SPOOFING: A PROPOSAL FOR NORMALIZING DIVERGENT SECURITIES AND COMMODITIES FUTURES REGIMES

High-frequency trading is the use of "extraordinarily high-speed and sophisticated computer programs for generating, routing, and executing orders" by professional traders in the securities and commodities futures markets.[1] Up until five years ago, high-frequency trading was a topic reserved to industry insiders and financial news sources.[2] This changed in 2010 when one high-profile event "took high-frequency trading from the edges of public consciousness to being front page news."[3]

On the afternoon of May 6, 2010, the Dow Jones Industrial Index ("Dow"), one of the most widely cited measures of stock market health, fell 1000 points in a matter of minutes.[4] As the fall quickened, "the sell-off seemed to overwhelm computer and human systems alike."[5] Some seemingly stable stocks, like Accenture and Boston Beer, traded for just a penny per share.[6] Then, within a couple of minutes, the stock index and individual stock values largely recovered.[7] The Dow ended the day at 4:00 p.m. down just 347.8 points.[8]

No one seemed to know what had caused the breathtaking event that would become known as the "Flash Crash."[9] Confusing coverage of the event from leading financial news source CNBC went viral.[10] At one point, CNBC journalists were suggesting that street riots in Athens, Greece, had sparked the sell-off even though

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1. Concept Release on Equity Market Structure, 75 Fed. Reg. 3594, 3606 (Jan. 21, 2010) (to be codified at 17 C.F.R. pt. 242).
2. *See* Charles R. Korsmo, *High-Frequency Trading: A Regulatory Strategy*, 48 U. RICH. L. REV. 523, 523 (2014).
3. *Id.*
4. Graham Bowley, *U.S. Markets Plunge, Then Stage a Rebound*, N.Y. TIMES (May 6, 2010), http://www.nytimes.com/2010/05/07/business/07markets.html.
5. *Id.*
6. Bob Pisani, *'Flash Crash' 5 Years Later: What Have We Learned*, CNBC (May 5, 2015), http://www.cnbc.com/2015/05/05/flash-crash-5-years-later-what-have-we-learned.html.
7. Bowley, *supra* note 4.
8. *Id.*
9. Korsmo, *supra* note 2, at 526–27.
10. *See Street Signs* (CNBC television broadcast May 6, 2010), https://www.youtube.com/watch?v=86g4_w4j3jU.

live side-by-side coverage of the events showed the streets of Athens were quiet as the market plummeted.[11] Elsewhere, market professionals "feared the occurrence of a cataclysmic event of which they were not yet aware" was causing the sell-off.[12] Yet there was no terrorist attack or natural disaster.[13] The unparalleled event seemed entirely inexplicable.

Securities and Exchange Commission ("SEC") Chairwoman Mary Schapiro called the chairmen of the major securities exchanges and other industry insiders to Washington, D.C., two days after the Flash Crash.[14] The group discussed the events of May 6 and their causes.[15] While no clear answers emerged from the discussion, what Schapiro learned in that meeting led the SEC and the Commodity Futures Trading Commission ("CFTC") to jointly investigate the activities of high-frequency traders.[16] The SEC-CFTC joint report, along with best-selling books by Michael Lewis and Scott Patterson, ignited a national dialogue about high-frequency traders and their practices.[17]

As high-frequency traders faced scrutiny in the wake of the Flash Crash, a great interest was taken in their particular practices.[18] One of the practices that came under scrutiny was spoofing.[19] Spoofing is a scheme that involves a trader, or a "spoofer," placing large trades in hopes of inducing others to act in response to those trades; the "spoofer" then cancels his initial trades

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11. *Id.*

12. COMMODITY FUTURES TRADING COMM'N & SEC. & EXCH. COMM'N, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010 4–5 (2010) [hereinafter JOINT REPORT], http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

13. *See* Korsmo, *supra* note 2, at 526; *see also* JOINT REPORT, *supra* note 12.

14. SCOTT PATTERSON, DARK POOLS 274–75 (2012).

15. *See* Michael Corkery, *SEC Chairman Admits: We're Outgunned By Market Supercomputers*, WALL STREET J. (May 11, 2010, 2:38 PM), http://blogs.wsj.com/deals/2010/05/11/sec-chairman-admits-were-outgunned-by-market-supercomputers/.

16. *See generally* JOINT REPORT, *supra* note 12.

17. *See* Justin Fox, *High Frequency Trading: Threat or Menace*, HARV. BUS. REV. (Apr. 3, 2014), https://hbr.org/2014/04/high-frequency-trading-threat-or-menace/. *See generally* MICHAEL LEWIS, FLASH BOYS (2014); PATTERSON, *supra* note 14.

18. Joseph De Simone et al., *Increased Public and Private Scrutiny of High-Frequency Trading*, MAYER BROWN (May 14, 2014), https://www.mayerbrown.com/files/Publication/272e9281-0ab5-481d-b98b-bca0b872e344/Presentation/PublicationAttachment/53b4f4ad-1a78-4553-9ede-d850bf05458c/UPDATE_Increased_Public-Private_Scrutiny_0514.pdf.

19. John Sanders, *What is Spoofing?*, J SANDERS: AVVOCATO AMERICANO (Apr. 22, 2015), https://jsandersavvocatoamericano.wordpress.com/2015/04/22/what-is-spoofing/.

in order to capture a profit on trading positions he holds on the opposite side of the market.[20] For example, a high-frequency trader might purchase shares of a thinly-traded stock at five cents per share, which the trader would want to sell for a profit at a higher price. The trader would then place several very large buy orders that other traders would interpret as a strong conviction that the stock will soon increase in value. Those other traders would in turn place orders to buy at increasingly higher prices. Meanwhile, the initial trader discreetly cancels his large orders. Finally, the initial trader sells the five-cent shares he purchased at the start of the scheme to the traders he fooled into bidding the price higher to ten cents.

Although spoofing received little attention before the Flash Crash, it appears to be a widespread practice.[21] By one estimate, there are ten to twenty highly suspicious trading incidents and several hundred more moderately suspicious incidents per day.[22] Such regular, disruptive, and manipulative activity seems to be something regulators would notice and address. However, it may be that the practice was able to escape the notice of regulators because its necessary conditions were something regulators themselves had created.[23]

One of the necessary conditions for a high-frequency trading scheme that is carried out by rapid trading through algorithm-based computers, of course, is the spread of technology into the securities and commodities markets.[24] The spoofer does *not* want his spoofing orders to be accepted before he can cancel them (recall that he really wants to sell—he is only asking to buy in order to affect others' behaviors), and only a computer can reliably cancel orders fast enough that other traders will not have time to accept the bid. The algorithm-based trading that customarily executes spoofing schemes grew in usage slowly over the past two decades and now accounts for over half of all trading.[25] This was partially a natural consequence of the internet age and partially a result of market reforms, which

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20. *Id.*

21. Bradley Hope et al., *Navinder Sarao's 'Flash Crash' Case Highlights Problem of 'Spoofing' in Complex Markets*, WALL STREET J. (May 6, 2015), http://www.wsj.com/articles/navinder-saraos-flash-crash-case-highlights-problem-of-spoofing-in-complex-markets-1430943635.

22. *Id.*

23. *See* PATTERSON, *supra* note 14, at 5–6 (describing the slow rise of high-frequency traders using computers).

24. *Id.* at 60–62.

25. Matthew O'Brien, *Everything You Need to Know About High-Frequency Trading*, ATLANTIC (April 11, 2014), http://www.theatlantic.com/business/archive/2014/04/everything-you-need-to-know-about-high-frequency-trading/360411/.

were specifically designed to enable electronic trading by computers.[26] Most significantly, the "Order Handling Rules,"[27] which went into effect in 1997, opened the door for public exchanges facilitated and populated by computers.[28]

The second necessary condition for the rise of spoofing is the maker-taker market making system.[29] As early as 1998, just after the Order Handling Rules were introduced, an Electronic Communication Network ("ECN") stock exchange began offering a rebate to high-frequency traders who would make liquidity[30] on its exchange by trading against participants with outstanding limit orders.[31] At the same time, the exchange operators would charge the institutional traders who took that volume a fee slightly larger than the rebate.[32] The exchange operator would keep the difference between the rebate and the charge.[33] The maker-taker system has been praised for creating "liquidity," "competition," and "efficiency" in the markets.[34] Within a decade of its introduction, "this 'maker-taker' system became the de facto method of trading for the vast majority of the U.S. stock market."[35] Even the New York Stock Exchange ("NYSE") now uses this system.[36] However, this purposefully created system encourages high-frequency traders to spoof the market by paying them for the market activity they generate.[37]

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26. *See* Gary Stone, *The Maker-Taker Model and Access Fees: It's Time for the SEC to Correct the Prisoner's Dilemma*, BLOOMBERG TRADEBOOK (Jan. 24, 2014), http://www.bloombergtradebook.com/blog/maker-taker-access-fees/.

27. Order Execution Obligations, Exchange Act Release No. 37619A, 61 Fed. Reg. 48290 (Sept. 6, 1996).

28. *Id.*

29. *See* Stanislav Dolgopolov, *The Maker-Taker Pricing Model and Its Impact on the Securities Market Structure: A Can of Worms for Securities Fraud?*, 8 VA. L. & BUS. REV. 231, 255 (2014).

30. *See Liquidity*, INVESTOPEDIA, http://www.investopedia.com/terms/l/liquidity.asp (last visited Apr. 17, 2016) (defining the term and explaining the significance of liquidity in financial markets).

31. *See* PATTERSON, *supra* note 14, at 157.

32. Dolgopolov, *supra* note 29, at 234–35.

33. *Id.*

34. OPTIVER, *Micro-Structural Issues of the European Equity Markets*, COMMITTEE EUR. SEC. REGULATORS (Apr. 30, 2010), http://www.optiver.com/pdf/Optiver%20response%20on%20CESR%20Equity%20Market%20Microstructure%20consultation.pdf.

35. PATTERSON, *supra* note 14, at 42.

36. Dave Michaels, *Trading Rebates Skew Markets, NYSE and Allies Tell SEC*, BLOOMBERG BUS. (Feb. 21, 2014, 12:01 AM) http://www.bloomberg.com/news/articles/2014-02-21/trading-rebates-skew-markets-nyse-and-allies-tell-sec.

37. Stone, *supra* note 26.

Although the SEC and CFTC may bear some responsibility for the rise of spoofing, the Flash Crash seems to have convinced them spoofing has become a problem. In an effort to reduce or eliminate spoofing, both the SEC and CFTC have brought enforcement actions against high-frequency traders since the Flash Crash.[38] Some of these cases have received a great deal of attention from major media outlets.[39] However, even as spoofing cases proliferate, there has been considerable confusion among both legal and financial professionals about the laws that prohibit spoofing.[40]

The current confusion concerning the prohibitions against spoofing is perhaps best observed by considering various reports about the arrest of Navider Singh Sarao.[41] On April 21, 2015, legal and financial professionals were shocked when the CFTC and the Department of Justice ("DOJ") filed complaints against a UK-based trader named Navider Singh Sarao and his one-man trading firm.[42] The civil and criminal complaints allege that Sarao regularly spoofed the market for E-Mini S&P 500 near month futures contracts.[43] Sarao's particularly aggressive spoofing activity on May 6, 2010, the CFTC asserts, "contributed to market conditions that led to the Flash Crash."[44]

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38. *See* Press Release, Commodity Futures Trading Comm'n, CFTC Charges U.K. Resident Navinder Singh Sarao and His Company Nav Sarao Futures Limited PLC with Price Manipulation and Spoofing (Apr. 21, 2015), http://www.cftc.gov/PressRoom/PressReleases/pr7156-15 [hereinafter *Sarao*]; Press Release, Sec. & Exch. Comm'n, SEC Charges N.Y.-Based Brokerage Firm with Layering (Sept. 25, 2012), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171484972#.VQCXKuF3HfY [hereinafter *Trade Alpha*]; Press Release, Sec. & Exch. Comm'n, SEC Charges Owner of N.J.-Based Brokerage Firm with Manipulative Trading (Apr. 4, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541406190#.VQCYr-F3HfY [hereinafter *Visionary Trading*].

39. *See* Peter J. Henning, *'Spoofing,' a New Crime with a Catchy Name*, N.Y. TIMES: DEALBOOK (Oct. 6, 2014), http://dealbook.nytimes.com/2014/10/06/a-new-crime-with-a-catchy-name-spoofing/?_r=0; Aruna Viswanatha et al., *'Flash Crash' Trader Sarao Accused Rivals of Misconduct*, WALL STREET J. (May 13, 2015), http://www.wsj.com/articles/trader-accused-in-flash-crash-accused-rivals-of-misconduct-1431556193.

40. John Sanders & Andrew Verstein, *Legal Confusion as to Spoofing*, HUFFINGTON POST (May 12, 2015), http://www.huffingtonpost.com/andrew-verstein/legal-confusion-as-to-spo_b_7268518.html.

41. *See id.*

42. *See* Kurt Eichenwald, *The 'Flash Crash' Case Doesn't Add Up*, NEWSWEEK (Apr. 29, 2015), http://www.newsweek.com/2015/05/08/flash-crash-case-doesnt-add-326066.html.

43. *See id.*

44. *Sarao*, *supra* note 38.

The allegations against Sarao are difficult to comprehend because of the two different regimes that prohibit spoofing.[45] Sarao is accused of spoofing a relatively obscure, albeit very large, commodities futures market while the Flash Crash took place in the high-profile stock market.[46] The former market is regulated by the CFTC;[47] the latter is regulated by the SEC.[48] The two regimes regulated by the SEC and CFTC have different statutes and regulations regarding spoofing. If there is any misunderstanding about which regulatory regime governs a particular trader's conduct, this will necessarily lead to an incorrect analysis of the complaints against him.

Several financial journalists seem to believe that the securities law regime of the SEC controls the Sarao case.[49] One example comes from a *Business Insider* article written by Portia Crowe the day that the complaints were filed.[50] Crowe draws on the experience of former SEC attorney Celiza Bragança for a history of spoofing cases, including the description of a spoofing case tried fifteen years ago, and a definition of spoofing.[51] However, the article also asserts that spoofing was outlawed just a few years ago through the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[52] This inconsistency should have raised a red flag for the author as well as her readers. The information gleaned from the SEC sources was wholly irrelevant to the CFTC's complaint against Sarao. The legal analysis in the article was certain to be off base because of this confusion.

Perhaps the best example of the confusion surrounding the Sarao case comes from a *Newsweek* article by Pulitzer Prize-winning journalist Kurt Eichenwald. Eichenwald argues that the case against Sarao did not "add up" because Sarao's alleged activity did

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45. *See* Sanders & Verstein, *supra* note 40.

46. *See id.*

47. *Mission & Responsibilities*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/About/MissionResponsibilities/index.htm (last visited Apr. 17, 2016).

48. *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about/laws.shtml (last visited Apr. 17, 2016).

49. *See* Portia Crowe, *Traders Have Been 'Spoofing' the Market and Now Regulators Are Finally Catching On*, BUS. INSIDER (Apr. 21, 2015, 4:13 PM), http://www.businessinsider.com/what-is-spoofing-the-market-2015-4; Eichenwald, *supra* note 42; Peter J. Henning, *The Fine Line Between Smart and Illegal*, N.Y. TIMES: DEALBOOK (Apr. 27, 2015), http://www.nytimes.com/2015/04/28/business/dealbook/the-fine-line-between-smart-and-illegal.html?_r=1.

50. Crowe, *supra* note 49.

51. *Id.*

52. *Id.*; *see also* Pub. L. No. 111-203, 124 Stat. 1376, 1739 (2010) (codified in scattered sections of the U.S. Code).

not match the SEC's definition of spoofing as announced through a case several years ago.[53] Eichenwald writes, "The definition of spoofing used in that 2012 SEC case doesn't fit the criminal complaint against Sarao. If he relied on the 'commonly known' definition the SEC used, how could he have had the intent to commit a crime? And again, without intent, there is no crime."[54]

There is a great deal wrong with what Eichenwald finds so vitally important. First, Eichenwald's assertion that the complaint against Sarao and the SEC's prior description of spoofing do not match is as correct as it is irrelevant. The securities and commodities regimes have very different rules on spoofing that were written seventy-five years apart.[55] Also, the fact that Sarao might have relied on or even known the SEC's views on spoofing are equally irrelevant. As a futures trader, Sarao should familiarize himself with commodities futures laws and the CFTC's rules. Finally, the "intent" under the commodities futures trading regime is the intent to cancel the trade, which is manifestly evident by the regularity with which Sarao cancelled his trades.[56] Under neither regime is it necessary to prove the "intent to commit a crime."[57]

Perhaps the observed confusion about the law governing spoofing is in large part because *the law* does not exist. There are, as has already been noted, two distinct regimes governing spoofing activity.[58] One belongs to the securities law regime regulated by the SEC;[59] the other belongs to the commodities futures law regime regulated by the CFTC.[60] The two regimes have different definitions of spoofing.[61] Understanding the distinctions between the regimes is important in the near-term for enforcement action purposes.[62] In the long-term, those distinctions are important to understand because they are likely to affect the behavior of market participants.[63]

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53. Eichenwald, *supra* note 42.
54. *Id.*
55. This is a comparison of the year in which the securities law prohibiting market manipulation, the Securities Exchange Act of 1934, was written and when Dodd-Frank was written. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (1934) (codified at 15 U.S.C. § 78a) (passed in 1934); Dodd Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1739 (2010) (codified in scattered sections of the U.S. Code) (passed in 2010).
56. Sanders & Verstein, *supra* note 40.
57. Eichenwald, *supra* note 42.
58. Sanders & Verstein, *supra* note 40.
59. *Id.*
60. *Id.*
61. *Id.*
62. *See id.*
63. *Id.*

Part I of this Comment will fully explain the two regimes, securities and commodities futures, which prohibit spoofing. Part II highlights the potential effects on market participation caused by the two divergent regimes. Part III offers a proposal which is a practical solution that the SEC can use to mitigate the negative effects of the regimes' differences. Finally, Part IV of the Comment serves as the conclusion.

I. SPOOFING REGIMES

It has been noted that because of a "historical accident" there are different laws governing spoofing in the securities and commodities futures markets.[64] The source of market manipulation laws for the securities market is the Securities Exchange Act of 1934[65] ("Exchange Act"), and the primary regulator of that market is the SEC.[66] The source of market manipulation laws for the commodities futures market is the Commodity Exchange Act of 1936[67] ("CEA"), and the primary regulator of that market is the CFTC.[68] One result of maintaining separate and oft-amended regimes is that "[o]ur laws prohibit spoofing a half dozen times, each time with different elements, and *only one time by name*."[69]

The SEC, when it has brought enforcement actions against traders engaged in spoofing, has claimed that the traders have violated § 9(a)(2) and § 10(b) of the Exchange Act as well as Rule 10b-5.[70] This Comment focuses exclusively on § 9(a)(2) because it fits the practice of spoofing most directly. Section 10(b) and its attendant rules are catch-all provisions that capture activities as far afield from spoofing as insider trading.[71] By contrast, § 9(a)(2) more closely fits the activity of spoofers by prohibiting schemes using "apparent active trading" to manipulate market prices of securities.[72]

The CFTC also alleges that traders engaged in spoofing activities have violated multiple provisions of the CEA and rules

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64. *Id.*

65. Ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78pp (2012)).

66. 15 U.S.C. § 78(u) (2012).

67. Ch. 544–45, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. § 1 (2012)).

68. 7 U.S.C. § 6b-1 (2012).

69. Sanders & Verstein, *supra* note 40.

70. *Trade Alpha*, *supra* note 38; *Visionary Trading*, *supra* note 38.

71. *See Insider Trading*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/answers/insider.htm (last visited Apr. 17, 2016).

72. Securities Exchange Act of 1934, 15 U.S.C. § 78i(a)(2) (2012).

promulgated thereunder.[73] Traditionally, the CEA section prohibiting manipulation was § 9(1).[74] Under that section, the CFTC had to demonstrate that: "(1) the accused had the ability to influence market prices; (2) that [he] specifically intended to do so; (3) that artificial prices existed; and (4) that the accused caused the artificial prices."[75] After the Flash Crash, Congress amended the CEA through Dodd-Frank to address spoofing directly.[76] At least one attorney-scholar has observed that there is a great deal of overlap between these alleged violations.[77] However, only one of the statutory provisions, the Dodd-Frank prohibition, addresses spoofing by name.[78] With the aid of the CFTC's guidance, it has become clear that the Dodd-Frank prohibition, codified in § 6c(a)(5)(C) of the CEA, will be the basis of spoofing complaints filed by the CFTC going forward.[79] Therefore, this Comment will focus on that prohibition when discussing spoofing in the commodities futures market.[80]

A. *Securities*

One possible approach to reining in the high-frequency traders who attempt to spoof the securities market is to aggressively use § 9(a)(2) of the Exchange Act to punish market manipulation. Section 9(a)(2) states that it shall be unlawful for any person to make a series of transactions in a security, thus manipulating the market by "creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the

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73. Complaint at 4, Commodity Futures Trading Comm'n v. Nav Sarao Futures Ltd., No. 1:15-cv-03398, 2015 WL 1843321 (N.D. Ill. Apr. 17, 2015); *see also* Gregory Scopino, *The (Questionable) Legality of High-Speed "Pinging" and "Front Running" in the Futures Market*, 47 CONN. L. REV. 607, 660–63 (2015) (noting that the CFTC has used several sections of the CEA and various rules thereunder to bring enforcement actions against spoofers).

74. Commodity Exchange Act, 7 U.S.C. § 9(1) (2012).

75. DiPlacido v. Commodity Futures Trading Comm'n, 364 F. App'x 657, 661 (2d Cir. 2009) (alteration in original).

76. Sanders & Verstein, *supra* note 40.

77. *See* Scopino, *supra* note 73, at 607 (arguing that several high-frequency trade practices violate anti-manipulation rules within the CEA).

78. Sanders & Verstein, *supra* note 40.

79. Andrew Harris & Matthew Leising, *Market Manipulation Complaints Are Common but Prosecutions Rare*, BLOOMBERG BUS. (Apr. 23, 2015), http://www.bloomberg.com/news/articles/2015-04-23/market-manipulation-complaints-are-common-but-prosecutions-rare (quoting CFTC lawyer Cliford Histed as saying spoofing would be prosecuted where the intent is to cancel the order, a clear indication that the Dodd-Frank provision rather than others will be the focus of the CFTC's actions).

80. *See* Commodity Exchange Act, 7 U.S.C. § 6c(a)(5)(C) (2012).

purpose of inducing the purchase or sale of such security by others."[81]

Section 9(a)(2) was originally directed at what some argue was one of the most worrisome practices in the early twentieth-century securities markets—investment pools.[82] Investment pools "ran up the prices of securities on an exchange by a series of well-timed transactions, effected solely for the purpose of 'manipulating' the market price of the security."[83] Once the price was pushed higher through manipulation, the traders taking part in the scheme would sell their shares at a profit.[84] One observing the spoofing activities of high-frequency traders in the twenty-first century might notice the similarities between their tactics and those of earlier investment pools. Specifically, in spoofing, the high-frequency trader uses the illusion of trading activity to induce others to place orders that move market prices in the spoofer's favor.[85]

Given the long-term prohibition against manipulating the securities market, many have been shocked that high-frequency traders were able to spoof the market so consistently and successfully before the Flash Crash.[86] Eric Hunsader, a high-frequency trading expert, echoed the thoughts of many in saying, "We can't understand why this is allowed to continue, because at the core, it is pure manipulation."[87] Two years after the Flash Crash shed light on this practice, the SEC took action against spoofers.[88] It began by using § 9(a)(2) of the Exchange Act to bring enforcement actions against high-frequency traders.[89]

The SEC has had success bringing enforcement actions against high-frequency traders engaged in spoofing schemes since 2012.[90] One early enforcement action was brought against Trade Alpha Corporate Ltd. ("Trade Alpha") and Demostrate LLC in 2012.[91] In

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81. Securities Exchange Act of 1934, 15 U.S.C. § 78i(a)(2) (2012).

82. *See* DAVID L. RATNER & THOMAS LEE HAZEN, SECURITIES REGULATION IN A NUTSHELL 131–32 (7th ed. 2002). *But see* Paul G. Mahoney, *The Stock Pools and the Securities Exchange Act*, 51 J. FIN. ECON. 343, 344 (1999) (questioning whether stock pools actually manipulated securities markets). *See generally* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 28 (1983) (discussing congressional concerns about investment pool practices).

83. RATNER & HAZEN, *supra* note 82, at 131.

84. *See id.*

85. Sanders & Verstein, *supra* note 40.

86. PATTERSON, *supra* note 14, at 62–63.

87. *Id.*

88. *Trade Alpha*, *supra* note 38.

89. *Id.*

90. *See, e.g.*, *id.*

91. *Id.*

that scheme, traders placed genuine orders for a thinly-traded stock that were meant to be executed.[92] The same traders then immediately entered several orders on the opposite side of the market from the genuine trade.[93] This sudden explosion of activity caught the attention of algorithm-driven trading machines deployed by other firms.[94] When those trading machines placed genuine orders against the initial genuine order, Trade Alpha and Demostrate would cancel their open orders.[95] They would then place a genuine order on the opposite side of the market to profit from the artificial price.[96] The scheme allowed for small but consistent profits eventually totaling more than $1.25 million.[97] The firms' scheme was discovered and stopped by the SEC, but only after it was used for twenty-one months.[98]

The SEC's complaint against Trade Alpha, which was based on a violation of § 9(a)(2), stated that the culpability of the firm stemmed from its intentional "manipulation" of the securities market to produce "artificial prices."[99] The fact that the scheme was carried out using the latest computer technology and high-frequency trading algorithms was inconsequential to the SEC.[100] Robert Khuzami, Director of the SEC's Division of Enforcement, declared, "Manipulation, whether executed by e-mail, instant message, or multiple phantom orders, is still manipulation."[101]

Another instance of the SEC using § 9(a)(2) against high-frequency traders engaged in spoofing came in 2014. On April 4, 2014, the SEC announced charges of spoofing and a settlement against a high-frequency trader, Visionary Trading LLC, and its broker, Lightspeed Trading LLC.[102] The scheme consisted of posting false orders to attract algorithm-based trading machines to take a position.[103] Once the trades of the algorithm-based trading machines executed and moved the market to an artificially elevated or depressed level, Visionary Trading would take the opposite position and profit when prices normalized.[104] The scheme led to

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92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.*
97. *See id.*
98. *Id.*
99. *See id.*
100. *See id.*
101. *Id.*
102. *Visionary Trading*, *supra* note 38.
103. *Id.*
104. *See id.*

just over $1 million in profits for Visionary Trading.[105] The SEC stopped the scheme, but only after it was used unabated from May 2008 to November 2011.[106]

In its release statement, the SEC stated that the spoofing scheme employed by Visionary Trading involved intentional "manipulative trading of publicly traded stocks" that "created fluctuations in the national best bid or offer of a stock."[107] Sanjay Wadhwa, senior associate director of the SEC's New York Regional Office, explained in the SEC's release statement that "[t]he fair and efficient functioning of the markets requires that prices of securities reflect genuine supply and demand."[108] Wadhwa further warned, "Traders who pervert these natural forces by engaging in layering or some other form of manipulative trading invite close scrutiny from the SEC."[109] The SEC had made clear through its post–Flash Crash enforcement actions that it was willing to punish high-frequency traders whose spoofing activities intentionally manipulated market prices.

Shortly after the Flash Crash, SEC Chairwoman Mary Schapiro told Congress that her agency's "tools for collecting data and surveilling our markets are wholly inadequate."[110] The fact that the 2012 case against Visionary Trading was two full years after the Flash Crash attests to that view.[111] However, it seems that the SEC is beginning to catch up to the high-frequency traders. Now, the SEC is able to break down in detail the algorithms and trading strategies employed by the high-frequency traders it charges.[112] This may be, in part, because of the new tools created to help the agency dissect market activity.[113] Most significantly, data tools possessed by the Financial Industry Regulatory Authority ("FINRA") have enabled the SEC to track orders and trading activity in a way it could not in 2010.[114]

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105. *See id.*
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.* (utilizing a synonym for "spoofing" that is falling out of fashion).
110. PATTERSON, *supra* note 14, at 63.
111. *See, e.g.*, *Visionary Trading*, *supra* note 38.
112. Marc H. Axelbaum et al., *What Coscia Conviction Means for High-Frequency Traders*, LAW360 (Jan. 7, 2016, 10:14 AM), http://www.law360.com/articles/742960/what-coscia-conviction-means-for-high-frequency-traders.
113. *See* Eric Hess, *Spoofing Surveillance and Enforcement a Major Challenge for Regulators*, TABB F. (May 18, 2015), http://www.tabbforum.com/opinions/spoofing-surveillance-and-enforcement-a-major-challenge-for-regulators.
114. *See id.*

The SEC's reliance on an old statute to prosecute modern misdeeds is perhaps what Congress intended when it wrote the Exchange Act's broad prohibitions against market manipulation. It is certainly a credit to the SEC that it has recognized its tools and dedicated itself publicly to their use instead of turning to Congress for a new statute or to the public rulemaking process for a new regulation. As Robert Khuzami suggested in 2012, the SEC has always had the authority to stop spoofing as it is market manipulation.[115] The SEC now seems to have the tools and the will to do so.

B. Commodities Futures

The other regime under which complaints against spoofers may be brought is governed by the CFTC.[116] The CFTC is responsible for regulating the commodities futures trading market.[117] This broad market includes futures contracts for oil, corn, silver, and other commonly used commodities.[118] It also includes futures contracts for indices like the S&P 500.[119] The CFTC, like the SEC, is responsible for bringing enforcement actions against those who seek to manipulate its markets.[120]

Those with primary authority to regulate the commodities futures exchanges,[121] since the passage of the CEA, have been far less concerned with prohibiting manipulative trading practices than its securities market counterpart.[122] There are a variety of theories concerning why this is true, which will not be explored in this Comment.[123] However, one example of the CFTC's slow response to manipulation concerns the London Interbank Offered Rate ("LIBOR") scandal uncovered in 2008.[124] Despite evidence of regular manipulative practices, the CFTC did not act to stop global rigging

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115. *See Trade Alpha*, *supra* note 38.
116. Sanders & Verstein, *supra* note 40.
117. *Mission & Responsibilities*, *supra* note 47.
118. *Id.*
119. *See id.*
120. *Id.*
121. *History of the CFTC*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/about/historyofthecftc/history_precftc (last visited Apr. 17, 2016).
122. Andrew Verstein, *Insider Trading in Commodities Markets*, 102 VA. L. REV. 447, 458–59 (2016).
123. *See* Rosa M. Abrantes-Metz, Gabriel Rauterberg & Andrew Verstein, *Revolution in Manipulation Law: The New CFTC Rules and the Urgent Need for Economic and Empirical Analyses*, 15 U. PA. J. BUS. L. 357, 362 (2013) (describing the burdens of the typical manipulation case as "insuperable").
124. *Timeline: Libor-Fixing Scandal*, BBC NEWS: BUS. (Feb. 6, 2013), http://www.bbc.com/news/business-18671255.

of the LIBOR benchmark for five years after first being told of the scheme.[125] Perhaps more shocking is the fact that the CFTC has never had a rule against insider trading.[126] This is despite the fact that there is a well-documented tradition of insider trading in the commodities market dating to at least 1817[127] and continuing to today.[128] It is within this tradition that the CFTC did not have a spoofing prohibition in place even as the practice became well known among market professionals.[129] It was only once § 6c(a)(5)(C) of the CEA was enacted, and amended as part of Dodd-Frank, that the practice of spoofing was addressed head-on.[130]

The Dodd-Frank prohibition states, "It shall be unlawful for any person to engage in any trading, practice, or conduct on or subject to the rules of a registered entity that . . . is, is of the character of, or is commonly known to the trade as, 'spoofing.'"[131] The prohibition then defines spoofing as "bidding or offering with the intent to cancel the bid or offer before execution."[132] Unlike § 9(a)(2) of the Exchange Act, this statute does not require an intention to manipulate the price.[133] The trader simply has to enter the order with the intention to cancel it before execution.[134]

Initially, it seems that proving such an intent on the part of high-frequency traders would be very difficult.[135] The CFTC is unlikely to find a smoking-gun email declaring a trader's intent to place and cancel trades before execution. A document like that is

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125. *Id.*

126. Phillip McBride Johnson, *Is an SEC and CFTC Merger a Perfect Fit?*, FUTURE & OPTIONS WORLD (Mar. 20, 2014), http://www.fow.com/3321790/Is-an-SEC-and-CFTC-merger-a-perfect-fit.html.

127. *See* JERRY W. MARKHAM, LAW ENFORCEMENT AND THE HISTORY OF FINANCIAL MARKET MANIPULATION 245 (2014) (describing the facts of Laidlaw v. Organ, 15 U.S. 178 (1817), in which a tobacco merchant gained an advantage in the New Orleans market by trading on non-public information about the War of 1812).

128. Ann Davis, *Cargill's Inside View Helps It Buck Downturn*, WALL STREET J. (Jan. 14, 2009), http://www.wsj.com/articles/SB123189501407679581.

129. Thomas K. Cauley et al., *Rules Against "Spoofing" and Other Disruptive Trading in Futures, Swaps and Options*, 7 HEDGE FUND L. REP., no. 42, Nov. 2014, at 1, 4.

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

131. Commodity Exchange Act, 7 U.S.C. § 6c(a)(5)(C) (2012).

132. *Id.*

133. Sanders & Verstein, *supra* note 40.

134. *See id.*

135. Crowe, *supra* note 49.

even less likely to be obtained from a one-man firm like Sarao's.[136] This intent can be demonstrated, however, by circumstantial evidence.[137] This sort of evidence is easily obtainable and persuasive as high-frequency traders like Sarao enter and cancel thousands of orders a day.[138] In Sarao's case, he was cancelling ninety-nine percent of the orders he placed.[139]

The ability to produce a clear record of high-frequency traders' rapid placement and cancellation of a high volume of orders is something regulators lacked in 2010.[140] At least one regulator likened the pursuit of high-frequency traders in 2010 to "chasing a Ferrari whilst riding a bicycle."[141] Recently, regulators have obtained new tools that allow analysis of up to fifty billion market events daily.[142] Empowered by these tools and Dodd-Frank, the CFTC has "brought several civil spoofing cases since 2012."[143]

On July 22, 2013, the CFTC announced the first successful enforcement action against traders under the new Dodd-Frank prohibition on spoofing.[144] The action was brought against Panther Energy Trading LLC and its principal, Michael J. Coscia.[145] The CFTC stated that Coscia used "a computer algorithm that was

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136. *See* Matt Levine, *Guy Trading at Home Caused the Flash Crash*, BLOOMBERG VIEW (Apr. 21, 2015), http://www.bloombergview.com/articles/2015-04-21/guy-trading-at-home-caused-the-flash-crash.

137. David I. Miller et al., *The U.S. Government's Charge Against "Spoofing,"* LEXOLOGY (June 18, 2015), http://www.lexology.com/library/detail.aspx?g=708481f9-eaf5-4953-8abd-2ce45604f3ab (noting that the CFTC has warned a pattern of activity is sufficient, but not necessary, evidence to prove spoofing).

138. Sanders & Verstein, *supra* note 40.

139. *Id.*

140. *See* Press Release, Sec. & Exch. Comm'n, SEC Approves New Rule Requiring Consolidated Audit Trail to Monitor and Analyze Trading Activity (July 11, 2012), https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483188#.

141. John Bates, *Fast and Furious: High Frequency Trading Raises Hackles*, WALLSTREET & TECH. (Apr. 10, 2014, 3:48 AM), http://www.wallstreetandtech.com/trading-technology/fast-and-furious-high-frequency-trading-raises-hackles/a/d-id/1268853?.

142. Hess, *supra* note 113.

143. Bradley Hope, *As 'Spoof' Trading Persists, Regulators Clamp Down*, WALL STREET J. (Feb. 22, 2015, 10:34 PM), http://www.wsj.com/articles/how-spoofing-traders-dupe-markets-1424662202.

144. Press Release, Commodity Futures Trading Comm'n, CFTC Orders Panther Energy Trading LLC and Its Principal Michael J. Coscia to Pay $2.8 Million and Bans Them from Trading for One Year, for Spoofing in Numerous Commodity Futures Contracts (June 22, 2013), http://www.cftc.gov/PressRoom/PressReleases/pr6649-13 [hereinafter *Panther Energy*].

145. Hope, *supra* note 143.

designed to illegally place and quickly cancel bids and offers in futures contracts."[146] By placing a small legitimate order on one side of the market and then following it with many large orders on the opposite side of the market that would spoof the market before being cancelled, Panther Energy Trading and Coscia were able to consistently profit on the small legitimate trades.[147]

While the enforcement action against Panther Energy Trading and Coscia may appear similar to those against securities market spoofers, there is a very important distinction between them. Most significantly, nowhere in the CFTC announcement is the word "manipulation" used to describe the scheme.[148] Instead, the CFTC stressed the fact that the algorithm was *designed* to place and then quickly cancel orders.[149] This design in the algorithm is an expression of the trader's intent. This intention to place and cancel orders is the definition of spoofing as prohibited under Dodd-Frank.[150] In addition to the design of the algorithm, the CFTC relied on a record of placed and quickly cancelled trades across a number of commodity futures contracts markets for evidence of the trader's intent.[151] This early case has been demonstrative of Dodd-Frank's application.

While the Panther Energy Trading enforcement action was an important first prosecution under the Dodd-Frank prohibition, perhaps the most famous enforcement action brought by the CFTC against a trader is the complaint against Navinder Singh Sarao.[152] Sarao's case is exceptional in several regards. The first is that Sarao is a high-frequency trader engaging in spoofing the U.S. commodities futures market from his parents' UK flat.[153] The second is that Sarao did not agree to a settlement with the CFTC, as other traders confronted with evidence of spoofing have, and that has led to the filing of criminal and civil complaints against him in U.S. federal district court as well as an extradition battle.[154] Finally, the complaint against Sarao alleges that his spoofing was a direct contributor to the Flash Crash.[155]

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146. *Panther Energy*, *supra* note 144.
147. *Id.*
148. *See id.*
149. *See id.*
150. *See* Commodity Exchange Act, 7 U.S.C. § 6c(a)(5)(C) (2012).
151. *Panther Energy*, *supra* note 144.
152. *See Sarao*, *supra* note 38.
153. Joseph Y. Calhoun, *Down the Rabbit Hole*, SEEKING ALPHA (Apr. 27, 2015, 1:40 AM), http://seekingalpha.com/article/3103676-down-the-rabbit-hole.
154. *Sarao*, *supra* note 38.
155. *Id.*

Despite the aforementioned exceptional aspects of the Sarao case, the complaint is much like other CFTC enforcement actions against spoofers. First, Sarao is alleged to have used an algorithm and "other manual spoofing techniques whereby Defendants allegedly would place and quickly cancel large orders with no intention of the orders resulting in transactions."[156] Also, Sarao is alleged to have engaged in spoofing over a long period of time.[157] In Sarao's case, he is alleged to have spoofed the market "for over five years and continuing as recently as at least April 6, 2015."[158] These similarities between Sarao's case and others indicate that the CFTC is constructing cases consistently, focusing on long histories of quickly placing and cancelling orders with a trading algorithm.

One element of the Sarao complaint, which carries great importance for the long-term prosecution of spoofing, distinguishes it from some other CFTC cases and all other SEC cases. This element is the combination of alleged violations. Other CFTC cases tend to allege that only spoofing, as defined in Dodd-Frank, has occurred.[159] SEC cases, on the other hand, tend to allege that manipulation has occurred.[160] The Sarao case alleges violations of statutory prohibitions against both spoofing *and* manipulation.[161] This indicates that the CFTC has separated the two offenses philosophically and that only a limited number of cases, with exceptional evidence of an intent to actually manipulate market prices, will feature manipulation allegations. Most cases will allege only that there was an intent to cancel a trade before it was placed. This element of the Sarao complaint highlights a critical distinction between the securities and commodities law regimes.

A third and final noteworthy enforcement action brought by the CFTC against traders for allegedly spoofing the commodities futures market occurred in May 2015.[162] The facts of this recent enforcement action, brought against Heet Khara and Nasim Salim,[163] mirrored those of other enforcement actions brought by the CFTC in multiple aspects. One similarity was that the alleged

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156. *Id.*
157. *Id.*
158. *Id.*
159. *See Panther Energy, supra* note 144.
160. *See Visionary Trading, supra* note 38.
161. *Sarao, supra* note 38.
162. *See* Press Release, Commodity Futures Trading Comm'n, CFTC Charges United Arab Emirates Residents Heet Khara and Nasim Salim with Spoofing in the Gold and Silver Futures Markets (May 5, 2015), http://www.cftc.gov/PressRoom/PressReleases/pr7171-15 [hereinafter *Emirate Scheme*].
163. *Id.*

spoofing scheme was carried out on a regular basis over an extended period of time.[164] In this case, the alleged scheme was carried out between February and April 2015.[165] Another similarity is that the scheme allegedly involved placing small legitimate orders on one side of the market, then placing large orders on the opposite side of the market that would spoof the market higher or lower before ultimately being cancelled, and then profiting from a more favorable execution price on the small legitimate order.[166] Finally, the pair allegedly carried out their spoofing of the Commodity Exchange, Inc. gold and silver market by using high-frequency trading algorithms domiciled abroad.[167] In the case of Khara and Salim, the alleged activities were carried out from the United Arab Emirates.[168]

The basis of the CFTC complaint against Khara and Salim is now a familiar one. As previously noted, the CFTC has taken issue with the disruption of the commodities futures market and an intent to place and cancel orders before execution of those orders.[169] The CFTC has based its case against Khara and Salim on the same theory of spoofing as defined in Dodd-Frank.[170] The CFTC press release announcing the enforcement action against Khara and Salim stated that the pair "engaged in unlawful disruptive trading practices known as 'spoofing' in the gold and silver futures markets by placing bids and offers with the intent to cancel them before execution."[171] The focus of the complaint is on market disruption rather than price manipulation and the intent to cancel trades rather than the intent to affect market prices.[172] In addition to this affirmation of the CFTC's theory of spoofing, the enforcement action against Khara and Salim indicates that the CFTC will continue to rely on circumstantial evidence in the form of many cancelled trades over an extended period of time to prove an intent to cancel on the part of alleged spoofers.[173] In its complaint against Khara and Salim, the CFTC argued that intent was clearly evidenced by the fact that the traders cancelled 100% of their 212 sell orders.[174]

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164. *See Sarao*, *supra* note 38.
165. *Emirate Scheme*, *supra* note 162.
166. *Id.*
167. *See id.*
168. *See id.*
169. *See, e.g.*, *Sarao*, *supra* note 38.
170. *See Emirate Scheme*, *supra* note 162.
171. *Id.*
172. *See id.*
173. *See id.*
174. *See* Gregory Meyer, *Two Traders Charged with "Spoofing,"* FIN. TIMES (May 6, 2015, 4:41 AM), http://www.ft.com/cms/s/0/a5765a84-f394-11e4-a979-00144feab7de.html.

In the past three years, the CFTC's treatment of spoofing has changed substantially. First, the regularity of CFTC enforcement actions against spoofers seems to be increasing.[175] Second, as highlighted above, the standardization of the CFTC's complaints is increasing.[176] Finally, the CFTC and the exchanges it regulates have openly stated that they are prioritizing the prosecution of spoofers.[177] Traders are surely noticing these developments as the CFTC moves to "find and swiftly prosecute those who engage in such disruptive trading practices."[178] As a result, "[t]raders are on notice and looking for ways to avoid even the appearance of being market manipulators" or spoofers.[179] Their attempts to avoid suspicion and prosecution for spoofing activities are important, as any changes in the behavior of traders may affect the broader markets in which they operate.

II. POTENTIAL EFFECTS OF VARIED REGIMES

The differences between the securities and commodities futures spoofing regimes are substantial. Most significantly, the two regimes require the regulators who bring the enforcement actions to prove different intents on the part of traders.[180] Dodd-Frank's requirement to prove an intent to cancel the order to buy or sell commodities futures places a relatively small burden on the CFTC.[181] Furthermore, the evidence of that intent can be easily garnered from the new means of data collections that allow the CFTC to meticulously arrange order data to show a long-term, high-volume pattern of placing and immediately cancelling orders.[182] The SEC, by contrast, must prove a subjective intent to manipulate the market price of the given security.[183] That is much tougher to prove as a practical matter because an intent to manipulate market prices is not as obvious as looking at the raw trade and order data. There

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175. There was a relatively long period of time between the first and second enforcement actions, with a shorter period of time between the second and third enforcement actions. *See, e.g.*, *Panther Energy*, *supra* note 144; *Sarao*, *supra* note 38; *see also Emirate Scheme*, *supra* note 162.

176. *Compare Emirate Scheme*, *supra* note 162, *with Sarao*, *supra* note 38.

177. *See* Sarah N. Lynch, *CFTC Says CME Directed to Beef Up 'Spoofing' Enforcement*, REUTERS (May 14, 2015, 4:22 PM), http://www.reuters.com/article/us-cftc-cme-group-spoofing-idUSKBN0NZ1LW20150514.

178. *Emirate Scheme*, *supra* note 162.

179. Lucy Ren, *High Profile 'Spoofing' Cases Put Traders on Edge*, MEDILL REP. CHI. (May 22, 2015), http://news.medill.northwestern.edu/chicago/high-profile-spoofing-cases-put-traders-on-edge/.

180. Sanders & Verstein, *supra* note 40.

181. *Id.*

182. Hope, *supra* note 143.

183. Sanders & Verstein, *supra* note 40.

are three reasons this difference between the two regimes is important.

First, legal and financial professionals should prepare for a deluge of spoofing allegations against high-frequency traders in the commodities futures market. Dodd-Frank gave the CFTC a relatively low burden in making out a complaint against spoofing traders.[184] The CFTC must simply prove that the defendants intended to cancel their trades when they placed them.[185] With this small burden, the only thing preventing successful prosecutions was the lack of reliable data to use as evidence.[186] The Sarao complaint offers strong evidence that the CFTC is getting better at combing and arranging that data to build solid cases.[187] Some are already calling the CFTC's efforts to rein in spoofing "a new area" of criminal and civil enforcement for commodities traders.[188] High-frequency traders may be seeing the writing on the wall.

Second, as a result of a more active and successful CFTC, there may be an exodus of high-frequency traders from the futures markets to the securities markets. The higher likelihood of being successfully prosecuted in the commodities futures market creates a higher regulatory cost, both in gross and relative terms, of doing business as a high-frequency trader in that market.[189] Some movement to the friendlier securities regime should be anticipated, especially given that high-frequency traders could transition their operations from one market to another with relative ease.[190] However, because trading in the futures markets can lead to larger, faster gains on smaller investments than trading in the securities markets, there may be a reluctance on the part of high-frequency traders to abandon the futures markets quickly.[191] This attractive feature of the commodities futures market may only temper, rather than prevent, the movement of traders from one market to the other.

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184. *See id.*
185. Commodity Exchange Act, 7 U.S.C. § 6c(a)(5)(C) (2012).
186. *See* Bates, *supra* note 141.
187. *See Sarao*, *supra* note 38.
188. Miller et al., *supra* note 137.
189. *See generally* Wim Marneffe & Lode Vereeck, *The Meaning of Regulatory Costs*, 32 EUR. J.L. & ECON. 341, 353 (2011) (defining regulatory costs and their importance to decision making).
190. *See generally* LEWIS, *supra* note 17 (describing the work of high-frequency traders in arbitraging the commodities futures and securities markets).
191. *Security Futures—Know the Risks, or Risk Your Future*, FINRA, http://www.finra.org/investors/security-futures-know-your-risks-or-risk-your-future (last visited Apr. 17, 2016).

Third, as a result of the effects of different regimes for the different markets, calls for regulatory changes in the securities market are to be anticipated. One response may be a call for a change in enforcement actions or the creation of a specific prohibition against spoofing in the securities market that is in line with Dodd-Frank's prohibition against spoofing in the commodities futures market.[192] Another possible response would be for renewed calls to place the securities and commodities futures under a single regulator. This would be expected, as "[f]rom time to time, but repeatedly, a call goes out to combine the [SEC] with the [CFTC]."[193] There does not appear to be a partisan divide between those who consider high-frequency trading to be "predatory" and repugnant in nature.[194] Perhaps a low public opinion of high-frequency traders would enable these changes to be possible despite a gridlocked political climate in Washington, D.C.[195]

III. PROPOSED RESPONSE

In light of the possible negative repercussions from different regulatory regimes, the SEC should take steps to rein in the excesses of high-frequency traders who use technological advantages to manipulate the securities markets. Fortunately, hard fought changes to securities laws and time-consuming writing of regulations are not necessary. All that is needed is for the SEC to change its approach to spoofing enforcement actions by insisting on more severe punishments.

A review of the SEC's spoofing enforcement actions to date shows that punishments have been quite lenient.[196] Executives who orchestrated the spoofing scheme at Trade Alpha for at least a year after receiving express warnings from FINRA were suspended for only two to three years as part of a settlement with the SEC.[197] Executives at Visionary Trading, who had been spoofing the market for more than three years, agreed to similar suspensions as part of their own settlement with the SEC.[198] Despite calls for tougher sanctions against market manipulators, the SEC's most recent

192. *See* Commodity Exchange Act, 7 U.S.C. § 6c(a)(5)(C) (2012).
193. Johnson, *supra* note 126.
194. *See id.*
195. Bart Chilton, *No Need to Demonize High-Frequency Trading*, N.Y. TIMES: DEALBOOK (July 7, 2014, 2:59 PM), http://dealbook.nytimes.com/2014/07/07/no-need-to-demonize-high-frequency-trading/?_r=0 (describing the public characterization of high-frequency trading as "predatory" in nature).
196. *See Trade Alpha*, *supra* note 38; *Visionary Trading*, *supra* note 38.
197. *See Trade Alpha*, *supra* note 38.
198. *See Visionary Trading*, *supra* note 38.

spoofing enforcement action resulted in a settlement that imposed no suspension whatsoever.[199]

What is perhaps more surprising is that prior settlements did not punish non-executives at those trading firms in any way whatsoever, despite the fact that such employees would have held FINRA licenses and understood their actions were in clear violation of anti-manipulation rules.[200] Under the settlements, those individuals could have returned to the same desks at the same firms the very next day. To balance the regulatory costs of the regimes and limit the negative effects of differing spoofing prohibitions, the SEC should punish high-frequency traders who manipulate the market through spoofing with greater severity. This includes the imposition of lifetime bans.

A. *Precedent for Lifetime Bans*

Although it may seem extreme to those unaccustomed to the financial industry, lifetime bans from the securities industry have been used before in circumstances where common schemes shook public confidence in the securities markets.[201] For example, in the wake of scandals involving manipulation and insider trading in the 1980s, the famous junk bond trader Michael Milken was banned from the financial industry for life after being found guilty of insider trading in 1989.[202] Where Milken has attempted to skirt that ban, he and those who assist him have been targets of additional SEC probes.[203]

In the early years of the twenty-first century, the securities market was rocked by a series of high-profile financial scandals.[204] The most noteworthy of these scandals involved executives at

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199. *See* Press Release, Sec. & Exch. Comm'n, SEC Charges Firm and Owner with Manipulative Trading (Oct. 8, 2015), https://www.sec.gov/news/pressrelease/2015-236.html.

200. *See id.*; *see also Trade Alpha*, *supra* note 38; *Visionary Trading*, *supra* note 38.

201. *Securities Ban for Milken*, N.Y. TIMES (Mar. 19, 1991), http://www.nytimes.com/1991/03/19/business/securities-ban-for-milken.html (describing Milken's lifetime ban for being part of "Wall Street's biggest scandal" during the junk bond era).

202. Jane Applegate, *The Indictment of Michael Milken: Drexel Employees at 'Junk Bond' Office Feel Anger, Numbness Over Indictments*, L.A. TIMES (Mar. 30, 1989), http://articles.latimes.com/1989-03-30/news/mn-900_1_michael-milken.

203. Charlie Gasparino, *Guggenheim's Milken Gaffe Leading to SEC Settlement*, FOX BUS. (Aug. 3, 2015), http://www.foxbusiness.com/business-leaders/2015/08/03/guggenheims-milken-gaffe-leading-to-sec-settlement/.

204. Dan Ackman, *WorldCom, Tyco, Enron—RIP*, FORBES (July 1, 2002, 9:32 AM), http://www.forbes.com/2002/07/01/0701topnews.html.

WorldCom, Tyco, and Enron.[205] Congress addressed the crisis of public confidence brought on by these scandals by passing the Sarbanes-Oxley Act of 2002 ("SOX").[206] SOX was passed to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws."[207] Still, with the public perception of a rigged securities market weighing on the SEC, investment banker Frank Quattrone was banned for life by the commission for obstructing justice in an investigation related to the misallocation of shares in initial public offerings.[208]

Most recently, with insider trading again a focus of enforcement, the SEC has sought lifetime bans in several cases.[209] For example, the SEC imposed a lifetime ban on former Goldman Sachs director Rajat Gupta in 2014 for passing inside tips to Galleon Group founder Raj Rajaratnam.[210] The SEC also sought a lifetime ban against hedge fund billionaire Stephen A. Cohen for systematically using insider trading to benefit his funds.[211] There is no question that the SEC has used lifetime bans as a deterrent when it appeared market corruption was getting out of control and affecting public confidence. The current spoofing of the securities market is precisely such a case.

B. *Rationale for Lifetime Bans for Spoofing*

As a general matter, more severe punishments for high-frequency traders who have engaged in spoofing schemes are warranted because spoofing is against each of the three mandates of

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205. *Id.*

206. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of U.S. Code); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005).

207. 116 Stat. 745.

208. However, the lifetime ban was later overturned on procedural grounds. Julie Creswell, *S.E.C. Overturns Investment Banker's Lifetime Ban from the Industry*, N.Y. TIMES (Mar. 25, 2006), http://www.nytimes.com/2006/03/25/business/25nasd.html?_r=0.

209. Joel Schectman, *SEC Commissioners Push Lifetime Bans on Executives*, WALL STREET J. (Feb. 26, 2015, 12:52 PM), http://blogs.wsj.com/riskandcompliance/2015/02/26/sec-commissioners-push-lifetime-bans-on-executives/.

210. Greg Stohr, *Supreme Court Rejects Ex-Goldman Director Rajat Gupta's Appeal*, BLOOMBERG POL. (Apr. 20, 2015, 9:31 AM), http://www.bloomberg.com/politics/articles/2015-04-20/ex-goldman-director-gupta-s-appeal-rejected-by-u-s-high-court.

211. Jordan Maglich, *SEC Sues Stephen A. Cohen; Seeks Lifetime Ban from Managing Investor Funds*, FORBES (July 19, 2013, 2:38 PM), http://www.forbes.com/sites/jordanmaglich/2013/07/19/sec-sues-steven-a-cohen-seeks-lifetime-bar-from-managing-investor-funds/.

the SEC.[212] The manipulation of securities prices through spoofing undermines market integrity, harms investors who make honest investments in the securities markets by subjecting their holdings to manipulated values, and stifles capital formation by undermining confidence in the markets.[213] This all adds to the substantial and growing perception that the stock market is "rigged."[214] Given the serious consequences of spoofing, severe punishments—including lifetime bans—are appropriate for those who spoof the securities markets.[215]

Lifetime bans for those who engage in spoofing can be justified on two more specific grounds. The first is that spoofing, as used by high-frequency traders, has become a widely publicized practice. That notoriety has affected public confidence, as it has in prior periods, which is essential to each of the SEC's three mandates.[216] This also means that the conduct of spoofers is having a much greater impact than the size of their ill-gotten gains would suggest. In this context, with more and more Americans believing the markets are "rigged," a lifetime ban seems appropriate for high-frequency traders who engage in spoofing.[217] It will send a signal that the markets are safe once again as some bad actors were banned and others were deterred by the threat of severe punishments.

The second more specific justification for utilizing lifetime bans is to raise the cost associated with spoofing in the securities market so that it is roughly equal to the cost of spoofing in the commodities market. Regulatory costs are oft-debated and seldom agreed on in strict terms.[218] However, no one seriously disputes whether the costs of complying with federal regulations are real.[219] Instead, those who seek to downplay the importance of those costs argue that

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212. *See* Scopino, *supra* note 73, at 677–78, 685–88; *What We Do*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about/whatwedo.shtml #.VNJTmi53HfY (last visited Apr. 17, 2016).

213. *See What We Do*, *supra* note 212.

214. *See* LEWIS, *supra* note 17, at inside sleeve.

215. *See Trade Alpha*, *supra* note 38; *Visionary Trading*, *supra* note 38; Mary Jo White, Chairwoman, U.S. Sec. & Exch. Comm'n, Speech at Council of Institutional Investors fall conference: Deploying the Full Enforcement Arsenal (Sept. 26, 2013), http://www.sec.gov/News/Speech/Detail/Speech/1370539841202 #.VQCd1eF3Hf.

216. *See What We Do*, *supra* note 212.

217. Schectman, *supra* note 209.

218. Clyde Wayne Crews, Jr., *The Cost of Government Regulation*, FORBES (July 6, 2011, 4:39 PM), http://www.forbes.com/sites/waynecrews/2011/07/06 /the-cost-of-government-regulation-the-barack-obama-cass-sunstein-urban-legend/.

219. Marneffe & Vereeck, *supra* note 189, at 341.

benefits of the regulations are most important, perhaps impliedly arguing that the regulated entity cannot do anything to avoid the costs.[220] However, the case of high-frequency traders offers a clear example of when regulated entities may exercise discretion in choosing between two competing regulatory regimes with vastly different costs.

Significantly, many high-frequency traders already trade in both the commodities futures and the securities markets. Some simply trade in both, while others actively seek to arbitrage the two markets.[221] Trading in both markets is so common that one company actually constructed a special fiber-optic route from Chicago's commodities futures market to New York's securities market, making 400 separate real estate transactions in the process.[222] That route would accommodate high-frequency traders hoping to use information obtained in one city's market and arbitrage it in the other.[223] In the end, the firm inked five-year contracts valued at $10.6 million each with high-frequency traders.[224] With so many high-frequency traders currently trading in both markets, it would be quite easy for a high-frequency trader to turn its attention completely to one market while avoiding the high regulatory costs of the other.

With the discretion to operate in either market, the regulatory costs of operating in the markets may become an essential consideration for high-frequency traders. Currently, as noted above, those who engage in spoofing are much easier to prosecute under the Dodd-Frank provision that governs spoofing in the commodities market.[225] The increased risk of successful prosecution is a cost.[226] This higher cost of spoofing in the commodities market may be creating a perverse incentive for market manipulators to move their manipulative schemes to the securities market. This is especially worrisome given that the average investor is much more likely to participate in the securities market.[227]

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220. *See* Crews, *supra* note 218.

221. Matthew Philips, *How the Robots Lost: High-Frequency Trading's Rise and Fall*, BLOOMBERG BUS. (June 6, 2013), http://www.bloomberg.com/bw/articles/2013-06-06/how-the-robots-lost-high-frequency-tradings-rise-and-fall.

222. LEWIS, *supra* note 17, at 12–15.

223. *Id.* at 15.

224. *Id.*

225. Sanders & Verstein, *supra* note 40.

226. Marneffe & Vereeck, *supra* note 189, at 349–51.

227. *See Is Investing in Commodities a Good Idea?*, WALL STREET J. (Aug. 2, 2013), http://www.wsj.com/articles/SB10001424127887323681904578643822549165446.

To prevent the imbalance in alternative regulatory regimes for high-frequency traders from bringing greater manipulation into the securities market where it can affect more retail investors, the SEC can raise the cost of engaging in spoofing in the securities market.[228] Because it does not involve the writing of a new statute or rule, the SEC can do this immediately. The SEC simply needs to exercise its discretion by raising the punishment it negotiates or litigates with those who violate the current law. This would not be the first time that the SEC has used increased punishment rather than legislation or rulemaking to effect changes in market practices.[229]

C. *Support for Lifetime Bans*

Tougher negotiated settlements by the SEC could not come as a surprise to high-frequency traders. History shows it is an option and recent SEC rhetoric indicates it is a strong possibility that the lifetime ban is an option the SEC is actively considering.[230] In fact, SEC Chairwoman Mary Jo White has promised a more aggressive approach to prosecuting market manipulation.[231] Chairwoman White promised during her confirmation hearing that the SEC's enforcement actions must be "bold and unrelenting."[232] She stated her conviction, which is in line with this Comment's proposal, that "proceeding aggressively against wrongdoers . . . also will serve to deter the unlawful practices of others who must be made to think twice and stop in their tracks, rather than risk discovery, pursuit and punishment by the SEC."[233] The need for this tough stance, she argued, was that market manipulation undercuts two of the SEC's mandates—investor confidence and market integrity.[234]

At the present time, Chairwoman White has the full support of some congressional leaders who are calling on her to back up her rhetoric with action.[235] Senator Elizabeth Warren of Massachusetts, for instance, has been a strong advocate for tougher enforcement action. In a sharply worded letter to Chairwoman White, Senator Warren argued that "the need for strong and effective regulations to

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228. *See* Sanders & Verstein, *supra* note 40.

229. Deborah Solomon, *SEC Considers Stronger Sanctions*, WALL STREET J. (June 16, 2003), http://www.wsj.com/articles/SB105571503064171800.

230. Schectman, *supra* note 209; Solomon, *supra* note 229.

231. White, *supra* note 215.

232. Letter from Elizabeth Warren, Senator, U.S. Congress, to Mary Jo White, Chairwoman, U.S. Sec. & Exch. Comm'n (June 2, 2015), http://www.warren.senate.gov/files/documents/2015-6-2_Warren_letter_to_SEC.pdf.

233. *Id.*

234. *See id.*

235. *See id.*

protect Americans and their investments is more important than ever."[236] At least two SEC Commissioners share Warren's view and are publicly advocating for more lifetime bans.[237] The next spoofing enforcement action would be a terrific opportunity for Chairwoman White to do just that and show traders that "further strengthen[ing] [of] the enforcement function of the SEC" truly is a high priority.[238] Doing so would balance the scales and inform high-frequency traders that no market regime is friendly to their spoofing schemes.

CONCLUSION

The practice of high-frequency traders to manipulate the markets through spoofing has become a concern for both market regulators and participants. The dual regulatory regimes for securities and commodities have caused substantial confusion in what could already be called a crisis of confidence in financial markets. To alleviate that confusion and bring balance to the regimes, the SEC should adjust its approach to spoofing enforcement actions. The simplest response, and one for which there is both precedent and contemporary support, is to impose lifetime bans against high-frequency traders who ignore well-established law and repeated warnings to engage in spoofing that is destroying confidence in the U.S. securities markets. The SEC should make this adjustment immediately. Otherwise it risks an influx of manipulative professional traders who will only add to the perception that the stock market is rigged.

*John I. Sanders**

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236. *Id.*
237. Schectman, *supra* note 209.
238. Letter from Elizabeth Warren to Mary Jo White, *supra* note 232.

* J.D. 2016 Wake Forest University School of Law; M.B.A. 2012 Liberty University; B.A. 2005 Wake Forest University. Between 2007 and 2013, employed by The Vanguard Group as a mutual fund specialist, exchange-traded fund ("ETF") expert, stock broker, and member of the management team. I would like to thank my wife Jessica. I have been blessed with a loving wife whose understanding of business, finance, and writing is exceptional. Her thoughtful critiques challenge me to produce more sound and accessible corporate and securities law arguments. Thank you also to Professors Andrew Verstein and Jaya Gokhale for guidance and feedback on this project. Finally, thank you to the *Wake Forest Law Review* staff and editors for their professionalism and thoroughness in editing.

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