a high-frequency trader.⁴⁸

Another consideration to bear in mind is that the CFTC is not the only regulatory body that monitors spoofing. First, FINRA, a self-regulatory organization, also penalizes those who participate in deceptive market practices.⁴⁹ FINRA monitors broker-dealer conduct to ensure compliance with FINRA’s rules, the Municipal Securities

⁴⁰ Kluchenek & Kahn, *supra* note 4, at 120 n.3 (citing Antidisruptive Practices Authority Contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 67,301, 67,302 (Nov. 2, 2010)).

⁴¹ *Id.*; Antidisruptive Practices Authority, 78 Fed. Reg. at 31,890 (May 28, 2013).

⁴² Antidisruptive Practices Authority, 78 Fed. Reg. at 31,896.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ Eliot Lauer, Jason Gottlieb & Alyssa Astiz, *Stay Afloat in the New Wave of High-Frequency Trading Actions*, N.Y. L.J., Feb. 25, 2013, at S4.

⁴⁸ Lincoln-Antoniou & Wolfe, *supra* note 2.

⁴⁹ *About FINRA*, FINRA, <http://www.finra.org/AboutFINRA/> (last visited Nov. 14, 2013).

Rulemaking Board's rules, and federal securities laws.⁵⁰ Second, the SEC prohibits conduct creating the same effect as spoofing through the Securities Exchange Act.⁵¹ This means that FINRA, the CFTC, and the SEC can penalize those who participate in spoofing. In addition to FINRA, the CFTC, and the SEC, various exchanges also penalize entities who participate in spoofing or other unfair market practices.⁵² For instance, NASDAQ penalized Hold Brothers for violating its own rules against manipulative market practices in addition to violating the Securities and Exchange Act.⁵³ As a penalty, the NASDAQ fined and censured Hold Brothers.⁵⁴ Finally, foreign regulators, such as the UK's Financial Conduct Authority ("FCA"), also penalize spoofing.⁵⁵ For example, the FCA fined Panther's owner, Michael Coscia, for spoofing.⁵⁶

G. Does the Punishment Fit the Crime?

Thus far, fines and censures have been common penalties issued against those who spoof.⁵⁷ But does the punishment fit the crime? In Coscia's case, CFTC Commissioner Bart Chilton thinks that the punishment may not have been enough.⁵⁸ Specifically, Chilton described Coscia's behavior as an "egregious violation" of U.S. trading laws and felt "dissatisfied" with the 12-month trading ban, believing the ban was too lenient.⁵⁹ Chilton even called the ban

⁵⁰ *What We Do*, FINRA, <http://www.finra.org/AboutFINRA/WhatWeDo/> (last visited Nov. 14, 2013).

⁵¹ Securities Exchange Act, 15 U.S.C. § 78i(a)(2) (2012).

⁵² *See, e.g.*, Popper, *supra* note 5; Letter of Acceptance, Waiver And Consent from Hold Bros. Online Inv. Servs. LLC to NASDAQ Stock Mkt. LLC 4 (Sept. 24, 2012), <http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p178690.pdf>.

⁵³ *See* Letter of Acceptance, Waiver And Consent from Hold Bros. Online Inv. Servs. LLC to NASDAQ Stock Mkt. LLC, *supra* note 52, at 1.

⁵⁴ *Id.* at 5.

⁵⁵ Lincoln-Antoniou & Wolfe, *supra* note 2.

⁵⁶ *Id.* at 2.

⁵⁷ *See supra* notes 5–15 and accompanying text.

⁵⁸ Press Release, Brad Chilton, Comm'r, CFTC, Concurring Statement of Comm'r Bart Chilton in the Matter of Panther Energy Trading LLC and Michael J. Coscia (July 22, 2013), <http://www.cftc.gov/PressRoom/PressReleases/chiltonstatement072213>.

⁵⁹ *Id.*

“a nice sabbatical” for a trader to develop new algorithms to “unleash” on the market once the ban expires.⁶⁰

H. Why Do Regulators Impose Lenient Penalties?

Perhaps one reason why agencies do not impose harsher penalties for spoofing lies in the mens rea requirement. In penalizing firms for spoofing, the SEC and CFTC have similar mens rea standards.⁶¹ Section 9 of the Securities Exchange Act prohibits any person, when trading, to “[depress] the price of such security, for the purpose of inducing the purchase or sale of such security by others”⁶² and requires *specific intent* “for the purpose of inducing the purchase or sale of such security by others” or “for the purpose of creating a false or misleading appearance [of market activity].”⁶³ Generally, specific intent is difficult to establish.⁶⁴ Consequently, prosecutors use Section 9 infrequently.⁶⁵

The CFTC, under its own regulations, requires that an individual act with scienter “beyond recklessness” when spoofing.⁶⁶ Scienter is defined as a “mental state embracing intent to deceive, manipulate, or defraud.”⁶⁷ Furthermore, trading algorithms make scienter and specific intent more difficult to prove since algorithms are not always clearly designed to spoof.⁶⁸

FINRA Rule 2020 says that no member shall “effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or

⁶⁰ *Id.*

⁶¹ Securities Exchange Act, 15 U.S.C. §§ 78a–78pp (2012); Antidisruptive Practices Authority, 78 Fed. Reg. 31,890, 31,890 (May 28, 2013).

⁶² Antidisruptive Practices Authority, 78 Fed. Reg. at 31,896.

⁶³ Maxwell K. Multer, *Open-Market Manipulation under SEC Rule 10b-5 and its Analogues: Inappropriate Distinctions, Judicial Disagreement and Case Study: Ferc’s Anti-Manipulation Rule*, 39 SEC. REG. L. J. 97, 97 (2011).

⁶⁴ Kluchenek & Kahn, *supra* note 4, at 129 n.48 (citing Jerry W. Markham, *Manipulation of Commodity Futures Prices—The Unprosecutable Crime*, 8 YALE J. ON REG. 281, 356–57 (1991)).

⁶⁵ Multer, *supra* note 63.

⁶⁶ Antidisruptive Practices Authority, 78 Fed. Reg. at 31,896.

⁶⁷ Lauer, Gottlieb & Asitz, *supra* note 47, at n.35 (citing Aaron v. SEC, 446 U.S. 680, 691 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, 194 n.12 (1976)).

⁶⁸ Lauer, Gottlieb & Astiz, *supra* note 47.

contrivance.”⁶⁹ Despite FINRA’s mens rea requirement, FINRA is an self-regulatory organization (“SRO”), which means that it can only bring enforcement actions by sanctioning broker-dealers under its administrative authority⁷⁰ and referring cases to other enforcement agencies that can bring actions in federal court.⁷¹ This explains why FINRA censures and fines individuals rather than going to court.⁷² Because the CFTC’s mens rea standard is similar to the SEC’s, the CFTC’s mens rea requirement is sometimes met if the SEC’s is met. Given the similarity between the mens rea standards for both agencies, they are often both satisfied by the same conduct. As a result, the SEC, CFTC, and FINRA may all penalize a violator for the same activity.

The difficulty of proving mens rea might also incentivize a regulatory agency to impose a smaller penalty to avoid the risk and cost of continuing litigation.⁷³ For instance, when Hold Brothers violated the law, the SEC decided to accept a settlement offer.⁷⁴ In the settlement offer, Hold Brothers accepted and consented to the penalties imposed upon it, but without admitting or denying the findings.⁷⁵ Thus, the specific intent requirement can result in more lenient punishment and temporary, though expensive, penalties.

Despite this potential concern, the CFTC’s scienter requirement serves an important function. The scienter requirement is designed to prevent good faith cancellations from being wrongly penalized.⁷⁶ Thus, while all traders should be diligent in their conduct, traders should not have to worry too much that a good faith trade cancellation will result in CFTC penalties.⁷⁷ Without this safety net, the fear of punishment for unintentional conduct might stunt market participation.

⁶⁹ FINRA RULE § 2020 (2008).

⁷⁰ FINRA RULE § 9211 (2008).

⁷¹ See 15 U.S.C. § 78s(d)(2) (2012).

⁷² See News Release, FINRA, *supra* note 1.

⁷³ Cf. Dan Markel, *Retributive Damages: A Theory of Punitive Damages as Intermediate Sanction*, 94 CORNELL L. REV. 239, 313 (2009).

⁷⁴ Hold Bros. On-Line Inv. Servs., LLC, Exchange Act Release No. 67924, [2012 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶¶ 80, 156 (Sept. 25, 2012).

⁷⁵ *Id.* at 1–2.

⁷⁶ Antidisruptive Practices Authority, 78 Fed. Reg. 31,890, 31,896 (May 28, 2013).

⁷⁷ *Id.*

I. Conclusion

Given the recent increase in anti-spoofing enforcement actions, traders may choose to avoid spoofing, find new ways to continue spoofing, or change nothing and continue to trade in good faith. Regardless of what traders decide, regulatory agencies have substantial power to adapt to new conduct and currently prefer greater enforcement of unfair market practices.

D. Deniz Aktas⁷⁸

⁷⁸ Student, Boston University School of Law (J.D. 2015).