Dodd-Frank and the Spoofing Prohibition in Commodities Markets

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Abstract

The Dodd-Frank Act amended the Commodity Exchange Act and adopted an explicit prohibition regarding activity commonly known as spoofing in commodities markets. This Note argues that the spoofing prohibition is a necessary step towards improved market discipline and price integrity in the relevant commodities markets. It fills an important gap in the CEA in relation to an elusive form of price manipulation activity by providing an explicit statutory authority on which regulators and market operators may rely in policing suspect trading strategies falling under the spoofing umbrella.

Congress’ explicit denouncement of spoofing as an illegal act has ramifications not only for traders, but also for brokers and market makers. In the past, when courts have considered the issue of secondary liability of brokers regarding manipulative activity of their customers in the context of wash sales, they have determined the CEA’s explicit prohibition of wash sales and the relatively easier identification of wash sales activity as important factors that may potentially increase the secondary liability risk of derivatives brokers. Applying the same analogy to spoofing, greater public awareness and the increasing visibility of spoofing activity (resulting from improvements in the monitoring systems of regulators and market operators) will provide strong incentives for market participants to adapt to changing norms.

However, areas of concern, such as risk of selective enforcement and inconsistencies among the applicable market rules, will pose challenges in the spoofing prohibition’s implementation. Therefore, regulators must seek cooperation with relevant market operators to encourage structural reform and self-regulatory measures, such as implementation of appropriate structural safeguards into the trading infrastructure.

KEYWORDS: Dodd-Frank, Commodity Exchange Act, Spoofing

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DODD-FRANK AND THE *SPOOFING* PROHIBITION IN COMMODITIES MARKETS

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The Dodd-Frank Act amended the Commodity Exchange Act and adopted an explicit prohibition regarding activity commonly known as *spoofing* in commodities markets. This Note argues that the spoofing prohibition is a necessary step towards improved market discipline and price integrity in the relevant commodities markets. It fills an important gap in the CEA in relation to an elusive form of price manipulation activity by providing an explicit statutory authority on which regulators and market operators may rely in policing suspect trading strategies falling under the spoofing umbrella. Congress’ explicit denouncement of spoofing as an illegal act has ramifications not only for traders, but also for brokers and market makers. In the past, when courts have considered the issue of secondary liability of brokers regarding manipulative activity of their customers in the context of wash sales, they have determined the CEA’s explicit prohibition of wash sales and the relatively easier identification of wash sales activity as important factors that may potentially increase the secondary liability risk of derivatives brokers. Applying the same analogy to spoofing, greater public awareness and the increasing visibility of spoofing activity (resulting from improvements in the monitoring systems of regulators and market operators) will provide strong incentives for market participants to adapt to changing norms. However, areas of concern, such as risk of selective enforcement and inconsistencies among the applicable market rules, will pose challenges in the spoofing prohibition’s implementation. Therefore, regulators must seek cooperation with relevant market operators to encourage structural reform and self-regulatory measures, such as implementation of appropriate structural safeguards into the trading infrastructure.

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INTRODUCTION

For a long time the illegality of spoofing has been a point of contention among lawyers and economists. Spoofing is a form of price manipulation activity.¹ A spoofer submits to a market non-bona fide price quotes in order to cause artificial price volatility.² It creates market noise, and makes an order book unreliable and deceptive for analysts and

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² Id.
traders. Usually, it is employed as part of a predatory trading strategy in which the trader actually holds an opposite market position—or has the intent to immediately take such a position—to take unfair advantage of the market’s confusion caused by the deceptive market signals created by the trader. Among myriad other important changes, the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) introduced a statutory prohibition on spoofing for the first time, with a limited application to commodities markets in its current form.

The spoofing provision is remarkable for two reasons. First, its enactment coincides with a growing discontent in the financial industry regarding predatory trading conduct in general. Second, though widely accepted as detrimental to the price discovery function of the markets, spoofing activity was in the past too elusive to prosecute under the general anti-manipulation authority of the Commodity Exchange Act (“CEA”). Thus, the prohibition has the potential to drastically alter the way markets operate by creating a stand-alone statutory prohibition that can be enforced by both agency actions and private lawsuits.

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6. See In re Amaranth Nat. Gas Commodities Litig., 730 F.3d 170, 184 (2d Cir. 2013) (“This makes sense: excessive speculation, just as much as manipulation, can result in market illiquidity and artificial prices.”).

7. For the difficulty of proving spoofing cases under the pre-Dodd-Frank anti-manipulation standard, see Bart Chilton, Comm’r, CFTC, Statement Regarding Anti-Fraud and Anti-Manipulation Final Rules: The Waiting (July 7, 2011), http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement070711 [https://perma.cc/5EFX-L3VT].

8. See 7 U.S.C. § 25 (2012). CEA’s explicit grant of authority for private right of action is a distinct feature of commodities law in comparison to the judicially developed availability of private right of action in securities law, the doctrine of which was, to a big
CEA broadly defines spoofing as “bidding or offering with the intent to cancel the bid or offer before execution” in relation to any trading that occurs on, or subject to, the rules of an exchange regulated by the Commodity Futures Trading Commission (“CFTC”). Although the prohibition applies to both manual and automated trading, in today’s markets where the majority of day trading is conducted via algorithmic trading strategies, the ramifications of the prohibition can be manifold for institutional proprietary traders, brokers, and market makers.

The increasing availability of hyper-frequency trading infrastructure to access the interrelated markets for thousands of different securities and derivatives contracts renders the policing of predatory trading practices a priority for market regulators and participants. In the age of advanced trading technology that is widely available, events such as the flash crash of 2010, during which the stock market fluctuated more than 9% within thirty-six minutes while “bids on dozens of ETFs (and other stocks) fell as low as a penny a share,” demonstrate the inherent fragility of daily extent, developed by the courts. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).


10. See RICHARD HAYNES & JOHN S. ROBERTS, CFTC, AUTOMATED TRADING IN FUTURES MARKETS (Mar. 13, 2015), http://www.cftc.gov/idc/groups/public/@economicanalysis/documents/file/oce_automatedtrading.pdf ("Recent studies on automated trading in domestic markets have found that often over half of the trades on securities and futures exchanges make some use of algorithms . . . to match trades, oversee certain order types (e.g., stop orders) and monitor general market risk."); see also CFTC v. Oystacher, No. 15-CV-9196, 2016 WL 3693429, at *15 (N.D. Ill. July 12, 2016) ("Algorithmic traders include a variety of participants, ranging from brokerage firms who seek favorable trade executions on behalf of clients entering long-term investment positions or hedges to proprietary firms who trade on a principal basis in pursuit of short-term profit opportunities.").


markets against disruptive market practices. Under the prohibition, a wide range of trading activity traditionally perceived as legitimate may constitute unlawful conduct as the traders’ algorithms and their design features will come under greater scrutiny.

On the other hand, there is great confusion in the trading industry regarding the spoofing prohibition, generally due to the difficulty of distinguishing spoofing from other similar but lawful conduct from a theoretical and practical standpoint. Despite the rule’s simplistic language, some critics are concerned with selective and discriminatory enforcement that may emanate from the difficulties in detecting minor incidents of spoofing in today’s vast global markets. Indeed, practical issues such as limited access to order book data, technical difficulties in developing proper detection systems, inconsistencies in the applicable market rules, and the asymmetrical enforcement standards of the responsible government and self-regulatory organizations have the potential to undermine the fundamental premise of the spoofing prohibition.

13. See generally Michael Lewis, Crash Boys, BLOOMBERG (Apr. 24, 2014), https://www.bloomberg.com/view/articles/2015-04-24/michael-lewis-has-questions-about-flash-crash [https://perma.cc/7374-N64K] (“On the day of the flash crash, Sarao never actually sold stocks. He was trying to trick the market into falling so that he could buy in more cheaply. But whom did he fool with his trick? Whose algorithms were so easily gamed that they responded to phony sell orders by creating a crash? Stupidity isn’t a crime. Still, it would be interesting to know who, at this particular poker table, on this particular day, was the fool.”).


16. Coherence in market rules and enforcement policies undercut arbitrage-seeking behavior and provide efficiencies in relation to compliance for all market participants. For a theoretical analogy see NASSIM N. TALEB, SKIN IN THE GAME 30-31 (May 28, 2016) (unpublished manuscript), http://www.fooledbyrandomness.com/minority.pdf [https://perma.cc/B6D5-SAQL]. (“The Kosher population represents less than three tenth[s] of [U.S. residents]. Yet, it appears that almost all drinks are Kosher. Why? Simply because going full Kosher allows the producer, grocer, restaurant, to not have to distinguish between Kosher and non-kosher for liquids, with special markers, separate aisles, separate inventories, different stocking sub-facilities. . . . If the people following the minority rule lived [in separation from the rest of the society], with their separate small economy, then the minority rule would not apply. But, when a population has an even spatial distribution, say the ratio of such a minority in a neighborhood is the same as that
This Note, however, argues that the prohibition is a necessary step towards improved market discipline and compliance standards, and fills an important gap in the CEA by providing explicit statutory authority to allow regulators to curb an activity that directly undermines the “efficient market hypothesis” and poses systemic risks to markets.\textsuperscript{17} In the context of wash sales, the courts have interpreted factors such as the specific prohibition of wash sales by the CEA and the relatively easy identification of wash sale activity as a legal basis that may potentially increase the secondary liability risk of derivatives brokers.\textsuperscript{18} Applying the same analogy to the spoofing context, it would be a fair assessment to say that the explicit statutory prohibition, greater public awareness regarding spoofing, and the increasing visibility of spoofing activity resulting from improvements in the monitoring systems of regulators and market operators will provide strong incentives for market participants to adapt to changing norms.\textsuperscript{19} In this context, it is likely that the CFTC’s and the SEC’s whistleblower programs will also incentivize independent market observers and analysts to detect and report suspicious market conduct and allow them to play a greater role in regulatory enforcement.

This Note first analyzes the normative elements of the new prohibition in comparison with the CEA’s pre-Dodd-Frank anti-manipulation authority. The Note then addresses the recent and ongoing
spoofing cases brought under the new statute, as well as other spoofing cases brought by the CFTC, the SEC, market operators, and private individuals under the pre-Dodd-Frank anti-manipulation provisions. The Note also compares the spoofing statute with similar norms in the securities area and delineates the divergence that is currently developing between the fields of commodities and securities laws in relation to the statutory requirements for a *prima facie* case of spoofing. Finally, the Note argues that, despite the criticism, the spoofing prohibition serves an important purpose and will play an integral role in improving market discipline not only through public enforcement, but also through private lawsuits, improved market monitoring, and self-regulatory actions.

**I. FROM PRICE-MANIPULATION UNDER CEA TO A STAND-ALONE CAUSE OF ACTION**

Pre-Dodd-Frank actions against spoofing were generally brought as claims of price manipulation20 or false reporting21 under the CEA.22 The explicit illegality of spoofing under the CEA is new, but activities which generally fall under spoofing have been prosecuted before by the SEC and self-regulatory organizations under various general anti-manipulation

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20. See 7 U.S.C. § 6(c)(a)(1)-(2) (2012) (making it illegal 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”). Generally, the CFTC required the following elements to be met: (i) offering to enter into the execution of transactions; (ii) involving the purchase or sale of a commodity for future delivery that; (3) caused a price to be reported, registered, or recorded that was not true and bona fide. Id.

21. See 7 U.S.C. § 13(a)(2) (prohibiting actions “caus[ing] [the delivery/transmission of] 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”).

provisions found within the respective securities statutes and other applicable market regulations.

A. CO-EXISTING NORMS

_Spoofing_ actions share large commonalities with anti-manipulation claims, but Dodd-Frank created a separate commodities spoofing cause of action that has some overlaps with as well as differences from the existing anti-manipulation norms.23 In fact, in its recent practice, the CFTC has treated the concepts separately by formulating claims for both price manipulation and spoofing independently in relation to the same conduct.24 This represents a picture where the spoofing prohibition tends to be treated by the regulators as a special form of manipulation, which requires the showing of a certain statutorily defined trading pattern sufficient to establish unlawful conduct.

Generally under the pre-Dodd-Frank manipulation standard, conduct such as spoofing only amounted to price manipulation where (i) the defendant had the _ability to influence_ market prices; (ii) an artificial price _actually existed_; (iii) the defendants _caused_ the artificial prices; and (iv) the defendants _specifically intended_ to cause the artificial prices.25 In most cases, the presence of actual causality and the existence of artificial prices usually hinged on the same factual inquiry that would also determine whether the more difficult to prove elements of the pre-Dodd-Frank

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23. Generally, the question of whether a case will be tried based on the pre-Dodd-Frank price manipulation standard or the new _spoofing_ prohibition depends on which rule was in effect at the time of the trading activity.


standard—“ability to influence market prices” and “specific intent to influence market prices”—were met. The “specific intent” element under the pre-Dodd-Frank standard purported to be the one that required the most clarity, especially concerning whether the showing of specific intent required something more than a general intent to affect market prices.

B. WILSON CASE: SPOOFING DOES NOT NECESSARILY “SOUND IN FRAUD”—ABILITY TO CAUSE AND THE EXISTENCE OF ARTIFICIAL PRICE

In Commodity Futures Trading Commission v. Wilson—a highly publicized spoofing case adjudicated under the pre-Dodd-Frank authority—a district court in the Southern District of New York rejected the defendant proprietary trading firm’s motion to dismiss, finding that the CFTC had alleged facts sufficient to establish a price manipulation claim under CEA Section 9(a)(2). The case involved the defendant's

26. See DiPlacido v. CFTC, 364 F.App’x at 661 (“Even supposing that all large traders in illiquid markets possess the ability to influence those markets, the Commission’s inclusion of ‘the ability to influence the market price,’ rather than market control, as an element of manipulation is hardly arbitrary or capricious, as three other elements, including specific intent, must also be satisfied to establish liability. . . . The Commission acted reasonably in concluding that DiPlacido had the ability to influence prices where, on the relevant dates, his trades over two minutes at the Close accounted for an average 14% of a full day’s volume.”).

27. CFTC v. Wilson, 27 F. Supp. 3d 517, 532 (S.D.N.Y. 2014) (quoting In re Energy Transfer Partners Nat. Gas Litig., 07 Civ. 3349, 2009 WL 2633781, at *5 (S.D. Tex. Aug. 26, 2009)) (“To meet the specific intent element of a claim for manipulation or attempted manipulation of a futures contract, the Commission must plead that Defendants ‘acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand.’”).

28. Id. at 522 (S.D.N.Y. 2014). The case related to the defendant’s activities that took advantage of the so-called convexity bias effect that occurs in the relevant market during the market’s daily settlement. Id. at 523-25 (“The CFTC alleges that DRW acquired its long position in order to take advantage of the convexity bias in the Three–Month Contract and the fact that IDCH did not apply a PAI adjustment that would counteract that bias . . . . In the months preceding its investment, DRW conducted research into the methodology used by IDCH in generating the IDEX Curve and setting the net present value of party’s open positions. In a July 23, 2010 email Wilson instructed several of his subordinates to ‘[c]onfirm the contract has full convexity bias (despite the fact they will force it to settle at non-convexity based prices)’ . . . . On August 30, 2010, after DRW had begun to acquire its open position, a DRW trader stated that the Three–
alleged spoofing in relation to an exchange-traded interest rate futures contract called the IDEX USD Three-Month Interest Rate Swap Futures Contract. In Wilson, the court rejected the defendant’s argument that a spoofing claim based on the CEA’s anti-manipulation authority should be subject to heightened pleading standards as applied to allegations that “sound in fraud.” According to the court, “although manipulation and attempted manipulation claims that ‘sound in fraud’ are evaluated under the heightened pleading requirements of Rule 9(b) . . . fraud [is] not a necessary element of a market manipulation claim.” In its decision, the court accepted the CFTC’s theory of attempted manipulation as non-fraudulent misconduct that is “not based on misleading statements or omissions, but rather on a particular trading strategy,” one that involved “the timing of trades intended to change the closing price.” Indeed, for the purposes of pleading standards, a similar conceptual separation between allegations of explicit and implicit price manipulation is well accepted in the securities law context. This approach is justified under
the efficient market hypothesis, which holds that “public information is immediately incorporated into . . . price.”

33 Spoofing, as a special form of implicit price manipulation, involves market manipulation by way of directly distorting the market price via sending non-bona fide orders to an exchange (as opposed to misrepresentations involving public statements and events). Accordingly, courts usually lower the pleading standard due to the subtle form of the alleged manipulation and the potentially onerous evidentiary challenges in meeting the burden of heightened pleading standards.

Here, the court held that the CFTC’s allegations passed the necessary pleading standards in establishing both the ability to influence market prices and the specific intent to do so, based on an investigation that showed that the firm’s management deliberately studied and executed the relevant market arbitrage opportunity. When defining the “existence of artificial prices,” the court borrowed a test from antitrust doctrine that defines the element broadly as any price that “does not reflect basic forces

be more difficult for plaintiffs to outline the scheme with great particularity; thus, market manipulation plaintiffs are given more leeway in alleging manipulative conduct.”

33. Id. at 579 (citing In re Exec. Telecard, Ltd. Sec. Litig., 979 F. Supp. 1021, 1028 (S.D.N.Y. 1997)) (“Under the efficient market hypothesis endorsed by the plurality in Basic v. Levinson, the price of a security reflects all publicly available information.”).

34. Id.

35. See Wilson, 27 F. Supp. 3d at 533. “[T]he CFTC has alleged that the head of quantitative research at DRW acknowledged that DRW could influence prices, stating that as a result of Defendants’ practices, the ‘IDCG settle curve is DRW defined.’” Id. ¶ 53. The CFTC has also alleged that another market participant complained to DRW in February 2011 that DRW “‘get[s] to set the mark,’” and that DRW continued its allegedly manipulative bidding activity through August 2011. . . . Defendants also maintain that their bids were ‘based on their own calculations and beliefs about value’ and, therefore, that the requisite intent was lacking. Def. Mem. 15–16. Although Defendants may attempt to prove at a later stage of the litigation that their bids reflected a ‘legitimate source of demand,’ see id., this issue is not appropriate for resolution at the motion to dismiss stage. With respect to both the manipulation and attempted manipulation claims, the CFTC has alleged facts capable of showing that Defendants specifically intended to influence the market price of the Three–Month Contract.”

36. Id. (“The CFTC alleges that DRW’s ‘head of quantitative research stated to Wilson that as a result of DRW’s “new regime,” the “IDCG settle curve is DRW defined.”’” Id. ¶ 53. The CFTC has also alleged that another market participant complained to DRW in February 2011 that DRW “‘get[s] to set the mark,’” and that DRW continued its allegedly manipulative bidding activity through August 2011. . . . Defendants also maintain that their bids were ‘based on their own calculations and beliefs about value’ and, therefore, that the requisite intent was lacking. Def. Mem. 15–16. Although Defendants may attempt to prove at a later stage of the litigation that their bids reflected a ‘legitimate source of demand,’ see id., this issue is not appropriate for resolution at the motion to dismiss stage. With respect to both the manipulation and attempted manipulation claims, the CFTC has alleged facts capable of showing that Defendants specifically intended to influence the market price of the Three–Month Contract.”).
of supply and demand." Thus, the tests for showing the necessary ability to cause artificial prices and the existence of artificial prices have metastasized into a single inquiry for purposes of a motion to dismiss. This was contrary to a Southern District of Texas court decision that found the pre-Dodd-Frank anti-manipulation standard—and its condition regarding the existence of an artificial price—unconstitutionally vague as applied to certain defendants. Some of the evidence factored in by the Wilson court included the duration of the relevant trading activity (the defendant adopted spoofing for more than 118 days without entering into an actual trade) and other facts and circumstances surrounding the defendant’s trading behavior. The court took into account the excessive price differences resulting from the defendant’s bids, and the rapid order withdrawals by the defendant during the settlement period when the market became particularly exposed to this trading strategy due to the convexity bias. The court found the defendant’s arguments defending its conduct as lawful arbitrage activity that actually served to correct the market price unpersuasive. The evidence was sufficient to meet the “causality” standard for deciding on the motion to dismiss. Thus, the case is a reminder of the wide traction the spoofing prohibition had achieved even in the pre-Dodd-Frank regime. This is particularly striking

37. Id. at 533 (quoting CFTC v. Parnon Energy Inc., 875 F. Supp. 2d 233, 245 (S.D.N.Y. 2012)) (“[M]arket manipulation in its various manifestations is implicitly an artificial stimulus applied to (or at times a brake on) market prices, a force which distorts those prices, a factor which prevents the determination of those prices by free competition alone.”).

38. Parnon Energy Inc., 875 F. Supp. 2d at 245 (citing Pepsico, Inc. v. Coca-Cola, 315 F.3d 101, 108 (2d Cir. 2002)) (“By analogy to antitrust law, where an element of proof involves the ability to affect prices, a complaint is sufficient if it alleges ‘direct measurements of a defendant’s ability to control prices . . . .’”).

39. United States v. Radley, 659 F. Supp. 2d 803, 813–14 (S.D. Tex. 2009), aff’d, 632 F.3d 177 (5th Cir. 2011) (“The government fails in this regard because the definition of ‘artificial’ is uncertain, and that uncertainty makes application of the manipulation statute unconstitutionally vague as applied to the facts of this case. . . . Today’s markets are filled with speculators attempting to make profits based on movement in prices of commodities and other products with no intention of ever consuming or producing them. That is what the defendants were doing in this case, and there is no law or case which prohibits speculation.”).

40. Wilson, 27 F. Supp. 3d at 533–34.

41. Id.

42. Id.

43. Id. at 535.
as the pre-Dodd-Frank anti-manipulation authority subjected spoofing claims to particularly difficult *prima facie* case standards of archetypical price manipulation cases.

II. POST-DODD-FRANK STANDARD: INDEPENDENT CAUSE OF ACTION FOR SPOOFING

Section 747 of Dodd-Frank adopted three separate commodities offenses in relation to all commodities trading activity occurring in regulated markets. These offenses include (i) “violating bids or offers;” (ii) “intentional or reckless disregard for the orderly execution of transactions during the closing period;” and (iii) all conduct that “is of the character of, or is commonly known to the trade ‘spoofing’ (bidding or offering with the intent to cancel the bid or offer before execution).”

Section 747 also further amended Section 4c(a) of the CEA to grant broad authority to the CFTC to promulgate such “rules and regulations as, in the judgment of the Commission, are reasonably necessary to prohibit the trading practices” enumerated in Section 747 together with “any other trading practice that is disruptive of fair and equitable trading.”

The new prohibition will lower the *prima facie* case threshold in price manipulation claims involving spoofing since it does not require the showing of “specific intent” and the existence of or the ability to cause artificial prices. Prior to Dodd-Frank, spoofing cases brought under the general price manipulation statute had to show *specific intent* to

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44. 7 U.S.C. § 6c(a)(5) (2012). Although this paper focuses on *spoofing*, CEA Section 4(c)(a)(5) also makes it illegal to “violate bids and offers” under a strict liability standard (to buy or sell any contract for prices except the lower/highest available offer/bid prices), see id. § 6c(a)(5)(A), and other activities that demonstrate intentional or reckless trading patterns during the closing period of markets (an activity commonly referred to as “banging the close”). See id. § 6c(a)(5)(B). According to the CFTC, the rule against “violating bids and offers” does not introduce a “best execution standard across multiple markets,” and the trader’s obligation regarding the rule is limited to the confines of the specific trading venue utilized at a given moment of time. See *Antidisruptive Practices Authority*, 76 Fed. Reg. 14,943, 14,946 (proposed Mar. 18, 2011). The CFTC also stated this prohibition shall apply primarily in trading environments where a person exercises at least some control over the selection of bids and offers, and shall generally not apply when the trading occurs on an electronic trading system where bid matching occurs automatically. See id.

manipulate the market price. For conduct that occurred following the enactment of Dodd-Frank, the claimants will need to show specific intention only with regards to the spoofing activity, viz., sending orders without having a bona fide intent to enter into actual transactions. The statutory prohibition will function as a gap-filler by establishing three important legal assumptions: (i) that spoofing is a per se form of price manipulation, (ii) that price manipulation is a primary motive for the perpetrator of spoofing, and (iii) that it is generally irrelevant whether the perpetrator had the actual ability to manipulate the market price. In cases where the defendant’s bid-offer practices establish a consistent pattern indicating a conscious effort to avoid entering into any transactions, the requisite intent element can be easily met, unlike the onerous prima facie case standard of the classical price manipulation cases. On the other hand, as is discussed below, the enactment of the spoofing statute seems to have created a divergence between the anti-manipulation standards in commodities and securities laws, since as of yet, there is no explicit statutory prohibition in securities laws against spoofing.

Since its enactment, the new spoofing statute was thus far upheld against constitutional challenges for vagueness. Courts rejected this challenge, since, when taken together with the relevant guidance issued by the CFTC, the statute provided a sufficient definition in declaring spoofing an unlawful conduct.

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46. See supra Section I.A.

47. In United States v. Coscia, the relevant jury instruction focused on the intent element without requiring the showing of other elements of prima facie price manipulation. United States v. Coscia, 177 F. Supp. 3d 1087, 1094 (N.D. Ill. 2016) (“The instruction the Court ultimately adopted reads, in relevant part: ‘Spoofing’ is defined as bidding or offering with the intent to cancel the bid or offer before execution. To find this element satisfied, you must find that the government has proven beyond a reasonable doubt that, at the time Mr. Coscia entered the bid or offer specified in the Count that you are considering, he intended to cancel the entire bid or offer before it was executed, and that he did not place the bid or offer as part of a legitimate, good-faith attempt to execute at least part of that bid or offer.”).

48. See United States v. Coscia, 100 F. Supp. 3d 653, 656 (N.D. Ill. 2015); see also CFTC v. Oystacher, No. 15-CV-9196, 2016 WL 4439945, at *2 (N.D. Ill. Aug. 23, 2016) (“Defendants essentially assert three arguments: i) the Spoofing Statute is unconstitutionally vague, ii) CFTC Regulation 180.1 is unconstitutionally vague, and ii) the Spoofing Statute constitutes an unconstitutional delegation by Congress. The Court disagrees with all three.”); Vill. of Hoffman Estates v. Flipside, Hoffman Estates, Inc., 455 U.S. 489, 498 (1982) (“[E]conomic regulation is subject to a less strict vagueness
A. CFTC INTERPRETIVE GUIDANCE

The CFTC did not issue any final rules regarding spoofing. However, the agency sought public comments on various questions regarding the new prohibition and issued a proposed interpretive order, interpretive guidance, and policy statement to guide the industry on its interpretation of Section 4c(a)(5)(C). Since the enactment of the prohibition, the CFTC has avoided narrowing the scope of spoofing into a pre-defined set of market behavior. Instead it has adopted a case-specific approach heavily reliant on particular facts and circumstances of the suspect market behavior.

1. Something More Than Recklessness

According to CFTC interpretation, the statute requires a market participant “to act with some degree of intent, or scienter, beyond recklessness” for his conduct to constitute a breach of the CEA’s spoofing prohibition. Different than the strict liability standard accepted for “violat[ion of] bids and offers,” the statutory language of spoofing requires a showing of “intent to cancel a bid or offer before execution,” and the CFTC has stated that a showing of something greater than “reckless trading, practices, or conduct” is necessary to establish a test because its subject matter is often more narrow, and because businesses, which face economic demands to plan behavior carefully, can be expected to consult relevant legislation in advance of action. Indeed, the regulated enterprise may have the ability to clarify the meaning of the regulation by its own inquiry, or by resort to an administrative process.”).

49. Regarding other CEA anti-manipulation provisions, the agency has adopted Prohibition on the Deployment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41,398 (July 14, 2011).


violation. Generally, a violation will not exist if the cancellation of the bid or offer was “part of a legitimate, good-faith attempt to consummate a trade.” In relation to “partial fills,” the agency abstained from declaring a bright line rule and generally stated that it shall conduct a facts-and-circumstances test based on an evaluation of the greater “market context,” “the person’s pattern of trading activity,” and other factors when distinguishing between legitimate trading and spoofing.

On July 14, 2011, the CFTC also adopted CFTC Regulation 180.1(a)(1) pursuant to its authority under Section 753 of Dodd-Frank. In relevant part, 180.1(a)(1) makes it unlawful for any person, directly or indirectly, in connection with any swap, or contract of sale of any commodity . . ., or contract for future delivery on or subject to the rules of any registered entity, to intentionally or recklessly . . . [u]se or employ, or attempt to use or employ, any manipulative device, scheme, or artifice to defraud.

In spoofing cases, CFTC generally relies on both Rule 180.1 and the statutory provision.

Under commodities laws, scienter generally requires “the intent to deceive, manipulate, or defraud.” Generally, a successful scienter pleading alleges facts showing that the defendants had motive and opportunity to commit the fraud, or alternatively, provides strong circumstantial evidence of “conscious misbehavior or recklessness.” To sufficiently plead illegitimate motives, a plaintiff should present concrete

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53. Id.
54. Id.
55. Id.; see also United States v. Coscia, 100 F. Supp. 3d 653, 656 (rejecting the argument that the rule’s application is ambiguous in relation to partial fills).
58. In re Amaranth Nat. Gas Commodities Litig., 612 F. Supp. 2d 376, 383 (S.D.N.Y. 2009), aff’d, 730 F.3d 170 (2d Cir. 2013); see also id. at 383 n.20 (quoting Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007)) (“Although the Supreme Court was discussing securities fraud, its language is equally applicable to commodities fraud.”).
59. Id. (citation omitted).
benefits “that could be realized by one or more of the false statements and wrongful nondisclosures alleged.”

2. Relevant Markets and Transactions

The spoofing prohibition covers all bids and offers on products traded on all registered entities, including bids and offers made in pre-open periods or during other trading stoppages. Pursuant to Section 2(a)(1)(C)(ii) of the CEA, futures contracts on broad-based security indexes also fall within provisions of CEA, together with futures on narrow-based security indexes, which are jointly regulated by the CFTC and the SEC.

The agency further declared that a violation of the spoofing prohibition could occur in any trading platform, regardless of whether the platform operates on “order book functionality,” so long as the participants have the ability to send executable orders or transact against pending orders. According to the agency’s interpretation, examples of

60. Id.
61. Id.; see also In re Bunge Global Markets, Inc., CFTC No. 11-10 (Mar. 22, 2011).
62. Amaranth, 612 F. Supp. 2d at 383. For a background on different market structures, see Charlie X. Cai et al., Trading Frictions and Market Structure: An Empirical Analysis, 35 J. BUS. FIN. & ACCT. 563, 564-65 (2008) (“Consistent with earlier studies . . . our initial results suggest that the total cost of trading is lower on order driven systems. There is no doubt that for liquid securities the real cost of trading is lower because of increased order and competition from public investors (through limit order placement) for the provision of liquidity. However, our analysis also indicates that informational asymmetry is significantly higher on order driven systems, which could possibly be due to the anonymity of market participants (and counterparties to transactions) or stealth trading by informed investors. Significantly, order size has a major impact upon the level of informational and real frictions and medium trades have very high informational costs compared to small and large trades.”); see also James J. D. Wang & S. Viswanathan, Market Architecture: Limit Order Books Versus Dealership Markets 2 (Aug. 1998) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=135852 [https://perma.cc/676P-VJ7D ] (“(1) [A] risk neutral customer prefers to trade in a limit-order market instead of in any hybrid or dealership markets; (2) a risk averse customer prefers to trade in a dealership market over a limit-order book market when the number of market makers is large and when the variation in order size is significant; and (3) for risk averse customers, the hybrid market structure, when properly structured, dominates the dealership market.”). See also generally Stanislav Dolgopolov, The Maker-Taker Pricing Model and Its Impact on the Securities
spoofing include (i) “submitting or cancelling bids or offers to overload the quotation system of a registered entity,” (ii) “submitting or cancelling bids or offers to delay another person’s execution of trades,” (iii) “submitting or cancelling multiple bids or offers to create an appearance of false market depth,” and (iv) “submitting or canceling bids or offers with intent to create artificial price movements upwards or downwards.”

Although spoofing has been previously prohibited by self-regulatory organizations, such prohibition was based on general conduct rules. Following the CFTC releases, the Chicago Mercantile Exchange (“CME”) and Intercontinental Exchange (“ICE”) incorporated into their rules the above listed activities that the CFTC declared as examples of spoofing. The CME and ICE rules also expressly prohibit the entry of orders with the intent to modify them “to avoid execution.”

B. COSCIA CASE: INTENT TO SPOOF—CONSTITUTIONALITY OF THE PROHIBITION

The new prohibition was first tested following an enforcement action brought by the CFTC, in which the Commissioners ordered an energy trading company and its sole owner executing high frequency trading strategies to pay a monetary fine for breaching the prohibition.

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64. CHI. MERCANTILE EXCH., MARKET REGULATION ADVISORY NOTICE: DISRUPTIVE PRACTICES PROHIBITED (2014); ICE FUTURES U.S., INC., TRADING RULES 4.02(l) (2012). The CME rule also identifies various conduct that would not be deemed spoofing such as an “order, entered with the intent to execute a bona fide transaction, that is subsequently modified or cancelled due to a perceived change in circumstances;” an “unintentional, accidental, or ‘fat-finger’ order;” and a bona fide stop-loss order. CHI. MERCANTILE EXCH., supra, at 4-5.
65. CHI. MERCANTILE EXCH., supra note 64, at 2; ICE FUTURES U.S., INC., supra note 64, at 4.02(l).
66. In re Panther Energy Trading LLC, CFTC No. 13-26, 2013 WL 3817473, at *2 (July 22, 2013) (“First, the algorithm placed a relatively small order on one side of the market at or near the best price being offered to buy or sell, in this instance a sell order for 17 contracts at a price of $85.29 per barrel, which was a lower price than the contracts then being offered by other market participants. Thus, the Respondents’ offer was at the lowest, i.e., [...] best, offered price. Second, within a fraction of a second, the Respondents entered orders to buy a relatively larger number of Light Sweet Crude Oil futures..."
Subsequently the sole owner of the company was found guilty by a jury for commodities fraud, as the Northern District of Illinois court rejected a motion for a new trial. In doing so, the court rejected arguments that a high number of order cancellations is an inherent and natural part of hyper-frequency trading and that the spoofing prohibition is unconstitutionally vague by failing to provide guidance regarding partial fills. The court also paid particular focus to evidence regarding the trading program and the programmer’s testimony regarding the program’s design, including its special features such as the placement of large quote orders to “stimulate the market,” the cancellation of large orders as soon as they started to fill, and a timer mechanism that was set on quote orders to avoid entering into any transactions. By holding that statutory authority regarding spoofing provides a proper definition for the unlawful conduct, the court also distinguished the case from prior case law where defendants prevailed in challenges brought against certain language in the contracts at progressively higher prices: the first bid at $85.26, the second bid at $85.27, and the third bid at $85.28. The prices of Respondents’ bids were higher than the contracts then being bid by other market participants. Thus, Respondents’ placed their bids at the highest, i.e., best prices. By placing the large buy orders, Respondents sought to give the market the impression that there was significant buying interest, which suggested that prices would soon rise, raising the likelihood that other market participants would buy the 17 lots the Respondents were then offering to sell. Although Respondents wanted to give the impression of buy-side interest, Respondents entered the large buy orders with the intent that these buy orders be canceled before the orders were actually executed.

68. Id. at 1092-93. The court discussed the vagueness argument in depth in its prior opinion. See United States v. Coscia, 100 F. Supp. 3d 653, 657 (N.D. Ill. 2015) (“According to Coscia, the ongoing debate surrounding the meaning of spoofing ‘illustrates the crucial point that the status of Mr. Coscia’s alleged conduct was an open question from the outset.’ (Def.’s Mem., ECF No. 28, at 24.) At the time of the alleged trades, September 2011, the only available interpretation of the statute was the CFTC’s proposed, nonbinding guidance. Even if this guidance had been binding, Coscia argues that his conduct was not encompassed by any of the three examples provided.”).
69. Coscia, 177 F. Supp. 3d at 1087. (“[Government] introduced evidence, for example, suggesting that Coscia placed many more large quote orders than other traders, and then cancelled them at an unusually high rate (on one exchange at a rate of 99%). (Trial Tr. 299-300; Govt. Exs. ICE Summ. Charts 2-3.) The fact that some of his large orders were partially filled may have been a result of an imperfect program, as the Government points out—at least, the jury was entitled to believe so.”).
CEA. Under the CFTC guidance that was issued recently, the defendant’s arguments based upon general uncertainty in the public about the scope of the spoofing activity were unconvincing. The court emphasized the significance of the intent element in distinguishing between spoofing and bona fide Fill-Kill and partial-fill orders.

C. OYSTACHER CASE: THRESHOLD FOR INJUNCTIVE RELIEF—INTENT REVISITED

In Oystacher, the alleged spoofing act did not involve automated trading via algorithms, but rather involved manually conducted trading activity. Remarkably, the relevant enforcement action was based on complaints from various industry insiders, including well-known high-frequency trading firm Citadel, whose traders detected the defendant’s suspicious activity in the E-Mini Standard & Poor’s 500 Stock Price Index Futures Contracts market (“ES Market”) with their own resources. ES

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71. Coscia, 100 F. Supp. 3d at 659 (N.D. Ill. 2015) (“Congress had not defined the challenged term in the statute. In contrast, § 6(a)(C)(5) provides a definition of ‘spoofing.’”).

72. Id. (“Coscia’s alleged ‘intent to cancel’ sets his conduct apart from the legitimate trading practices described in his memorandum. The conduct in the Indictment involves the entry of large-volume orders with the intent to ‘immediately cancel.’”).

73. CFTC v. Oystacher, No. 15-CV-9196, 2016 WL 3693429, at *8 (N.D. Ill. July 12, 2016) (“Defendant Oystacher is a manual trader. (Tr. at 928.) As such, he manually executes trades based on his own observations. (Id. at 928-29.) To aid his manual trading, he uses a computer mouse that places pre-configured contract quantities depending on which buttons he clicks. (Id. at 966-67.) Specifically, the left button on Defendant Oystacher’s mouse submits larger orders, while the right button submits smaller orders. (Id.) These amounts vary depending on which markets Defendant Oystacher trades in. (Id. at 967.) In addition, Defendant Oystacher utilizes a ‘randomizer tool’ that randomizes the contract quantities he orders by either adding or subtracting a small amount each time he places an order.”).

74. Id. at *3 (“The defendant’s suspect activities spanned into the Commodity Exchange, Inc.’s High Grade Copper Futures Contracts market in December 2011, the New York Mercantile Exchange’s Light Sweet Crude Oil Futures Contracts market in May 2012, the NYMEX’s Henry Hub Natural Gas Futures Contracts market in November and December 2012, the Chicago Board Options Exchange’s Volatility Index...”)
Market is “one of the most liquid equity index futures in the world,” and Citadel was “one of the largest traders in the world on the ES market.” The company’s traders observed what they believed to be spoofing in May 2013 when Citadel’s profitability started to decline, and as a result, it was forced to unwind its participation in the ES market by over 50%.

Subsequently, the company started to investigate market data and develop a program to detect extreme order patterns, such as “instances of large order cancellations followed by quick trades on the opposite side at the same price.”

There were also investigations filed against the defendant by NYMEX, COMEX, CME, ICE, and EUREX. To decide whether to grant the CFTC’s requests for injunctive action to bar the defendant from trading, in a highly publicized eight-day hearing, the court heard testimonies from the representatives of domestic and international hyper-frequency trading firms, exchanges, regulatory authorities, and academic experts. The issue was whether the CFTC met its burden to show a statutory violation, and whether “there [was] a reasonable likelihood of future violations” that would justify the injunction. The court rejected the defendant’s argument for a heightened standard of proof in reaching its decision regarding the preliminary injunction. In doing so, the court categorized spoofing and price manipulation claims separately from other claims of fraud by refusing to adopt the Second Circuit’s heightened standard for similar claims in securities laws.

Futures Contracts market in February and March 2013, the Chicago Mercantile Exchange’s E-Mini Standard & Poor’s 500 Stock Price Index Futures Contracts market in June and December 2013 and January 2014, and the CME’s Ten Year T-Note Treasury Futures market in February 2016.”)

75. Id. at *9.
76. Id.
77. Id. at *10 (“Specifically, Citadel’s Pull-Swipe Detector flagged order entries where 1) over fifty percent of the total display size on one side of the market was cancelled just before 2) a trade of at least two hundred contracts was entered on the opposite side—a ‘fairly large trade’ relative to the ‘size showing at the top of the book,’ according to Mr. May. (Id. at 28-29,)”)
78. Id. at *19.
79. Id.
80. Id. at *6.
81. Id. at *7 (“A number of other circuits have opted not to follow Unifund, instead applying the default standard the Seventh Circuit employs. See SEC v. Fife, 311 F.3d 1, 8 (1st Cir. 2002) (refusing to apply the Second Circuit’s statutory-injunction standard as
The court also addressed and rejected the argument that the prohibition lacked an “intelligible principle” and therefore was an unconstitutional delegation of power to the CFTC and federal courts.\textsuperscript{82} The court summarized the relevant constitutional law principles that govern Congress’ authority to obtain assistance in the function of its legislative duties, the legislative history of Dodd-Frank, and the authority granted to the CFTC for interpreting and enforcing the CEA, as well as its various rulemaking powers.\textsuperscript{83}

The manual spoofing activity in \textit{Oystacher} consisted of “large (at least doubling the number of contracts offered or bid at those price levels, or better) passive order(s) on one side of the market at or near the best bid or offer price, which were intended to be canceled before execution.”\textsuperscript{84} To complete the scheme, the defendant would then cancel or attempt to cancel all of the spoof order(s) before they were executed and virtually simultaneously “flip” [its] position from buy to sell (or vice versa) by placing at least one aggressive order on the other side of the market at the same or better price to trade with market participants that had been induced to enter the market by the spoof orders they just canceled.\textsuperscript{85}

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\textsuperscript{83} Id.
\textsuperscript{84} Oystacher, 2016 WL 3693429, at *1.
\textsuperscript{85} Id. at *4 ("The CFTC’s Complaint . . . charges Defendants with (1) spoofing the futures market in violation of Section 4c(a)(5)(C) of the CEA and (2) employing a
During the hearings, the court heard expert testimony from Professor Bessembinder who was hired by the CFTC in 2014 to study market data (limited order book data that is visible to market participants) and the order data (the more comprehensive and less accessible log of entire market activity) in relation to potential spoofing. One of the study methods used by Professor Bessembinder was primarily concentrated on “flip” patterns in the defendant’s trading.86 A flip is “a cancellation of an order [that was] followed by an opposite side order entry within 0.005 seconds and at the same or better price.”87 According to Professor Bessembinder, a flip is usually a very rare phenomenon that is never observed in almost 99% of the accounts trading in the relevant markets.88 The defendant ultimately had more than 28,000 orders that fitted the “flipping pattern” definition.89 The court also accounted for the defendant’s cancellations in terms of quantity90 and their percentage of the total order number. However, despite this evidence, the court ultimately rejected the CFTC’s request to bar the defendant from trading due to the CFTC’s failure to provide sufficient evidence that the defendant’s unlawful conduct would continue.91 Although the court voiced concerns regarding the defendant’s suspect activities that continued despite several investigations by various market operators, the court refused to issue an injunction, since the efforts of the defendant’s manipulative device, scheme, or artifice in violation of Section 6(c)(1) of the CEA and CFTC Regulation 180.1.”).

86. Id. at *23.
87. Id.
88. Id.
89. Id.
90. Id. at *25 (“In other words, Defendant Oystacher’s cancellations at the flip were larger than other participants’ in both absolute size and relative share of total entered orders. Defendant Oystacher cancelled 36.9 percent of his Natural Gas contracts, for example, while all other participants combined cancelled only 0.3 percent. (R. 134, CFTC Exh. 95, at 12.) He cancelled 35.2, 33.4, and 25.7 percent of his VIX, Crude Oil, and Copper contracts, respectively, while the rest of participants in those markets cancelled 0.1 percent in all three. (Id.) Finally, during December 2013 and January 2014, Defendant Oystacher cancelled 29.5 percent of his ES contracts, and all other market participants cancelled only 0.6 percent.”).
91. Id. at *39 (“Importantly, ‘past misconduct does not lead necessarily to the conclusion that there is a likelihood of future misconduct[,]’ While past misconduct can be ‘highly suggestive of the likelihood of future violations, ... the court should look to the ‘totality of the circumstances’” before drawing any inferences.” (citations omitted)).
compliance officer in implementing and enforcing restrictions on trading size and speed were sufficient to render the trading ban unnecessary. It was reported in October 2016 that the CFTC had agreed, in principle, to a settlement with the defendant.

D. SARAO AND OTHERS: EXTRATERRITORIAL APPLICATION, COLLECTIVE SPOOFING

The CFTC has reached successful settlements in several spoofing-related enforcement actions against traders located overseas. The enforcement case against Sarao was brought under the pre-Dodd-Frank authority. The U.K.-resident defendant was found to have conducted spoofing over a long span in the E-mini S&P futures market—including during the day of the infamous flash crash. The defendant operated a

92. Id. at *42 (“Defendants have implemented, among others, the ‘Dynamic Max Quantity at Price Tool’ and the ‘Delayed Replace for Cancel/Replace Tool’—compliance tools to self-monitor and regulate Defendant Oystacher’s trading size and speed, respectively. Importantly, these two trading characteristics are fundamental to Defendants’ ability to violate the relevant statutes and regulations, enhancing the effectiveness of Defendants’ discontinuance. All of the compliance tools Defendants have self-implemented are adverse to their interests. These tools aim to prevent Defendant Oystacher from successfully engaging in a “bait and switch flipping scheme.””).


95. Consent Order, Nav Sarao, supra note 94, at 11-12 (“During the Relevant Period, on average: it took only 500 milliseconds for the Dynamic Layering Program’s layered sell orders to move in unison and in symmetry with the market price after a change (either up or down) in market price. Defendants’ layered sell orders contained approximately 2,000 sell orders (at multiple price levels), with a combined average face value of approximately $128,615,160. The Dynamic Layering Program was active approximately 7 minutes at a time, and, when active, the E-mini S&P prices dropped, on average, more than 1 tick. Defendants’ Genuine Executed Orders were at least 1.7 times more profitable per contract traded when the Dynamic Layering Program was active than when no Spoof
“dynamic layering algorithm” using his own personal computer, which enabled him to deceive the market participants about the real market price. The evidence in the case demonstrates how an individual trader with modest technical resources can hold significant disruptive power in one of the most liquid markets when he consciously and consistently employs disruptive order strategies. The case also reflects the growing extraterritorial reach of U.S. commodities regulation.96

Similarly, in Khara, an enforcement action was brought against an individual trader and his introducing broker, both residents of the United Arab Emirates, for concerted spoofing activity (both as a principal and as an accomplice) regarding trade orders in the CME Globex Gold futures market.97 The case demonstrates how spoofing can be executed by the concerted actions of more than a single trader.98 The enforcement action

Orders were active. During the Relevant Period, only 90 of the Defendants’ 19,888 layered sell orders were even partially executed. During the Relevant Period, Defendants profited at least $9,667,258.22 as a result of the Dynamic Layering Program.”). 96. However, in Tower Research, a class action claim brought by Korean individuals against a U.S. resident for spoofing in a Korean stock index futures traded on CME Globex located in Illinois, the S.D.N.Y. granted the defendant’s motion to dismiss for failure to state sufficient contacts with the U.S. See Myun-Uk Choi v. Tower Research Capital LLC, 165 F. Supp. 3d 42, 49-50 (S.D.N.Y. 2016). In its Morrison analysis, due to the organizational separation between the CME (a domestic exchange) and the CME Globex, the court treated CME Globex “not as a domestic exchange but rather . . . simply a technological platform utilized by other exchanges to effectuate trading.” Id. at 50.

97. Consent Order, Khara, supra note 94.

98. See Complaint for Injunctive Relief at 6-7, Khara, No. 15 CV 03497 (JPO) (S.D.N.Y. May 5, 2015) (“For example, on April 28, 2015, Defendant Salim had an order for Gold futures on one side of the book. Defendant Khara entered layered orders on the opposite side of the book as Defendant Salim’s orders, which caused COMEX market participants to fill Defendant Salim’s orders. After Defendant Salim’s orders were filled, Defendant Khara cancelled his layered orders. An example of the coordinated effort to engage in spoofing is as follows: On April 27, 2015, at 05:49:37.957 a.m. Central Standard Time, Salim placed one 3-lot bid in the June 2015 Gold futures contract at the second book level (price of 11817). Approximately three seconds later, at 05:49:40.725 a.m., Khara began to enter 5-lot offers. Between 05:49:40.725 and 05:49:43.725 a.m., Khara entered 17 5-lot offers for a total sell side exposure of 85 contracts. The offers were entered in descending price starting at 11820 through 11818. One millisecond after entering the fourteenth 5-lot offer (05:49:43.420 a.m.) all contracts of Salim’s bid traded (05:49:43:421). After this sequence, Khara cancelled all of his offers. Based on this conduct, Market Regulation conducted a review of Defendants’ accounts, for the period of March 1, 2015 to April 29, 2015, in the April 2015 Gold, June 2015 Gold and May 2015 Silver contracts. During the Relevant Period, Defendants Khara and Salim appeared
E. SELF-REGULATORY ACTIONS; PRIVATE ACTIONS AND ANONYMOUS DEFENDANTS; WHISTLEBLOWER REPORTS

In the enforcement of the law and regulatory rules relating to technically sophisticated hyper-frequency trading activities, the practical constraints necessitate greater involvement of exchanges in the policing of suspicious trading activities. Proponents of structural reform argue that instead of emphasizing ex post enforcement of abstract and complicated laws and regulations, the reform efforts must focus on revising and developing market structures, which will restrain or eliminate manipulative activity by their own design. Therefore, policies, procedures, and technological tools developed by the exchanges hold great importance in reaching an efficient equilibrium between public and private regulation due to the exchanges’ primary positions as the day-to-day enablers and managers of the trading infrastructure.

In recognition of its greater role in this regard, the CME Group brought sixteen cases related to spoofing before the CME Business Conduct Committee in 2015—a substantial increase from the number of such cases in 2014. These cases were generally brought under Rules to routinely place large aggregate quantities opposite smaller orders that would then trade, and then the large orders would be cancelled. On information and belief, Khara traded more than 300 futures contracts as a result of Salim’s large opposite-side exposure, and Salim traded more than 150 futures contracts as a result of Khara’s large opposite side exposure.”.

99. See id.
102. Yedav, supra note 100, at 1090.
This development can be attributed to various factors. First, to avoid liability risk, exchanges may be taking the initiative by acting timely to nullify potential future claims that they may face as alleged enablers of illegal conduct. Secondly, such rapid advancement of spoofing enforcement on the exchange level can also be explained by a greater consensus among market participants against spoofing, and a demand by the market to improve fairness and integrity in the markets in this regard. In this respect, greater enforcement of the spoofing prohibition by exchanges can also act as a safeguard for the industry to avoid negative reputational costs, which may result from CFTC enforcement actions.

On the other hand, another important feature of the spoofing prohibition is that the statute explicitly makes it available to private market participants as a private cause of action. From a regulatory efficiency perspective, this development is likely to have both positive and negative effects. From an enforcement resources perspective, an increase in the number of private lawsuits brought against conduct that allegedly constitutes spoofing will lighten the CFTC’s burden in enforcing the prohibition and encourage the agency to focus its enforcement on the most important cases. This will also improve the actual deterrent effect of the prohibition. On the other hand, private

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104. E.g., HTG Capital Partners, LLC v. Doe(s), No. 15 C 02129, 2015 WL 5611333, at *5 (N.D. Ill. Sept. 22, 2015) (“CME Group’s Market Regulation Advisory Notice also clarifies that ‘Rule 575 prohibits the type of activity identified by the Commission as “spoofing,” including submitting or canceling multiple bids or offers to create a misleading appearance of market depth and submitting or cancelling bids or offers with intent to create artificial price movements upwards or downwards.””).


107. For a critique of judicially created private rights of action in areas entrusted to agency enforcement, see Richard B. Stewart & Cass R. Sunstein, Public Programs and Private Rights, 95 HARV. L. REV. 1193, 1206-07 (1982) (“Judicial creation of private rights of action raises greater difficulties when the legislature has entrusted enforcement of a statutory scheme to a specialized administrative agency that is empowered to issue rules or to adjudicate controversies under the statute. In this context, private rights of action may usurp the agency’s responsibility for regulatory implementation, decrease legislative control over the nature and amount of enforcement activity, and force courts to determine in the first instance the meaning of a regulatory statute.”).
litigation will impede the cohesive development of law in this area by excluding the agency and its expertise, and potentially cause interpretative differences between different circuits and the agency in relation to the particulars of the spoofing prohibition.\(^\text{108}\) Furthermore, because the private claimants will often be members of the particular exchange in which the alleged spoofing activity took place, certain restrictions that are frequently found in the exchange rules—such as compulsory arbitration and data confidentiality—will likely undermine the efficient enforcement of the spoofing prohibition through private litigation.

As a relevant example, in 2015 a trader in the Chicago Board of Trade filed a claim against anonymous defendants for conducting spoofing.\(^\text{109}\) The plaintiff also issued a non-party subpoena to the CME Group—which operates CBOT and CMEX exchanges—to identify the anonymous counterparties and provide the relevant market data pertaining to the suspicious activity.\(^\text{110}\) The defendants challenged this subpoena on privacy grounds, and CME joined the motion.\(^\text{111}\) Subsequently, the anonymous defendants moved to compel arbitration under CBOT rules, as required for the resolution of disputes arising between CBOT members. The court ultimately granted the defendants’ motion to proceed anonymously and their motion to compel arbitration after in-camera review of the relevant evidence documenting the defendants’ membership in CBOT.\(^\text{112}\) The case demonstrates the difficulties of bringing private actions for spoofing due to the informational asymmetries in the market structure, as well as due to potential forum shopping problems and other market asymmetries that may result from the conflict among different enforcement rights of market participants based on the particular market(s) of which they are members.

However, as demonstrated in cases like *Oystacher* where the agency action substantially relied on data provided by other trading firms, the jurisdictional and other problems the market participants may have in bringing private actions are likely compensated by the CFTC’s newly


\(^{110}\) *Id.*

\(^{111}\) *Id.*

established whistleblower program. The program provides monetary incentives to industry insiders and other individuals in possession of material information regarding potential spoofing activity who report such information to the CFTC.\footnote{7 U.S.C. § 26 (2012); 17 C.F.R. § 165 (2017) (providing the rules and requirements of the whistleblower program).} In fact, market participants often conduct in-depth studies regarding the markets—order books in particular—as part of their day-to-day trading business with significant analytical tools and analysts at their disposal. Under the CFTC’s whistleblower program, such firms and individuals can be granted significant monetary awards once the agency finds that they have reported \textit{substantive} and \textit{original} information about the deployment of disruptive trading strategies such as spoofing and thus have significantly assisted the CFTC’s enforcement activities.\footnote{17 C.F.R. § 165.2 (2017). Subject to a decision by the agency’s staff and based on the applicable rules, Dodd-Frank authorizes the agency to grant awards that are between 10 and 30 percent of the monetary sanctions successfully imposed in the judicial or administrative action resulting from the original information. \textit{Id.} § 165.8.} As a result of the aforementioned limits that market participants will have in pursuing private rights of action, there is potential for an increase in the number of trading firms and independent observers who will seek to monetize such material information they may have generated in their internal market studies. In this sense, the whistleblower program may reduce informational asymmetries and improve enforcement efficiencies by placing the CFTC in a more central position in monitoring wrongful conduct and evaluating potential incidents of illegality based on the agency’s greater statutory purpose and institutional power. On the other hand, the monopolization of enforcement power at the hands of the regulators may predicate a selective enforcement agenda, which may cause a sentiment of indiscriminate and inconsistent enforcement of the rules within the expanding jurisdiction of the agency.
III. COMPARING CEA SPOOFING PROHIBITION WITH SECURITIES LAWS

Generally, SEC actions for spoofing in trading have been primarily brought under Section 9(a)(2) of the Securities Exchange Act (“Exchange Act”). Section 9(a)(2) of the Exchange Act makes it unlawful to:

effect, alone or with one or more other persons, a series of transactions in any security . . . creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

Although the language of the provision effectively brings spoofing under its coverage, it more closely resembles the pre-Dodd-Frank commodities price manipulation standard, and significantly differs from the simplistic formulation adopted in the CEA (as amended by Dodd-Frank). Thus, with the enactment of the standalone commodities spoofing cause of action, a divergence seems to have formed between the price manipulation prohibitions of the commodities and securities laws with respect to the activities that fall under the definition of spoofing. More specifically, the CEA’s spoofing prohibition requires a simple showing that the defendant did not have a bona fide intent to enter into a transaction when submitting an offer or a bid to the relevant market. On the other hand, Section 9(a)(2) requires the showing of specific intent to manipulate market prices, and a simple showing of spoofing activity may not be sufficient in some cases to meet the more onerous pleading standard.

118. Id.
Generally, markets for individual stocks, narrow-based index contracts, and corresponding futures and option markets are regulated by the SEC. However, the SEC shares regulatory authority with the CFTC in relation to securities-based swaps, and the CFTC has greater regulatory authority over broad-based index funds—such as S&P 500 index funds and other equity-based passive index ETFs—that have recently seen tremendous growth as convenient and diversified vehicles for investors to channel their capital into equity markets. This interconnectivity between commodities and securities markets was clearest during the flash crash, in which spoofing-like activity in index markets was a likely factor in causing massive market volatility. Thus, a concerted harmonization effort by the SEC and the CFTC, as well as the Financial Industry Regulatory Authority and the National Futures Association is necessary to streamline market monitoring and enforcement mechanisms and to remediate the potential conflicts between the two legal domains.\(^\text{120}\) If left unaddressed, the current situation may encourage regulatory forum shopping among traders, who may channel their activities to less-regulated trading regimes.\(^\text{121}\)

CONCLUSION

The statutory enactment provides clarity to at least the fundamental questions of whether spoofing is a disruptive practice, and whether it negatively affects market integrity and markets’ pricing functions by creating a statutory assumption in the positive.\(^\text{122}\) Although the spoofing prohibition could previously be enforced under the general commodities


\(^{121}\) Sanders, *supra* note 117, at 536.

\(^{122}\) See Craig Pirrong, *I’m Not Spoofing You About Judicial Overkill*, STREETWISE PROFESSOR, (Nov. 4, 2015), http://streetwiseprofessor.com/?p=9678 [https://perma.cc/VJF6-8HLH]. Professor Pirrong also argues that the impact of spoofing conduct will be limited because the victims of spoofing are generally sophisticated traders who can respond quickly to market conditions and take prompt action to protect themselves from further damage. *See id.; see also* Jane Croft, *Ex-SEC Economist to Testify on Flash Crash*, FIN. TIMES, (Oct. 22, 2015) https://www.ft.com/content/c6d56100-78c5-11e5-a95a-27d368e1dd7 [https://perma.cc/4863-P6XJ] (“A former chief economist of the US Securities and Exchange Commission is set to testify on behalf of a UK trader accused of playing a role in the flash crash of 2010 while trading from his bedroom.”).
anti-manipulation laws, defendants in these cases could assert a wide range of defenses and even raise the issue of whether spoofing, from a market theory perspective, can be a form of price manipulation. By creating a stand-alone cause of action for spoofing, the prohibition can be seen as an attempt to simplify the already complex inquiries that usually arise in price manipulation claims (though it does not make them any easier). These issues are often difficult for lay juries to properly digest, since the defendants often rely on expert opinions who use advanced market theory. Although the adoption of the stand-alone prohibition does not solve the evidentiary difficulties in establishing the required mental state (i.e., not having the intent to enter into transactions), it provides a much-needed explicit normative basis on which regulators and market operators can rely.

The enactment of the independent cause of action is also likely to lift compliance standards. It will reduce the threshold for potential secondary liability of market-makers, clearing brokers, and other intermediaries who knowingly turn a blind eye to spoofing by their clients and customers—in effect aiding and abetting conduct that is unlawful under the CEA. At least in the Second Circuit’s jurisprudence, a strong showing of affirmative assistance may not be necessary to meet 12(b)(6) pleading standards to create secondary liability in similar cases. The risk for secondary liability is particularly high for futures commission merchants who transmit orders on behalf of their clients. In the context of wash sales, the courts have considered the fact that wash sales were specifically prohibited by the CEA and the relatively easier identification of wash sale activity as factors that may potentially increase the liability risk of

123. See In re Amaranth Nat. Gas Commodities Litig., 730 F.3d 170, 183 (2d Cir. 2013) (“[A] complaint with weak allegations about a defendant’s affirmative assistance may still state a claim for aiding and abetting if its allegations about the defendant’s knowledge and intent are particularly strong, and vice versa.”).

124. 7 U.S.C. § 1a(28) (defining futures commission merchant); see also First Am. Discount Corp. v. CFTC, 222 F.3d 1008, 1010 (D.C. Cir. 2000) (“An FCM is the commodity market’s equivalent of a securities brokerage house, soliciting and accepting orders for futures contracts and accepting funds or extending credit in connection therewith.”).

derivatives brokers. For self-regulating entities and trading infrastructure providers, the adoption of a prudent compliance strategy can minimize future regulatory risks.

The spoofing prohibition may affect algorithmic traders significantly by forcing traders to modify their existing trading algorithms. Different from manual spoofing, when a trader employs algorithmic trading to conduct spoofing, the algorithm’s code often provides direct evidence to establish the necessary element of intent. It may, at first sight, seem difficult to draw a bright line between lawful trading and spoofing activity in the world of high frequency trading, as order cancellation is a natural part of most legitimate trading strategies. However, spoofing can be distinguished from other hyper-frequency strategies such as pinging and front-running, as when properly deployed, the latter strategies involve bona fide transactions entered into with an intent to detect market appetite. Regardless of order size, market participants are advised to review their algorithmic trading strategies, insofar as they involve frequent and volatile position changes (flips) and high cancellation ratios if they can be interpreted to demonstrate that the relevant order cancellations have no legitimate purpose other than causing artificial price movements. Under the statutory definition, a single event of order cancellation is sufficient to establish the offense if the co-existing factors provide sufficient circumstantial evidence that the trader, more likely than not, never intended to enter into any transaction when submitting the bid or the offer.

On the other hand, the rule’s effectiveness in providing fair and meaningful deterrence from suspicious conduct will largely depend on the developing case law, and clarity in the CFTC’s future regulatory guidance and enforcement actions. Indeed, due to the prominence of hyper-frequency trading strategies in today’s markets, the CFTC is faced with a difficult task in monitoring numerous markets within its jurisdiction and identifying the instances of spoofing among millions of order

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126. Amaranth, 730 F.3d at 187 (“Wash orders are explicitly banned by the CEA and, because they involve simultaneous or shortly spaced transactions to buy and sell the same quantity of a commodity or stock, they are much more recognizable to the broker transmitting them.”).


128. However, the difficulties of factual determinations by juries in price manipulation cases and the exchange’s reliance on mandatory arbitration will likely inhibit the development of judicially created rules.
cancellations. This practical difficulty may inevitably cause the agency to pursue actions against the most visible high-volume traders in a disproportionate manner, which may in turn undermine the promise of the spoofing prohibition as a market rule that is enforced in a fair and equal manner for all market participants. The potential risks posed by the prospect of selective enforcement can be mitigated by greater cooperation with market operators by prioritizing self-regulatory measures and other structural safeguards that may be implemented within the daily trading infrastructures.

From a compliance perspective, the rule poses a particular challenge for market actors, as the scope of the prohibition and the evidentiary difficulties that often arise in showing the necessary intent to commit spoofing may undermine the market actors’ efforts to properly assess the relevant regulatory risks and to devise proper implementation policies.129

The current state of the law, where a stand-alone spoofing prohibition exists only as applicable to commodities markets, can also create asymmetrical regulatory standards between commodities and securities markets. This problem might be particularly acute and may cause legal discrepancies in relation to financial assets that have the characteristics of both a commodity and a securities instrument and that are subject to regulation by both the SEC and CFTC.

As the relevant case law further develops and the CFTC fine-tunes its interpretation of what can potentially constitute spoofing, participants of the commodities markets are advised to pay close attention to these developments and to revise their trading strategies, relevant policies and procedures, and technical infrastructure to ensure compliance with the new standards emerging in this field.

129. See Letter from R.T. Leuchtkaiser to Brent J. Fields, Sec’y, SEC (Sept. 4, 2015), https://www.sec.gov/comments/sr-bats-2015-57/bats201557-3.pdf [https://perma.cc/E38R-N5UE] (“It’s also a mystery how a firm can post bona fide orders on eight exchanges if it fully intends to cancel on seven of them when any one trades. That behavior sounds as if it easily falls within the spoofing definitions quoted earlier . . . . At minimum, in this example the business model seems to bake in an 87.5% intention of cancelling any given order before it’s executed. At what point does ‘market making’ become spoofing in this model? We can likely agree any firm posting an order it is 100% certain to cancel is over the line. Now move that line to 99%. If I intend to cancel 99 times out of 100, is that a bona fide order? How about a 9-in-10 intent to cancel? How about 7-in-8? And how does anyone looking at an exchange’s quote tell the difference?”).