

Record Spoofing Settlement Provides Guidance For Traders

By Charley Mills and Matt Kulkin (November 15, 2019)

The U.S. Department of Justice and the Commodity Futures Trading Commission on Nov. 6 separately entered into related and coordinated resolutions of criminal and civil charges with Tower Research Capital LLC, a proprietary trading firm. While this case is significant because it resulted in the largest total monetary sanction ever assessed in a case based on alleged spoofing in futures markets[1] — \$67.4 million — derivatives traders and their counsel should note several important takeaways from these dispositions.



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Specifically, the Tower settlements provide insight into the increasing coordination between the DOJ and the CFTC in spoofing investigations, the framing of spoofing violations, cooperation credit, and the elements of adequate corporate compliance programs.

The CFTC settlement order also identifies new legal issues for market participants who may need a CFTC-issued waiver from the U.S. Securities and Exchange Commission's private securities offerings prohibition for bad actors under SEC Rule 506(d).



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Spoofing is a discrete offense under Section 4c(a)(5)(C) of the Commodity Exchange Act[2] for bidding or offering on a CFTC-registered exchange or trading facility with the specific intent to cancel the bid or offer before execution.

The alleged wrongdoing involved thousands of instances of spoofing by three former Tower traders in E-mini futures contracts on the Chicago Mercantile Exchange and Chicago Board of Trade during the period between March 2012 and December 2013.[3]

While spoofing is at the heart of the alleged unlawful activity, it more importantly served in combination with otherwise lawful and genuine bids and offers as the foundation for the DOJ's and CFTC's more serious charges of criminal and civil fraud.

Pursuant to the DOJ's resolution, Tower entered into a deferred prosecution agreement, or DPA, with the fraud section of the DOJ's Criminal Division and the U.S. Attorney's Office for the Southern District of Texas, and consented to the filing of a criminal information in the federal district court in Houston that charged one count of criminal commodities fraud under Title 18 of U.S. Code Section 1348(1).[4]

That provision makes it a felony, as relevant here, to knowingly execute, or attempt to execute, "a scheme or artifice to defraud any person in connection with any commodity for future delivery."

The DPA included Tower's admission to a statement of facts attached to the DPA and to the allegations in the criminal information. Pursuant to the DPA, if Tower complies with its terms over the next three years, the DOJ will seek dismissal with prejudice of the information and will not file charges in the future against Tower based on the conduct described in the DPA.

The CFTC's order charged civil violations of both the CEA's anti-spoofing prohibition and the anti-manipulation and antifraud provisions in CEA Section 6c(1)[5] and CFTC Rules 180.1(1) and (3) thereunder.[6] The order also imposed a cease and desist order against future violations and, somewhat controversially, effectively waived Tower's disqualification from making private securities offerings on the basis of the so-called "bad actor" provisions of SEC Rule 506(d)(1) of Regulation D[7] as a consequence of the findings in the CFTC order.

This aspect of the order spawned a dissent from CFTC Commissioner Dan Berkovitz[8] and a separate expression of "extreme reservation" from Commissioner Rostin Behnam[9], who voted in favor of the settlement. The order also sets forth Tower's agreement to "undertakings" that commit it to, among other things, cooperate for a period of five years in any current or future CFTC investigation or action related thereto, and comply with the obligations relating to its corporate compliance program and reporting requirements set forth in the DPA.[10]

DOJ and CFTC Coordination

The DOJ's involvement began with a CFTC referral to it of Tower's activities for criminal investigation. The identical and reciprocal structure of the DOJ's and the CFTC's monetary sanctions reflects the deep coordination between them in the ultimate disposition of their investigations. As discussed below, the reliance on the application of the federal sentencing guidelines, rather than the CFTC's enforcement policies, to determine the monetary credit Tower received for its cooperation and remedial measures is emblematic that the criminal disposition is naturally the leading concern in reaching a global settlement.

The Government's Theory of Fraud

The Tower case seems to be an example of how the lawfulness or unlawfulness of any derivatives market order can depend on the context in which it is entered and executed. That an order that complies with all the market rules might nonetheless be considered unlawful when used in a way that contravenes market integrity.

The DOJ and CFTC theory of fraud is not based on allegations of spoof orders alone. Rather, they allege that the fraud arose from Tower's use of spoof orders in combination with entering permissible and otherwise legitimate "iceberg" orders, and that the alleged scheme was designed to trick other market participants into executing against the iceberg orders, while Tower's traders cancelled the spoof orders before they could be filled.

One takeaway from the government's theory of fraud is that market participants using iceberg orders should be mindful of how they might be perceived to act with one's other open market orders to avoid misperceptions of creating false appearances of supply and demand in the order book.

Iceberg orders are orders that permit other market participants to see only a portion of the full size of the orders at any given time. Nothing signifies to the market that an order is an iceberg order, such that other market participants have no notice that an additional volume of orders lies beneath what is visible to them in the exchange's order book. In short, they hide the full supply and demand of resting bids and offers in an order book.

The government contends that Tower's traders intended to and did use the combination of illegitimate spoof orders and legitimate iceberg orders to create a false appearance of an imbalance of offers to sell — supply — and bids to buy — demand — in the exchanges' order books.

The criminal information and CFTC order allege that the traders would load up one side of the market with spoof orders that were intended to be cancelled before they could be executed against and enter iceberg orders on the other side of the market, which made the visible bids or offers on that side seem out of balance with those on the other side.

The information and CFTC order allege that the apparent imbalance deceived other market participants "into believing something that was not true, namely that the visible order book accurately reflected market-based forces of supply and demand."^[11] The information further alleges that the Tower traders thereby tricked them "into reacting to the apparent change and imbalance in supply and demand by buying and selling E-Mini futures contracts at quantities, prices, and times that they otherwise likely would not have traded."^[12]

The information alleges that in this way the traders placed spoof orders "with the intent to fraudulently and artificially move the price of any given E-Mini futures contract in a manner that would increase the likelihood that one or more of their opposite-side Genuine Orders would be filled by other market participants," generating profits or avoiding losses for the Tower traders.

It also is noteworthy that nowhere in the information, DPA or CFTC order is there any allegation of contemporaneous communications by the traders that expressed their alleged fraudulent intent. Perhaps there is such evidence that the government simply chose not to identify in these dispositions, but in their absence the government's allegations of fraudulent intent would seem to have been based originally on inferences from trading patterns alone.

Credit for Cooperation and Remedial Actions

Tower received a significant reduction in the assessed monetary penalty as a reward for its extensive cooperation with the DOJ and CFTC during the investigation, its commitment to continue to cooperate in the future, and its extensive remedial efforts. Although the CFTC has its own policies and practices with respect to providing cooperation credit, here the application of credit under the federal sentencing guidelines controlled the outcome.

The DPA specifically provides that, although Tower received no credit for self-reporting, it received a 25% reduction from the low end of the penalty range under the federal sentencing guidelines as a result of its cooperation. The DOJ and Tower agreed that the low end of criminal penalties under the sentencing guidelines would have been \$32,593,849, equating to the pecuniary loss suffered by the alleged victims of Tower's violation, and therefore the 25% reduction for cooperation credit reduced the fine to \$24.4 million.

The DOJ's agreement to charge only one count of the criminal commodities fraud statute, and not also charge criminal violations of the CEA provisions that were the basis for the CFTC's civil penalties, likely saved Tower from an assessment of a higher base penalty under the guidelines before the 25% reduction was applied.

The DPA based the reduction of the criminal penalty on the following:

- Tower receiving full credit for cooperation, which included:
 - Providing regular presentations to the government of all facts known to it;

- Voluntarily making employees available for interviews; and
- Collecting, analyzing and organizing voluminous evidence.
- Tower implementing extensive remedial measures which included:
 - Swiftly terminating the three traders involved in the alleged spoofing;
 - Enhancing Tower's compliance program and internal controls to deter spoofing and fraud;
 - Making substantial investments in staffing and resources for the legal and compliance teams;
 - Updating procedures with an emphasis on the prohibition against spoofing; and
 - Expanding and enhancing Tower's compliance program and training to all traders and the dissemination of bulletins and alerts on regulatory compliance issues and developments.
- Tower had no criminal history.
- Tower had resolved the matter with the CFTC.
- Tower committed to ongoing cooperation.

Application of Restitution Payments Toward a Class Action Settlement

The DPA provides that the fraud section of the DOJ's Criminal Division and the U.S. Attorney's Office for the Southern District of Texas have discretion to determine whether any portion of the restitution paid pursuant to the DPA for victims shall be used to pay class members in full or partial satisfaction of any settlement or judgment in any class action based on the same or similar allegations. The DPA, however, also provides that no portion of the funds shall be paid for attorney fees in any class action.

CFTC Exemption of Tower from Disqualification From Private Securities Offerings

In the past, companies entering into settlements with the CFTC that wished to rely on SEC Rule 506 of Regulation D after the settlement to make exempt private securities offerings have conditioned settlement offers on receiving a waiver from the CFTC from being disqualified from reliance on Rule 506 pursuant to the SEC's bad actor rule in SEC Rule 506(d)(1)(iii)(B).

As in Tower, the CFTC generally has been willing to grant such waivers. But the views expressed by Berkovitz and Behnam with respect to the CFTC's order indicates less certainty in that area in the future.

SEC Rule 506 of Regulation D provides the requirements to qualify for an exemption. The SEC's bad actor rule in SEC Rule 506(d)(1)(iii)(B) provides that any issuer will be disqualified from relying on the exemption under Rule 506 if, among other things, the issuer is subject to a final order of the CFTC based on a violation of any law or regulation that

prohibits fraudulent, manipulative, or deceptive conduct entered within 10 years of a securities sale.

SEC Rule 506(d)(2), however, provides that such disqualification will not apply if the regulatory authority that entered the order (here, the CFTC) advises the SEC in writing that disqualification should not arise as a consequence of the order.

Berkovitz dissented from the CFTC's waiver determination based on his legal analysis that the CFTC does not have authority to exempt anyone from SEC Rule 506(d)(1), because no statute confers that authority on the CFTC or authorizes the SEC by rule to confer such authority on the CFTC. In short, Berkovitz takes the position that the waiver from disqualification is *ultra vires*.

Behnam, in a separate concurrence, expressed his extreme reservation that the CFTC should provide such waivers. He opined:

[Given] the gravity of Tower's actions, which involved unprecedented levels of spoofing, I am not comfortable advising the SEC that the automatic disqualification should not apply. In instances of this magnitude, where fraud and abuse harmed market integrity and market participants, the SEC should be the sole authority regarding whether or not a waiver should result.

He further explained that there is no need for the CFTC to make such a determination in a settlement order because the determination can await until Tower wishes to make an exempt offering and that:

[The] SEC is best suited to issue waivers to its market participants from its rule; not the Commission. In this instance, where Tower has not previously been required to register with the CFTC or the SEC, there is ample time for the SEC to consider whether the CFTC's action against Tower today should result in automatic disqualification.

Elements of an Effective Corporate Compliance Program

Attachment C to the DPA sets forth the requirements Tower must meet to establish a compliance program that is compliant with the DPA. This serves as a useful compendium of the elements of a satisfactory commodity trading compliance program. Those elements include:

- Ensuring that the company's governing body and senior management provide strong, explicit and visible support and commitment to its policy against violations of the commodities laws and the company's compliance code;
- Developing and promulgating clearly articulated and visible corporate policies against violations of the commodities laws in a written compliance code;
- Taking appropriate measures to encourage and support the observance of ethics and compliance policies and procedures against violation of the commodities law by personnel at all levels of the company;
- Developing policies and procedures on the basis of periodic risk assessments and no less than annually reviewing and updating them as appropriate to ensure their continued effectiveness;

- Assigning responsibility to one or more senior corporate executives for the implementation and oversight of the company's compliance code, policies and procedures; authorizing the corporate official to report to the company's controlling body or an appropriate committee of them; and providing the official with an adequate level of autonomy from management, as well as sufficient resources and authority to maintain such autonomy;
- Maintaining appropriate mechanisms for periodic training for all company personnel that require such training (e.g., all members of an LLC and officers, all employees in positions of leadership or trust, all traders, internal audit, sales, legal, compliance and finance);
- Requiring certifications from all such personnel of their compliance with the training requirements;
- Maintaining an effective system for providing guidance to all personnel on complying with the company's compliance code and policies and procedures, including when they need advice on an urgent basis;
- Maintaining an effective system for internal and, where possible, confidential reporting by personnel concerning violations of the law or the company's compliance code, policies and procedures and for protection of such reporting personnel;
- Maintaining an effective and reliable process with sufficient resources for responding to, investigating and documenting violations;
- Maintaining mechanisms designed to effectively enforce its compliance code, policies and procedures, including appropriately incentivizing compliance and disciplining violations;
- Maintaining appropriate disciplinary procedures to address violations and take reasonable steps to reason remedy harm from misconduct and prevent further misconduct; and
- Maintaining an effective trade surveillance program capable of detecting trading activity that has indicia of fraudulent, manipulative, or otherwise unlawful misconduct.

Conclusion

In announcing the Tower case, CFTC Chairman Heath Tarbert noted that "the CFTC will be tough on those who break the rules."

Similarly, Special Agent in Charge Emmerson Buie of the FBI's Chicago Field Office reminded market participants that the FBI will "continue to work with its prosecutorial partners to safeguard the market from unlawful influence and hold violators accountable."

These statements, as well as the CFTC's "continued importance ... on parallel efforts with ... law enforcement partners" should remind futures traders that they can face both civil and criminal liability for their conduct.

Market participants should take immediate steps to ensure that appropriate policies and procedures are in place — and followed — that minimize the possibility for employees to engage in conduct that could result in monetary and reputational harm to their firms.

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[1] The monetary sanctions are apportioned among approximately \$32.5 million in payment for restitution of victim's losses, \$10.5 million for disgorgement of ill-gotten gains, and \$24.4 million for criminal/civil penalties.

[2] 7 U.S.C. § 6c(a)(5)(C).

[3] The specific contracts included the E-mini S&P 500 and E-mini NASDAQ 100 futures contracts traded on the CME and the E-mini Dow (\$5) futures contract traded on the CBOT. In 2018, two of the traders entered guilty pleas for conspiracy to engage in wire fraud, commodities fraud and spoofing, and the third has been indicted and the case remains pending.

[4] U.S. v. Tower Research Capital LLC, Criminal No. 19-cr-819 (S.D. Tex.). Available at <https://www.justice.gov/opa/press-release/file/1215851/download>.

[5] 7 U.S.C. § 9(1).

[6] 17 C.F.R. § 180.1(1) and (3). In the Matter of Tower Research Capital LLC, CFTC Doc. No. 20-06 (Nov. 6, 2019).

[7] 17 C.F.R. § 230.506(d)(l) (2019).

[8] Dissenting Statement of Commissioner Dan M. Berkovitz, In re Tower Research Capital LLC: Waiver of SEC "Bad Actor" Disqualifications, available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement110719>.

[9] Statement of Commissioner Rostin Behnam Regarding Tower Research Capital LLC, available at <https://www.cftc.gov/PressRoom/SpeechesTestimony/behnamstatement110719>.

[10] Tower entered into the settlement with the CFTC without admitting or denying the CFTC's findings and conclusions in its settlement order, except to the extent that Tower admitted any finding in any related action against Tower by, or any agreement with, DOJ or any other governmental agency or office. The CFTC order also provides that Tower does not consent to the use of Tower's Offer of Settlement or the CFTC's Order, or the findings and conclusions in the Order, "by any other party in any other proceeding." This might prove relevant to Tower with respect to a pending putative class action against it in

the U.S. District Court for the Northern District of Illinois concerning the same trading activity. *Boutchard v. Gandhi, et al.*, No. 18-cv-7041 (N.D. Ill.).

[11] Criminal Information at paragraph 6.

[12] *Id.* at paragraph 7.