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'Spoofing': The SEC Calls It Manipulation, But Will Courts Agree?

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SHUTTERSTOCK

In recent years, the U.S. Securities and Exchange Commission (SEC), Commodity Futures Trading Commission, and the Department of Justice have pursued an increasing number of cases involving a relatively new form of alleged market manipulation known as "spoofing." See, e.g., *U.S. v. Coscia*, No. 14-cr-00551 (N.D. Ill.); *In re Panther Energy Trading*, CFTC Docket No. 13-26 (2013); *CFTC v. Nav Sarao Futures*, No. 15-cv-03398 (N.D. Ill.); *In re Hold Brothers On-Line Investment Services*, Exchange Act Release No. 67924 (SEC Sept. 25, 2012); *SEC v. Lek Secs.*, No. 17-cv-1789 (S.D.N.Y.).

If securities or commodities trading were a poker game, spoofing would be loosely analogous to bluffing your opponent. Typically, spoofing occurs when a trader sends a large order (for example, a "bid" or "buy" order) into the market with an intent to cancel it before it can be executed, while at the same time placing a smaller order on the other side of the market (for example, an "offer" or "sell" order) that they hope will be executed. The "spoofer" uses the large buy order to encourage other market participants—who may assume the large order means prices are trending upwards—to transact with them by executing against their smaller sell order. Once the smaller order is executed, the spoofer will quickly cancel their large buy order since their goal was never to have it executed in the first place. Spoofers will often reverse and repeat this behavior over and over again,

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sometimes hundreds of times, each time earning a small profit.

In 2010, as part of the Dodd-Frank Act, Congress specifically prohibited spoofing in the futures markets under the Commodity Exchange Act (CEA). 7 U.S.C. §6c(a)(5)(C). However, there is no such specific prohibition under the federal securities laws. As a result, the SEC has typically prosecuted spoofing under the general antifraud provisions of §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The SEC has also prosecuted spoofing claims under §9(a)(2) of the Exchange Act. While this statutory provision is outside of the scope of this article, it is worth noting that §9(a)(2) governs "transactions in any security." 15 U.S.C. §78i(a)(2). Arguably, bids and offers are not "transactions" until they are executed.

But the question of whether spoofing can in fact constitute illegal market manipulation under §10(b) and Rule 10b-5 is far from clear. While courts in different jurisdictions have handled this issue differently, in *ATSI Communications v. Shaar Fund*, 493 F.3d 87 (2d Cir. 2007), the U.S. Court of the Appeals for the Second Circuit held that open-market securities transactions cannot form the basis for a manipulation scheme under §10(b) and Rule 10b-5 without "something more." Since so-called "spoofing" orders are executable in the open market any time prior to cancellation, they arguably do not meet the *ATSI* standard. So far, no court in the Second Circuit has addressed this issue. This article analyzes spoofing under the open-market manipulation case law, focusing on the Second Circuit, where *ATSI* is binding precedent.

Circuit Split

The SEC has long expressed the view, endorsed by the D.C. Circuit, that otherwise legal open-market securities transactions can violate §10(b) and Rule 10b-5 if they are executed with the intent to move the price of a security. *Markowski v. SEC*, 274 F.3d 525, 528 (D.C. Cir. 2001); see also *Koch v. SEC*, 793 F.3d 147, 151 (D.C. Cir. 2015). By contrast, the Second Circuit in *ATSI* has applied a more exacting standard, requiring "something more" to assert a valid open-market manipulation claim. 493 F.3d. 87 (2d Cir. 2007). The standard is also the law in the Third Circuit under *GFL Advantage Fund v. Colkitt*, 272 F.3d 189, 207 (3d Cir. 2001), which was cited approvingly by the Second Circuit in *ATSI*, 493 F.3d at 101.

> Until the 'ATSI' standard and its application to spoofing is clarified, the SEC and defendants will both **face meaningful litigation risk in any spoofing enforcement action** filed in the Second Circuit.

In *ATSI*, the plaintiffs asserted that the defendants engaged in "death spiral financing," where they shorted a stock to drive its price down, to obtain discounted shares through the financing that could be used to cover their short position for a profit. 493 F.3d at 100. Plaintiffs alleged market manipulation under §10(b) and Rule 10b-5. The Second Circuit affirmed the lower court's dismissal of the complaint, holding that, "[t]o be actionable as a manipulative act, short selling must be willfully combined with *something more* to create a false impression of how market participants value a security." 493 F.3d at 101 (emphasis added). The court found that the short sales, though undertaken with the intent to drive down the price, were not illegal because they were not "aimed at deceiving investors as to how other market participants have valued a security."493 F.3d at 100. The court distinguished open-market short sales from traditional forms of manipulative trading such as "wash sales" and "matched orders," which involve traders transacting with themselves or co-conspirators for the purposes of rigging stock prices. 493 F.3d at 100-101 (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 476-77 (1977) (internal quotations omitted)). A wash sale is a "sale of securities made at about the same time as a purchase of the same securities … resulting in no change of beneficial ownership." A matched order is an "order to buy and sell the same security, at about the same time, in about the same quantity, and at about the

same price" between parties who are colluding with one another. See Black's Law Dictionary, 1124, 1339 (7th ed. 1999).

Does 'Spoofing' Meet 'ATSI' Standard For Open-Market Manipulation?

To bring a §10(b) and Rule 10b-5 action under *ATSI*, the SEC or a private plaintiff will have to identify the "something more" that sets it apart from other open-market trading activity. In *Nanopierce Technologies v. Southridge Capital Management*, a court in the Southern District of New York found that the "something more" test could not be satisfied by "subjective intent to affect the price of a stock" alone. 2008 WL 250553, at *2 (S.D.N.Y. Jan. 29, 2008). This makes sense since *ATSI* appears to reject the SEC and D.C. Circuit test in favor of a more bright-line standard focusing on whether the open-market transactions are executed in a manner or in conjunction with other behavior that makes them more closely resemble inherently deceptive transactions such as wash trades or matched orders.

A core characteristic of wash trades and matched orders is that they lack economic substance because they involve little or no market risk. So-called "spoofing" orders, on the other hand, can involve substantial market risk because they are executable at any time prior to cancellation. Indeed, in the fast moving environment of modern day securities markets, it is not uncommon for an order that has only been exposed to the market for one second or less to be filled. See The Speed of the Equity Markets, SEC Data Highlight 2013-05 (Oct. 9, 2013). As a result, in the absence of additional factors that eliminate or at least drastically minimize execution risk, it can be argued that spoofing falls outside of the scope of §10(b) and Rule 10b-5 under *ATSI*. See, e.g., *Cohen v. Stevanovich*, 722 F. Supp. 2d 416, 424 (S.D.N.Y. 2010) (naked short selling was not deemed manipulative because "both parties … still bear the market risk of the transaction," unlike wash trades or other similar transactions).

Unfortunately, other courts in the Southern District of New York have muddied the analysis, suggesting that, even after *ATSI*, open-market transactions may constitute manipulative activity when coupled with "manipulative intent." 127 F. Supp. 3d 60 (S.D.N.Y. 2015). For example, in *In re Amaranth Natural Gas Commodities Litigation*, the court defined "something more" as "anything that distinguishes a transaction made for legitimate economic purposes from an attempted manipulation." 587 F. Supp. 2d 513, 535 (S.D.N.Y. 2008). While Amaranth was a commodities manipulation case, the court looked to *ATSI* as analogous precedent because the case was brought under the general anti-manipulation provisions of the CEA. Continuing, the court added that, "[b]ecause every transaction signals that the buyer and seller have legitimate economic motives for the transaction, if either party lacks that motivation, the signal is inaccurate." 587 F. Supp. 2d at 535. Similarly, in *Sharette v. Credit Suisse International*, the court opined that "something more" can encompass open-market transactions "coupled with manipulative intent." 127 F. Supp. 3d at 82. The SEC will no doubt rely on these cases in future spoofing litigations, despite their circular reasoning and questionable adherence to *ATSI*.

Conclusion

Until the *ATSI* standard and its application to spoofing is clarified, the SEC and defendants will both face meaningful litigation risk in any spoofing enforcement action filed in the Second Circuit. This notwithstanding, spoofing has clearly become a high enforcement priority for the SEC and other regulators. As a result, investment firms and broker-dealers who condone this activity, or who fail to have policies reasonably designed to prevent it, do so at their own risk.

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