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# Prosecutions Put High-Frequency Traders On High Alert

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Within the last six months, two United States attorneys have brought groundbreaking criminal prosecutions against high-frequency traders for manipulating markets through spoofing — i.e., entering a buy or sell order with the intent to cancel before the order's execution. One prosecution targeted high-frequency trading conduct in the commodities market, and the other in the stock market. Given that high-frequency trading accounts for a substantial percentage of trading volume in both markets,[1] these two prosecutions stand as likely harbingers of future criminal investigations and are certainly cause for concern for high-frequency traders, as the consequences for spoofing are no longer limited to civil penalties and industry bans.

## Spoofing Prosecution in Commodities Market

On Oct. 1, 2014, a federal grand jury in the Northern District of Illinois indicted Michael Coscia, a former floor trader and sole owner of Panther Energy Trading LLC, for allegedly violating the Commodities Exchange Act's anti-spoofing provision and committing commodities fraud.[2] The indictment marked the first time that the Commodities Exchange Act's anti-spoofing provision, which was added to the statute in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act, had been charged criminally.

The indictment alleges that beginning in 2011, Coscia used a high-frequency trading strategy in which he would enter large-volume orders that he intended to cancel before other traders could fill them.[3] Coscia's allegedly false information induced traders to act, which then moved the market in Coscia's favor, allowing him to purchase or sell contracts at an artificial price.[4] Coscia allegedly netted nearly $1.6 million in profits by spoofing trades.[5] Coscia then repeated this strategy in the opposite direction, immediately obtaining a profit by buying futures contracts at a lower price than he paid for them or by selling contracts at a higher price than he paid for them.[6]

To execute this strategy, Coscia allegedly designed his trading programs to place a "ping order" of a contract to "test the market and ensure that market conditions would allow his fraudulent strategy to work."[7] Coscia's programs then allegedly placed several layers of "quote orders" on the opposite side of the market from his trade orders to create the illusion of market interest.[8] The quote orders, according to the indictment, would typically be the largest orders in the market within three ticks of the best bid or offer price, "usually doubling or tripling the total quantity of contracts within the best bid or offer price."[9] Lastly, Coscia's programs were allegedly designed to cancel the quote orders within a fraction of a second automatically, without regard to market conditions, even if the market moved in a direction favorable to the quote orders.[10]

This criminal indictment was returned more than a year after the U.S. Commodity Futures Trading Commission's settlement with Coscia regarding the same underlying conduct. In July 2013, the CFTC entered into a settlement with Coscia that included a $1.4 million civil monetary penalty, a $1.4 million disgorgement and a $900,000 penalty to the Financial Conduct Authority.[11] In addition, the CFTC settlement banned Coscia from trading for one year.[12] Given the lapse of time between the civil and criminal enforcement of Coscia's conduct, the indictment unsurprisingly sent shock waves through the high-frequency trading community and marked a significant shift in criminal enforcement in the commodities market.

## Spoofing Prosecution in Securities Market

A similar shock wave was felt in the securities market after the January 2015 filing of criminal charges against Alexsandr Milrud in the District of New Jersey. On Jan. 13, 2015, Milrud was charged with conspiracy to commit securities and wire fraud for alleged spoofing conduct.[13] The complaint alleges that Milrud devised an "extensive and sophisticated international layering scheme" that involved recruiting online traders in foreign countries, including China and Korea.[14] Milrud allegedly solicited the help of the founder of a registered broker-dealer in New York and abroad, who turned out to be a cooperating witness for the government.[15]

Milrud allegedly told the cooperating witness that he had worked with a software company to program "hotkeys," or shortcuts, that have the ability to place and cancel multiple orders with only a few keystrokes.[16] When discussing his strategy with the cooperating witness, Milrud explained that his overseas stock traders used two trading accounts: a "dirty" account to orchestrate the manipulative spoofing, and a "clean" account to buy and sell the manipulated stock at a profit during the small window when the price had been artificially moved.[17]

According to the complaint, Milrud manipulated only "heavily traded" stocks that "had high volume" and the liquidity to facilitate the speedy spoofing scheme.[18] He allegedly admitted that, when other market participants saw the high volume of trades, they would "start to come in ... and basically, we [would] trade against them."[19] These repeated, fast-paced trades reaped incremental profits, ultimately reaching millions of dollars in ill-gotten gains.[20]

As part of Milrud's strategy, he allegedly made extensive efforts to conceal his spoofing scheme, including refusing to communicate about the scheme over the telephone, using third-party liaisons to conduct the illegal activity, and creating layers between himself and the spoofing conduct by using different computers, usernames, and IP addresses to bypass fraud detection services, and by using multiple trading and clearing firms to execute each transaction.[21]

In addition to the criminal charges, Milrud's conduct subjected him to a contemporaneous civil enforcement action. On the same day that the criminal complaint was filed, the U.S. Securities and Exchange Commission filed a civil enforcement action against Milrud based on the same underlying spoofing conduct for multiple violations of the securities laws, seeking disgorgement, civil penalties, and an injunction from further trading activities.[22]

## Conclusion

The prosecutions against Coscia and Milrud make clear that the penalties for high-frequency spoofing are no longer relegated to civil and administrative remedies only. These cases forecast a new wave of criminal investigations, particularly in light of the large percentage of trades conducted through high-frequency trading, and they send a clear warning to high-frequency traders that they may find themselves the subject of upcoming investigations.

Therefore, it is important that high-frequency trading firms adopt and implement policies and procedures to detect and prevent manipulative trading, including spoofing. These compliance programs should include regular monitoring of trades and testing of algorithmic trading programs. High-frequency-trading firms and their traders should avoid trading strategies that resemble manipulative trading activity whenever possible. They should also consider documenting the nonmanipulative rationale for high-frequency trading strategies.

—By Michael Martinez, Matthew A. Rossi and Melanie M. Burke

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[1] John McCrank, "Excusive: SEC Targets 10 Firms in High Frequency Trading Probe — SEC Document," Reuters, July 17, 2014, http://www.reuters.com/article/2014/07/17/us-sec-investigation-highfrequencytradin-idUSKBN0FM2TW20140717 ("High frequency trading firms account for more than half of all trades in the U.S. stock market, and are often seen as modern-day market makers."); Nick Baker and Sam Mamudi, "High Speed Traders Rip Investors Off, Michael Lewis Says," Bloomberg, March 30, 2014, http://www.bloomberg.com/news/articles/2014-03-30/high-frequency-traders-ripping-off-investors-michael-lewis-says (noting that "[h]igh-frequency traders account for about half of share volume in the U.S."); Tom Polansek, "CFTC Finalizes Plan To Boost Oversight of Fast Traders: Official," Reuters, Aug. 23, 2013, http://www.reuters.com/article/2013/08/23/us-cftc-trading-oversight-idUSBRE97M0ZH20130823 (commenting that "practice [of high-frequency trading] accounted for more than 60 percent of all futures volume in 2012 on U.S. exchanges such as CME Group Inc. and IntercontinentalExchange Inc.").

[2] United States v. Coscia, No. 14-CR-00551 (N.D. Ill. Oct. 1, 2014) available at https://ia801405.us.archive.org/1/items/gov.uscourts.ilnd.301298/gov.uscourts.ilnd.301298.1.0.pdf.

[3] Id. at ¶ 3.

[4] Id.

[5] Id.

[6] Id. at ¶ 12.

[7] Id. at ¶ 7.

[8] Id. at ¶ 9. The indictment notes that Coscia's quote orders were either orders to buy contracts at a higher price than the prevailing offer, or orders to sell contracts at a lower price than the prevailing bid.

[9] Id.

[10] Id. at ¶ 10.

[11] Press Release, 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 (July 22, 2013) available at http://www.cftc.gov/PressRoom/PressReleases/pr6649-13.

[12] Id.

[13] Criminal Complaint, United States v. Milrud, No. 15-mj-07001 (D.N.J. filed Jan. 12, 2015), available at http://www.justice.gov/usao/nj/Press/files/pdffiles/2015/Milrud,%20Aleksandr%20Complaint.pdf.

[14] Id. at 4-5.

[15] Id. at 3, 5

[16] Id.

[17] Id. at 6.

[18] Id.

[19] Id. at 7.

[20] Id. at 6-7.

[21] Id. at 6 n.1, 12-13.

[22] Complaint, Securities & Exchange Comm'n v. Milrud, No. 15-cv-00237 (D.N.J. Jan. 13, 2015), available at http://www.sec.gov/litigation/complaints/2015/comp-pr2015-4.pdf.

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