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Traders At Risk Of DOJ Wire Fraud Charges For Spoofing

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If there ever was a doubt about the increased focus on commodities fraud, such as spoofing, U.S. Commodity Futures Trading Commission chairman Christopher Giancarlo's recent testimony to Congress is a stark reminder: "[B]y any measure, enforcement has been among the most vigorous in the history of the CFTC, including more enforcement actions, more penalties, more large-scale matters, more accountability, more partnering with criminal law enforcement at home and abroad and more whistleblower awards than in prior years."[1]

Matt Kluchenek

As emphasized by Giancarlo, "we've increased our efforts to work with the Department of Justice ... as reflected by the significantly increased number of parallel filings. ... As part of our goal to deter wrongdoers, we recognize there is no greater deterrent than the prospect of criminal prosecution — and the reality of time in jail."

Linda Shi

Spoofing as a basis for bringing criminal prosecutions is a relatively recent phenomenon. In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which made it a violation of the Commodity Exchange Act to engage in various forms of disruptive trading conduct, including spoofing.

Spoofing is a form of trading that involves "bidding or offering with the intent to cancel the bid or offer before execution."[2] Put more simply, spoofing involves the intentional placement of non-bona fide orders. Under 7 U.S.C. § 13(a)(2), a knowing violation of the anti-spoofing provision is a felony, which carries up to 10 years' imprisonment and a fine of $1 million or three times the monetary gain, whichever is greater. The anti-spoofing provision is subject to a five-year statute of limitations.

The U.S. Department of Justice brought its first criminal indictment charging spoofing in 2014, in United States v. Coscia, in the Northern District of Illinois.[3] From 2014 through 2017, the DOJ charged only two other individuals with spoofing.[4] In 2018, however, the DOJ's Securities & Financial Fraud Unit led an aggressive initiative to investigate and prosecute spoofing in the commodity futures markets.[5]

The DOJ's fraud unit charged over a dozen individuals with spoofing-related crimes in 2018, with trials

set for 2019 in several spoofing cases.[6] The DOJ's fraud unit made clear its intention to "continu[e] to investigate and hold accountable individuals and institutions that undermine the integrity of the markets."[7] The CFTC has been equally aggressive in bringing civil enforcement actions.

As part of the 2018 initiative, the DOJ indicted two former Deutsche Bank commodities traders based on an alleged spoofing scheme that occurred between December 2009 and November 2011. The case, United States v. Vorley et al., is currently pending before Judge John Tharp in the Northern District of Illinois. But rather than charging a violation of 7 U.S.C. § 13(a)(2), the DOJ charged the defendants under the general wire fraud statute, 18 U.S.C. § 1343.

The DOJ proceeded in this way for two reasons. First, a prosecution under 7 U.S.C. § 13(a)(2) would have been time-barred under that statute's five-year statute of limitations period, insofar as the conduct in question occurred between December 2009 and November 2011.[8] Second, the DOJ could not have charged conduct that predated Dodd-Frank's passage under the anti-spoofing statute (a significant portion of the alleged scheme) under the Constitution's ex post facto clause, which prohibits Congress from passing any laws that criminalize conduct that was previously legal.[9]

In contrast to the anti-spoofing statute, the wire fraud statute is subject to a 10-year statute of limitations, provided the conduct "affect[ed] a financial institution."[10] In 1989, Congress extended the statute of limitations for wire fraud that affects a financial institution in response to the savings and loan crisis of the 1980s. Courts have interpreted this language broadly.[11]

While the wire fraud statute affords DOJ the potential benefit of an extended statute of limitations, wire fraud charges under 18 U.S.C. § 1343 require proof of a "materially false or fraudulent pretense, representation, or promise."[12] The anti-spoofing statute has no such requirement. That element presents a hurdle for the DOJ in Vorley — one that, based on the court's comments during a recent hearing, could prove to be insurmountable.

Specifically, in Vorley, the defendants filed a motion to dismiss the indictment, arguing that the government cannot proceed because spoofing does not involve a false or misleading statement. The defendants contend that, even if the orders in question were entered with the intent to cancel before execution, the orders were nevertheless bona fide because the defendants would have been obligated to honor them had the orders been accepted before cancellation.

During a hearing on the motion to dismiss, some of Judge John Tharp's comments suggested some sympathy for the defendants' argument. The issue is one of first impression, and the court's decision could significantly impact the DOJ's ability to prosecute spoofing activity that occurred prior to Dodd-Frank, or outside the general five-year statute of limitations period. Critically, a win for the DOJ could significantly expand the government's ability to prosecute alleged spoofing.

Background

Defendants James Vorley and Cedric Chanu previously worked at Deutsche Bank, trading precious metal futures on the Commodity Exchange Inc., or COMEX, an exchange owned by the CME Group Inc. COMEX is a designated contract market (i.e., a futures market), where traders place anonymous orders to buy and sell at specified prices and volumes.

The DOJ's indictment alleges that the defendants conspired "to deceive other traders by creating and communicating materially false and misleading information regarding supply or demand, in order to

induce other traders into trading precious metals futures contracts at prices, quantities, and times that they would not have otherwise, in order to make money and avoid losses for the co-conspirators."

The conspiracy purportedly involved the defendants' placement of "fraudulent orders," which the indictment defines as orders intended to be canceled before execution, and "primary orders," defined as orders on the opposite side of the market that the trader intends to execute. According to the indictment, the defendants "placed [f]raudulent [o]rders with the intent to artificially manipulate and move the prevailing price in a manner that would increase the likelihood that one or more of their [p]rimary [o]rders would be filled."

The indictment charged the defendants with one count of conspiracy to commit wire fraud affecting a financial institution in violation of 18 U.S.C. § 1349, and one count of wire fraud affecting a financial institution in violation of 18 U.S.C. § 1343. The defendants moved to dismiss the indictment, arguing that (1) the indictment fails to allege a false statement, as required under 18 U.S.C. § 1343; and (2) the wire fraud statute would be unconstitutionally vague if it were construed to apply to the defendants' alleged trading conduct.

False or Misleading Statements

As noted above, the wire fraud statute makes it a crime to "devise[] or intend[] to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises."[13] The DOJ's theory is that the defendants' orders were false or misleading because the orders "falsely and fraudulently represented to traders that [the defendants] and others were intending to trade the [orders] when," in fact, they "intended to cancel [the orders] before execution."[14]

The indictment further alleges that the defendants conspired "to deceive other traders by creating and communicating materially false and misleading information regarding supply or demand, in order to induce such traders into trading precious metals futures contracts at prices, quantities, and times that they would not have otherwise, in order to make money and avoid losses for the co-conspirators."[15] In essence, the DOJ alleges that an offer or bid carries with it an implicit representation "regarding the Defendants' intention to trade the [orders]."[16]

In response, the defendants argue that all of the defendants' offers and bids — regardless of the defendants' intent — were real orders exposed to actual market risk. Citing case law from the Seventh Circuit, the defendants argue that the court has not held that spoofed orders involve false representations of supply and demand.[17] To the contrary, in Coscia, the Seventh Circuit affirmed the defendant's commodities fraud conviction (in addition to the charges under spoofing statute), reasoning that subsection 1 of the commodities fraud statute does not require the prosecution to prove "[f]alse representations or material omissions."[18]

In addition, the defendants argue that the DOJ cannot charge wire fraud based on a failure to disclose that orders were placed with the intent to cancel prior to execution. Again, citing Seventh Circuit case law, the defendants contend that a nondisclosure of information — even if material — is only sufficient to sustain a wire fraud charge where the defendant has a fiduciary duty to disclose the information.[19] As the defendants point out, the indictment alleges no such fiduciary duties (nor could it, given the relationship between the Deutsche Bank traders and the potential market participants that could have been victims of the alleged fraud).

Constitutional Vagueness

In addition to arguing that their conduct did not involve any false or misleading statements, the defendants contend the wire fraud statute would be unconstitutionally vague if it were construed to apply to their alleged trading conduct. They argue that neither the plain language of the wire statute nor the cases interpreting the statute gave the defendants fair notice that spoofing involved the making of a materially false representation to the market. They also say that Congress did not criminalize spoofing until the Dodd-Frank Act, in which it described spoofing as a "disruptive practice."[20]

In response, the DOJ contends that the plain language of the wire fraud statute provided sufficient notice to the defendants that their conduct was prohibited, and that the Seventh Circuit in Coscia confirmed that spoofing can violate other statutes, so long as the elements of that statute are sufficiently alleged and proved.[21]

Oral Argument

The court held oral argument on the defendants' motion to dismiss on Jan. 24, 2019. At that hearing, the DOJ conceded that there were no affirmative misrepresentations or misstatements at issue in the case. Based on that concession, Judge Tharp honed in on whether the DOJ was conflating the intent and false statement requirements — two separate elements under 18 U.S.C. § 1343 — because "a scheme to defraud ... in and of itself is not enough to make ... any statement you made in furtherance of that fraud a misrepresentation."

Instead, "[t]he statement itself has to be false." The DOJ explained its position that when an order is being placed into the market, "it is creating artificial supply or demand in the market because there is no intent at the time it's being placed for it to actually be filled." According to the DOJ, the orders were false and misleading because by placing the trades, the defendants signaled to the market that they were "bona fide seller[s]" or "bona fide buyer[s], at a certain price when, in fact, they were not."

The court questioned this rationale, asking, "Why are you not a bona fide seller or buyer if you are bound to honor that trade if somebody accepts your bid or your offer?" The court also noted a potential line-drawing problem with the DOJ's theory, observing that "[n]obody intends to leave their orders on the market indefinitely." Put differently, "[e]veryone intends to pull [the orders] off if they're not hit after some period of time."

Tharp pressed the DOJ, asking, "So why is it artificial at two nanoseconds and not five nanoseconds?" The DOJ explained that, at the time the orders were placed, the defendants did not intend for them ever to be executed, and "[s]o by placing that into the market with the intent to cancel it before it could ever be executed, it is incorrectly informing the market."

Post-Argument Briefing

At the hearing, the court allowed the U.S. Chamber of Commerce, the Securities Industry and Financial Markets Association and the Futures Industry Association, or FIA, to file amicus briefs in support of the defendants. In their briefs, the amici argue that the DOJ's theory of wire fraud liability could criminalize legitimate commercial conduct and expand civil liability to such conduct as well.

The amici say that under the government's theory, parties to commercial transactions will need to disclose information regarding their motivations and intentions, which would be inconsistent with

common market practices. For instance, the FIA argues that "[i]t is not uncommon for a trader to buy some contracts even if its overall strategy is to take a net short position," and that it is "common for a market participant to try to disguise its strategy by relying on multiple different brokers to execute different pieces of large order."[22] According to the FIA, trading so as to prevent others from knowing one's trading strategy "is an accepted and legitimate phenomenon of trading in the futures markets."[23]

The DOJ filed a response brief to the amici on March 26, 2019. In its brief, the government contends that application of the wire fraud statute in this case is not novel, because there were "prior pleas to wire fraud charges based on spoofing."[24] In response to the amici's suggested parade of horribles, the DOJ argued the wire fraud statute requires more than "offers to enter into a commercial contract without disclosing one's intent or motivation for making such an offer."[25]

Instead, the wire fraud statute requires "an intent to mislead someone for the purpose of obtaining money or property."[26] The government explained its decision to prosecute spoofing under the wire fraud statute, instead of the anti-spoofing provision of the Dodd-Frank Act, explaining: "In addition to a longer limitations period, the wire fraud charges here also have higher penalties and address conduct that is more serious than merely spoofing — namely, engaging in spoofing with fraudulent intent and in order to obtain money or property from someone else."[27]

Conclusion

The DOJ has made clear that spoofing prosecutions are a priority. The DOJ's decision to charge the defendants in Vorley under the wire fraud statute further highlights its intent to aggressively pursue such prosecutions.

It is the first case to proceed solely under the wire fraud statute, without charges under the anti-spoofing provision of the Dodd-Frank Act or subsection 1 of the commodities fraud statute. The defendants and their amici argue that the DOJ's novel theory of wire fraud liability for spoofing is overly expansive, particularly when spoofing is already addressed under industry- and market-specific laws.

Market participants should pay close attention to Vorley, as the DOJ's theory would expand potential criminal liability and allow the DOJ to bypass the shorter limitations periods for the anti-spoofing and commodities fraud statutes. In addition, wire fraud affecting a financial institution carries up to 30 years' imprisonment[28] — 20 years more than a spoofing conviction or a violation of the commodities fraud statute, which are capped at 10 years' imprisonment.[29]

At the same time, depending on the outcome and Judge Tharp's rationale, an adverse decision for the DOJ could deal a blow to both the DOJ and the CFTC civil prosecutions, in that a rejection by the court, for example, of the DOJ's implicit representation theory regarding a market participant's intention to trade orders could provide defense counsel with potent ammunition to challenge both criminal and civil spoofing charges.

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[1] U.S. Commodity Futures Trading Commission, Regulatory Enforcement & Healthy Markets: Perfect Together!, Oct. 2, 2018, available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo56.

[2] 7 U.S.C. § 6c(a)(6)(C).

[3] Coscia was convicted of six counts of commodities fraud and six counts of spoofing. He was later sentenced to 36 months in prison.

[4] U.S. Department of Justice, Eight Individuals Charged with Deceptive Trading Practices Executed on U.S. Commodities Markets, Jan. 29, 2018, available at https://www.justice.gov/opa/pr/eight-individuals-charged-deceptive-trading-practices-executed-us-commodities-markets.

[5] See U.S. Department of Justice, Criminal Division, Fraud Section, Fraud Section Year in Review 2018, available at https://www.justice.gov/criminal-fraud/file/1123566/download.

[6] Id.

[7] Id.

[8] The DOJ has also relied on Subsection 1 of the commodities fraud statute in spoofing prosecutions. That statute prohibits the knowing execution of a scheme to defraud "any person in connection with any commodity for future delivery, or any option on a commodity for future delivery." 18 U.S.C. § 1348(1). Prosecutions under this statute are subject to a six-year statute of limitations, 18 U.S.C. § 3301, meaning the DOJ would have also been precluded from proceeding under Section 1348(1) in Vorley.

[9] See U.S. Const. Art 1, § 9.

[10] See 18 U.S.C. § 3293(2).

[11] United States v. Heinz, 607 Fed. App'x 53 (2d Cir. 2015).

[12] Seventh Cir. Pattern Crim. Jury Instr., § 1341, 1343, at p. 402 (2017 ed.).

[13] 18 U.S.C. § 1343. To obtain a conviction for wire fraud affecting a financial institution under the wire fraud statute, the DOJ must prove beyond a reasonable doubt that (1) the defendant knowingly devised or participated in a scheme to defraud; (2) the defendant did so with the intent to defraud; (3) the scheme to defraud involved a materially false or fraudulent pretense, representation, or promise; (4) for the purpose of carrying out the scheme or attempting to do so, the defendant caused interstate wire communications to take place; and (5) the scheme affected a financial institution. See Seventh Cir. Pattern Crim. Jury Instr., § 1343.

[14] United States v. Vorley et al., case no. 18 Cr 35, Dkt. 83 at 12.

[15] United States v. Vorley et al., case no. 18 Cr 35, Dkt. 12 at ¶ 3.

[16] United States v. Vorley et al., case no. 18 Cr 35, Dkt. 83 at 22.

[17] See United States v. Coscia, 866 F.3d 782 (7th Cir. 2017).

[18] Id. at 798.

[19] See, e.g., United States v. Dick, 744 F.2d 546, 550 (7th Cir. 1984).

[20] 7 U.S.C. § 6c(a)(5)(C).

[21] Id. at 25.

[22] United States v. Vorley et al., case no. 18 Cr 35, Dkt. 107 at 14.

[23] Id.

[24] United States v. Vorley et al., case no. 18 Cr 35, Dkt. 111 at 15.

[25] Id. at 24.

[26] Id.

[27] Id. at 26.

[28] 18 U.S.C. 1343.

[29] 7 U.S.C. § 13(a)(2).