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# The Flash Crash Case Against Sarao—Will The CFTC Prevail?

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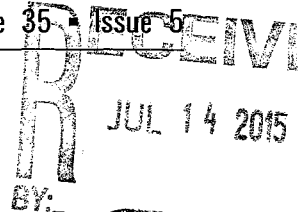
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## CUTTING BACK: REVISIONS TO DODD- FRANK DERIVATIVES RULES

By Gary E. Kalbaugh and Alexander F. L. Sand

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### I. Introduction

From the onset of the Financial Crisis until recently the prevailing winds have blown mostly in one direction: toward greater regulation of the off-exchange derivatives market. Emblematic of this trend is the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), passed in 2010, which President Obama described as “reform [that] will . . . rein in the abuse and excess that nearly brought down our financial system. [Dodd-Frank] will finally bring transparency to the kinds of complex and risky transactions that helped trigger the financial crisis.”<sup>1</sup>

The Commodity Futures Trading Commission (“CFTC”), under the direction of Gary Gensler, did much to carry out this mandate. As of December 31, 2014, the CFTC had finalized 50 rules required to be promulgated under Dodd-Frank, more than any other single regulator.<sup>2</sup> In addition to promulgating rules mandated by Dodd-Frank, the CFTC under

Gensler provided a vocal pro-regulatory cultural vision. For example, a few months prior to passage of Dodd-Frank, he argued:

In the last three decades, the over-the-counter derivatives marketplace has grown up. It is certainly no longer in its embryonic stage, but it remains unregulated. From total notional amounts of less than \$1 trillion in the 1980s, the notional value of this market has ballooned to more than \$300 trillion in the United States - that’s more than 20 times the size of the American economy; the contracts have become much more standardized; and rapid advances in technology - particularly in the last ten years - facilitate more efficient trading. While so much of this marketplace has changed significantly, the constant has been that it is still dealer-dominated.

When a corporation or another end-user wants to hedge a risk, they go to their bank and get a price quote. When they enter into transactions, those transactions largely stay on the books with their banks. The price is not discovered on transparent trading venues, such as exchanges, and the risk is not transferred from the dealer’s books to a central clearinghouse. This leaves significant risk in the system, risk that a year ago was borne by the taxpayers in the form of the largest financial bailout in history.

Much like the debate after the last great crisis in the 1930s about potential regulation for both

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the futures and the securities markets, we are now debating whether the over-the-counter derivatives market should be regulated. While the recent crisis seems to have eased and many banks are repaying TARP money, I believe that we still must enact regulatory reform to promote transparency and reduce risk in the evolving over-the-counter derivatives markets.<sup>3</sup>

Recently, however, these pro-regulatory winds have shifted and several notable provisions of the Dodd-Frank Act have been significantly scaled back, including provisions that were centerpieces of the original Act. In the futures and derivatives context, the most significant of these changes are the effective repeal of section 716 of the Dodd-Frank Act (the "Swap Push-Out Rule") and alteration of the margin requirements for swap dealers and major swap participants. Additionally, deadlines for complying with portions of section 619 of the Dodd-Frank Act (the "Volcker Rule"<sup>4</sup>) and for non-US swap dealers to comply with transaction-level swap requirements were significantly extended. Whether these rollbacks represent a targeted tailoring of the Dodd-Frank regulatory framework or signify a broader change in regulatory climate is yet to be seen.

This article will survey the affected rules and how they have changed. Section II of this article will focus on the Swap Push-Out Rule, Section III will discuss

the commercial end-user exemption to the margin requirements for uncleared swaps, Section IV will discuss postponements to the implementation of the Volcker Rule, Section V will discuss the expanded relief with respect to covered funds transactions for parties using the "solely outside the United States" exemption to the Volcker Rule, and Section VI will discuss relief with respect to CFTC transaction-level swap requirements.

## II. Swap Push-Out Rule

Section 716 of the Dodd-Frank Act (known as the "Swap Push-Out Rule"), as originally passed, prohibited entities engaged in many swaps activities from receiving federal assistance, effectively requiring swap trading operations to be pushed out from bank entities into non-bank affiliates. Specifically, banks significantly engaged in swaps activity would be unable to offer Federal Deposit Insurance Corporation ("FDIC") insurance<sup>5</sup> to their depositors or to access the Federal Reserve Discount Window.<sup>6</sup> Significant exceptions were provided for insured depository institutions engaged in interest rate and foreign exchange swaps, credit default swaps referencing an asset national banks were permitted to invest in, and any other swap entered into as a hedge against risk.<sup>7</sup> Nonetheless, the law had the effect of requiring non-bank affiliates of banks to engage in many swaps transactions in which the bank would otherwise engage.

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Risk Mitigation Act's provisions exempting commercial end-users from margin requirements apply equally to captive finance companies and, so long as the CFTC continues to exclude small banks from the definition of a "financial entity," small banks. Note that the Commodity Exchange Act requires the CFTC to "consider" excluding small banks from the definition of a "financial entity." Commodity Exchange Act § 2(h)(7)(C)(ii).

<sup>40</sup>Letter from The Coalition for Derivatives End-Users, Re: End-User Support for End-User Provisions in the Promoting Job Creation and Reducing Small Business Burdens Act (H.R. 37), January 6, 2015, available at <http://www.nam.org/Issues/Corporate-Finance-Management/Coalition-for-Derivatives-End-Users-Supports-CTU-Fix-in-Rep-Fitzpatrick-Bill.pdf>.

<sup>41</sup>Remarks by the President on Financial Reform.

<sup>42</sup>Hearing Before the Committee on Banking, Housing and Urban Affairs, Prohibiting Certain High Risk Investment Activities by Banks and Bank Holding Companies: Statement of Paul Volcker, S. Hrg. 11-771, Feb. 2, 2010. The federal agencies tasked with promulgating regulations implementing the Volcker Rule were the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the CFTC.

<sup>43</sup>See Federal Reserve Board, Order Approving Extension of Conformance Period Under Section 13 of the Bank Holding Company Act, Dec. 18, 2014, available at <http://www.federalreserve.gov/newsevent/press/bcreg/bcreg20141218a1.pdf>.

<sup>44</sup>See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Fund and Private Equity Funds, 79 Fed. Reg. 5536; 79 Fed. Reg. 5808; Federal Reserve Board, Order Approving Extension of Conformance Period.

<sup>45</sup>See Statement Regarding the Treatment of Collateralized Loan Obligations Under Section 13 of the Bank Holding Company Act, April 7, 2014, available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140407a1.pdf>.

<sup>46</sup>Order Approving Extension of Conformance Period at 4.

<sup>47</sup>See 12 U.S.C. §§ 1851(d)(1)(H) & (I); 12 C.F.R. § 248.13(b).

<sup>48</sup>12 C.F.R. § 248.13(b)(1).

<sup>49</sup>12 C.F.R. § 248.13(b)(1)(iii).

<sup>50</sup>Federal Reserve Board, Volcker Rule Frequently

Asked Questions, Feb. 27, 2015, available at <http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#13>.

<sup>51</sup>A "swap dealer" is defined as any person who: (1) holds itself out as a dealer in swaps, (2) makes a market in swaps, (3) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (4) engaged in any activity causing the person to be known in the trade as a dealer or market maker in swaps. Commodity Exchange Act § 1a(49). However, entities engaging in de minimis swap dealing activity are excepted from the definition. Commodity Exchange Act § 1a(49)(D).

<sup>52</sup>CFTC, Factsheet: Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/crossborder\\_factsheet\\_final.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/crossborder_factsheet_final.pdf). Entity-level requirements relate to: (1) capital adequacy, (2) chief compliance officer, (3) risk management, (4) swap data record-keeping, (5) swap data reporting, and (6) large trader reporting requirements. *Id.*

<sup>53</sup>CFTC Staff Advisory No. 13-69, Applicability of Transaction-Level Requirements to Activity in the United States, at p. 2, Nov. 14, 2013, available at <http://www.cftc.gov/ucm/groups/public/lrlettergeneral/documents/letter/13-69.pdf>.

<sup>54</sup>CFTC No-Action Letter 14-140, Extension of No-Action Relief: Transaction-Level Requirements for Non-U.S. Swap Dealers, Nov. 14, 2014, available at <http://www.cftc.gov/ucm/groups/public/lrlettergeneral/documents/letter/14-140.pdf>.

<sup>55</sup>*Id.*

<sup>56</sup>*Id.*

## THE FLASH CRASH CASE AGAINST SARAO—WILL THE CFTC PREVAIL?

*By Professor Ronald Filler and Professor Jerry W. Markham*

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## Introduction

On May 6, 2010, the so-called Flash Crash Day, the prices of e-mini S&P 500 futures contracts, the S&P 500 SPDR and other equity products dramatically dropped in value, followed by an almost immediate recovery. Some \$600 billion in market value disappeared briefly, and the Dow Jones Industrial Average plunged nearly 1000 points within a few minutes before its recovery.<sup>1</sup> We will refer to the May 6, 2010 market freefall simply as the "Flash Clash"

although several other names have been used for that event.

A joint-study of the Flash Crash by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) resulted in a report that largely blamed the event on a faulty order entered by Waddell & Reed, a large mutual fund complex. The Joint CFTC/SEC Report stated that:

"May 6 started as an unusually turbulent day for the markets. . . . Around 1:00pm, broadly negative market sentiments was already affecting an increase in the price volatility of some individual securities. . . . By 2:30pm, the S&P 500 volatility index was up 22.5 percent from the opening level, yields of ten-year Treasuries fell as investors engaged in a 'flight to quality,' and selling pressure had pushed the Dow Jones Industrial Average ("DJIA") down about 2.5%. . . . At 2:32pm, against this backdrop of unusually high volatility and thinning liquidity, a large fundamental trader (a mutual fund complex) initiated a sell program to sell a total of 75,000 E-Mini contracts (valued at approximately \$4.1 billion) as a hedge to an existing equity position. . . . This large fundamental trader chose to execute this sell program via an automated execution algorithm ("Sell Algorithm") that was programmed to feed orders into the June 2010 E-Mini market to target an execution rate set to 9% of the trading volume calculated over the previous minute, but without regard to price or time. . . . However, on May 6, when markets were already under stress, the Sell Algorithm chosen by the large trader to only target trading volume, and neither price nor time, executed the sell program extremely rapidly in just 20 minutes. . . ."<sup>2</sup>

The CME Group conducted its own study of the Flash Crash and issued a statement that objected to the blame placed on Waddell & Reed by the Joint CFTC/SEC Report.<sup>3</sup> The CME noted that Waddell & Reed's orders were only a small part of the volume of related trades and that traders paid little attention to those orders.

Nanex, a market data provider, also analyzed data from the Flash Crash and suggested that high-frequency traders (HFTs) might have been trying to

outsmart each other's computers with massive amounts of orders that were not intended to be filled. It further suggested that HFTs might also have been trying to paralyze the exchanges with massive orders in order to obtain an advantage over other traders.<sup>4</sup> Another analysis of the trading data by a group of economists concluded that HFTs did not trigger the crash but that their responses to the abnormally large sell orders may have worsened the situation.<sup>5</sup>

The Congressional Research Service also examined the Flash Crash and other high frequency trader concerns. Its report noted this differences in opinions on the reason for the Flash Crash, but did not seek to resolve those differences.<sup>6</sup> The CFTC seemingly stuck to its guns on what caused the Flash Crash for over four years. Therefore, it came somewhat of a surprise when the CFTC announced on April 21, 2015 that it had filed a lawsuit against a London trader and his firm in which it blamed those defendants as having materially contributed to the Flash Crash through "spoofing" orders that the trader entered from his parents' modest home in a London suburb.<sup>7</sup>

This article will examine, among other things, (1) the allegations set forth in the CFTC Complaint; (2) the theories of liability covering both the pre-Dodd-Frank Act<sup>8</sup> period and the post Dodd-Frank Act period; (3) how these differing theories of liability compare to other CFTC cases; and (4) whether the CFTC will prevail in this case against the defendants.

### Allegations in the CFTC Complaint

The CFTC's Complaint against the London trader and his firm (Navinder Singh Sarao and Nav Sarao Futures Limited (collectively, the "Defendants" or "Sarao")) charges those Defendants with unlawfully manipulating, attempting to manipulate and "spoofing," all with respect to the e-mini S&P futures contract.<sup>9</sup> Judge Wood of the U.S. District Court for the Northern District of Illinois issued an Order Granting the CFTC's Ex Parte Motion for Statutory Re-

straining Order and Other Relief on April 21, 2015.<sup>10</sup> Also, on April 21, 2015, the U.S. Department of Justice filed a Criminal Complaint against Sarao.<sup>11</sup>

The CFTC Complaint had been kept under seal since April 17, 2015 and was released on April 21, 2015, when Sarao, a UK resident, was arrested by UK authorities at the request of the U.S. Department of Justice.<sup>12</sup> The Complaint, which will be discussed in greater detail below, covers trading by the Defendants in the e-mini S&P 500 stock index futures contract for the period of April 2010 through April 6, 2015, during which time the Defendants utilized a "Layering" Algorithm on over 400 different trading days.<sup>13</sup> Accordingly, the CFTC is alleging fraudulent trading by the Defendants covering both pre-and post-Dodd Frank Act standards of liability.

The CFTC asserts, in essence, that the Defendants engaged in a massive effort to manipulate the CME's e-mini S&P 500 futures contracts (hereinafter referred to as "S&P e-minis") by "utilizing a variety of exceptionally, large aggressive, and persistent spoofing tactics" and that Defendants "schemed to design an automated system to manipulate the E-mini S&P price to their benefit."<sup>14</sup> The Complaint further alleges that "Defendants' actions caused artificial prices to exist in the intra-day price of the lead month of the E-mini S&P" on at least twelve trading days during the five year period.<sup>15</sup> To achieve this manipulative trading activity, the CFTC Complaint alleges that:

"Defendants utilized an automated 'layering' algorithm (the Layering Algorithm) that typically simultaneously layered four to six exceptionally large sell orders into the visible E-mini S&P central limit order book (Order Book). Each sell order was one price level from the next, generally beginning at least three or four price levels from the best asking price in the Order Book. As the market price moved, Defendants' Layering Algorithm automatically simultaneously moved the large sell orders, resulting in the orders remaining at least three or four price levels from the best asking price in the Order Book. This caused the orders to remain visible to other market participants in the Order Book,

with very little risk of the sell orders resulting in a consummated trade because each order was several price levels above the best asking price.”<sup>16</sup>

The CFTC alleges that the Defendants “placed hundreds of orders for tens of thousands of contracts that were modified thousands of times and eventually canceled over 99% without ever resulting in a trade.”<sup>17</sup> Also, the CFTC alleges that the Defendants “‘flashed’ large lot orders in a variety of lot sizes in the Order Book that were quickly canceled with no intention of these orders resulting in trades (Flash Spoofing),” although some orders were executed<sup>18</sup> As a result of these trading tactics, the CFTC Complaint alleges that the Defendants “traded on average \$7.8 billion in notional value, resulting in daily profits averaging approximately \$530,000. Defendants profited approximately \$6.4 million on the twelve” days noted above, and \$40 million in total.<sup>19</sup>

The most interesting of the various CFTC allegations is that Defendants used their trading strategies on May 6, 2010, the so-called Flash Crash Day, to create artificial prices. In support of this allegation, the CFTC alleges:

“Defendants first turned on the Layering Algorithm at 9:20am CT, placing four orders totaling 2,100 contracts. These orders were each one tick apart, starting three ticks away from the best ask. The orders were modified 604 times over the following six minutes so the orders were always at the third level of the sell-side of the order book or deeper, and then canceled with no executions, as the layering Algorithm was turned off. . . . While the first cycle of the Layering Algorithm was active, Defendant bought 1,606 contracts and sold 1,032 contracts.

At 11:17am CT, Defendants turned the Layering Algorithm on for more than two consecutive hours, until 1:40pm CT. During this cycle, Defendants utilized the Layering Algorithm to place five orders, totaling 3,000 contracts. A sixth order was added at around 1:13pm CT, increasing the total to 3,600 contracts.

Between 11:17am CT and 1:40pm CT, Defendants actions contributed to an extreme order book imbalance in the E-mini S&P market. That order book imbalance

contributed to market conditions that caused the E-mini S&P price to fall 361 basis points.”<sup>20</sup>

As a result of the Defendants’ trading schemes, the CFTC has alleged that the Defendants violated the CEA as follows:

1. Count One: Sections 6(c)<sup>21</sup> and 9(a)(2)<sup>22</sup> of the Commodity Exchange Act (“CEA”) for the period prior to August 15, 2011 and CFTC Regulation 180.2<sup>23</sup> for the period after August 15, 2011 for manipulating the E-mini S&P futures contract.
2. Count Two: Sections 6(c)(3)<sup>24</sup> and 9(a)(2)<sup>25</sup> of the CEA for the period prior to August 15, 2011 and Sections 6(c)(3), 9(a)(2) and 13(a)(2)<sup>26</sup> of the CEA and CFTC Rule 180.2 for the period after August 15, 2011 for attempting to manipulate the E-mini S&P market.
3. Count Three: Section 4c(a)(5)(c)<sup>27</sup> of the CEA for spoofing of the E-Mini S&P futures contract for the period of July 16, 2011 to the present.
4. Count Four; Sections 6(c)(1)<sup>28</sup> and 9(c)(1)<sup>29</sup> of the CEA and CFTC Rule 180.1<sup>30</sup> for use of manipulative devices in connection with trading the E-mini S&P futures contract.<sup>31</sup>

The CFTC Complaint seeks a host of remedies, including civil penalties of the greater of \$140,000 or three times the monetary gain from each of the thousands of alleged violations of the CEA.<sup>32</sup>

### **Allegations in the Criminal Complaint**

The Department of Justice (DOJ) alleged most of the same facts set forth in the CFTC Complaint through an Affidavit of Gregory LaBerta, a Special Agent of the Federal Bureau of Investigation (“FBI”).<sup>33</sup> What is interesting is that the Laberta Affidavit refers to a “consulting group” that assisted the DOJ in connection with its investigation and filing of the criminal complaint but this firm is not identified in

the Affidavit. The Affidavit stated that this Consulting Group determined that:

1. Sarao “typically executed a series of trades to exploit his own manipulative activity by repeatedly selling futures contracts only to buy them back at a slightly lower price.”
2. The Consulting Group “examined over 400 days on which Sarao traded E-Minis between April 2010 and April 2014 . . . and found that Sarao used the dynamic layering technique on approximately 63 percent of those days.”
3. Sarao also repeatedly used a different trading technique “188- and/or 289-lot orders on the sell side of the market, nearly all of which he canceled before the orders were executed” to “intensify the manipulative effects of his dynamic layering technique.”
4. Sarao used a third trading technique whereby he “flashed a large 2,000-lot order on one side of the market, executed an order on the other side of the market, and canceled the 2,000-lot order before it was executed.”<sup>34</sup>

LaBerta also stated that he spoke with another expert, who was not identified, who reviewed the analyses done by the Consulting Group and opined that Sarao’s “dynamic layering technique affected the market price of the E-Minis during that time period, creating artificial prices.”<sup>35</sup>

The Criminal Complaint, like the CFTC Complaint, alleges that Sarao’s actions contributed to the Flash Crash.<sup>36</sup> In particular, based on analyses done by the Consulting Group and the other expert, it was asserted that Sarao contributed to the order-book imbalance, and was thus a cause of the Flash Crash.<sup>37</sup>

The Criminal Complaint charges wire fraud (18 U.S.C. § 1343); criminal commodity fraud (18 U.S.C. § 1348); criminal manipulation under the CEA (7

U.S.C. § 13(a)(2)); and criminal spoofing (7 U.S.C. §§ 6(a) and 13(a)(2)).<sup>38</sup> Those charges carry a maximum of 380 years in prison if Sarao is convicted on all counts and given consecutive sentences. In the meantime, Sarao was unable to raise money for bail because his assets were frozen worldwide by U.S. authorities.<sup>39</sup>

### Comparing the Old and the New Theories

The CFTC’s Complaint against Sarao contains charges of: (1) actual and attempted price manipulation in violation of provisions of the CEA that existed before it was amended by the Dodd-Frank Act in 2010;<sup>40</sup> (2) manipulation under amendments added by Dodd-Frank;<sup>41</sup> and (3) “spoofing” violations under another provision added by Dodd-Frank.<sup>42</sup> The following is an analysis of the elements required to prove each of those charges.

#### Old School Anti-Manipulation Authority

The original anti-manipulation prohibitions contained in the CEA, when it was enacted in 1936, were at the very heart of the effort by Congress to regulate the commodity futures markets. However, the CEA failed to define what it meant by manipulation. It was, therefore, left to the government and the courts to define the term.<sup>43</sup> They came up with a four-part test that requires the following elements to be proved in order to establish an actual commodity price manipulation:

1. The trader had the ability to influence market prices;
2. The trader specifically intended to create an artificial price;
3. An artificial price occurred; and
4. the trader caused the artificial price.<sup>44</sup>

In an attempted manipulation case, the CFTC has



asserted that it need only prove specific intent through some overt act that was intended to be manipulative.<sup>45</sup>

The elements of manipulation and attempted manipulation under this pre-Dodd Frank authority are very difficult to prove. Indeed, while obtaining numerous settlements, the CFTC has won only one adjudicated manipulation case in its forty-year history.<sup>46</sup>

The reasons for this difficulty are many. For example, prominent economists testifying as experts on whether a price was artificial often disagree on that issue. Regression analysis by those experts, such as the one filed by the CFTC in support of the Sarao complaint,<sup>47</sup> are difficult for a fact finder to understand and subject to attack by other experts. In proving that a defendant caused an artificial price, opposing experts may disagree over whether the price was actually artificial. Expert economic analysis claiming that the defendant caused an artificial price is often subject to criticism for failing to account for every factor that might have affected the price.<sup>48</sup>

The intent requirement in the old CEA manipulation definition is even more problematic. The CFTC has held that “the requisite level of *mens rea* required to prove manipulation or attempted manipulation under the Commodity Exchange Act is that of ‘specific intent,’ or as that term is also commonly understood to mean today, ‘purposeful conduct.’”<sup>49</sup>

The CFTC Complaint alleges that the trading at issue was intended to move market prices so that Defendants could profit. However, the fact that a trader is seeking to move prices in one direction or another is not itself sufficient proof of manipulative intent. As the district court held in *CFTC v. Delay* in a similar context:

Simply stated, it is not a violation of the statute to report feeder cattle sales to the USDA with the intention of moving the CME index up or down—rather, to be unlawful, the reported sales must be sham or nonexistent transactions, or the reports must be knowingly false or misleading. In this case, it turns out that the sales were real and the reports were true.<sup>50</sup>

In this case, as described below, Sarao will undoubtedly argue that his trades were real ones because he was at market risk.

### New School Anti-Manipulation Authority

The CFTC’s claims under the new Dodd-Frank anti-manipulation authority also face some formidable obstacles. The language in that provision was borrowed from Section 10(b) of the Securities Exchange Act of 1934 (“34 Act”), which prohibits any “manipulative or deceptive device or contrivance.”<sup>51</sup> Under familiar canons of statutory construction, this means that this new language in the CEA will be interpreted in the same manner as it has been under the 34 Act.<sup>52</sup>

The Supreme Court held in *Ernst & Ernst v. Hochfelder*<sup>53</sup> that the use of the word “manipulative” in Section 10(b) of the 34 Act was “especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”<sup>54</sup> Later, as it did in the *Hochfelder* case, the Supreme Court in *Santa Fe v. Green*,<sup>55</sup> defined the term manipulation for purposes of Section 10(b) to refer “generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.”<sup>56</sup>

This same approach has been taken in criminal cases charging Section 10(b) violations. In *United States v. Mulheren*,<sup>57</sup> the Second Circuit set aside the conviction of the chief trader for a broker-dealer on manipulation charges brought under Section 10(b). That trader, John Mulheren, had been told by Ivan Boesky that a particular stock was a good buy and that it “would be great” if it traded at \$45, a price that would benefit Boesky’s holdings. Mulheren then entered an order for the stock at that price. The Second Circuit held that this conduct was too ambiguous to

support a manipulation charge because there was no evidence of trading practices commonly associated with manipulation, *e.g.*, wash trades.

The decision in the *Mulheren* case gave rise to a debate over whether “open market” trades, *i.e.*, *bona fide* orders that are subject to market risk, cannot be manipulative because they are real trades, as opposed to wash trades, matched trades, or other rigged trades.<sup>58</sup>

Subsequently, in *ATSI Communications Inc. v. The Shaar Fund Ltd.*,<sup>59</sup> the defendants were charged with engaging in a “death spiral” strategy in which they sold short to drive down prices and then covered their short position with securities bought at the lower prices set by their own short sales. The Second Circuit held that manipulation under Section 10(b) requires a showing that the defendant “engaged in market activity aimed at deceiving investors as to how other market participants have valued a security.”<sup>60</sup> The inquiry that must be made is to determine “whether trading activity sends a false pricing signal to the market.”<sup>61</sup> In that regard, the Court gives some assistance to the Sarao Defendants because it held that short selling in large volume to the distress of other market participants is not in and of itself actionable. Rather, to be manipulative, the short sales had to be willfully combined with some other activity that created a false impression of how market participants were valuing the security.<sup>62</sup>

Less helpful to the Sarao Defendants is a decision by the District of Columbia Court of Appeals in *Markowski v. SEC*,<sup>63</sup> where the open market trade defense was rejected. There, the defendants were supporting the price of a stock through real bids and offers. The Court noted the debate over whether open market trades could ever be manipulative, but concluded that the SEC’s *contra* position was not unreasonable, at least under the circumstances of that case. However, the Court noted that, in the absence of fictitious trades, it could be difficult to “separate a ‘ma-

nipulative’ investor from one who is simply overenthusiastic, a true believer in the object of investment. Both may amass huge inventories and place high bids, even though there are scant objective data supporting the implicit estimate of the stock’s value.”<sup>64</sup> In such circumstances, legality would “depend entirely on whether the investor’s intent was ‘an investment purpose’ or ‘solely to affect the price of [the] security.’”<sup>65</sup> Here, Sarao claims the former as his motive.

In any event, there are other defenses available to Sarao. The 34 Act language was borrowed by Dodd-Frank in order to reduce the CFTC’s burden to prove manipulative intent.<sup>66</sup> However, it is not entirely clear that the burden will be much different under the new provision. The Supreme Court held in *Ernst & Ernst v. Hochfelder*<sup>67</sup> that scienter must be proven in order to prove a claim brought under Section 10(b), *i.e.*, that the defendant acted with a mental state embracing intent to deceive, manipulate, or defraud.<sup>68</sup> This sounds like a specific intent requirement.

The Supreme Court has not further defined the standard for scienter under Section 10(b), but the lower courts have concluded that “reckless” conduct is sufficient to establish the requisite intent. However, that is still a high standard of proof of intent. The Seventh Circuit, which is the circuit where the *Sarao* case is lodged, has defined reckless conduct under Section 10(b) as a “highly unreasonable [act or] omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.”<sup>69</sup> This is a very high standard of intent and the difference between that standard and the specific intent required under the pre-Dodd-Frank anti-manipulation authority is apparently slight.<sup>70</sup>

### The New Spoofing Authority

The spoofing prohibition cited in the CFTC Com-

plaint against the Defendants was also added by Dodd-Frank. That provision prohibits any transaction that “is, is of the character of, or is commonly known to the trade as, “spoofing” (bidding or offering with the intent to cancel the bid or offer before execution).”<sup>71</sup>

The CFTC contends that Defendants placed hundreds of thousands of orders for the E-mini S&P futures contract in the near-month with the “intent” of cancelling those orders before execution.<sup>72</sup> Again, this raises the issue of the degree and nature of the required intent because, as noted below, Saro contends that he was engaged in a bona fide market strategy that required frequent cancellations.

The CFTC issued an interpretive guidance and policy statement after the anti-spoofing provision was added to the CEA by Dodd-Frank in which it addressed the issue of intent in spoofing cases.<sup>73</sup> The CFTC stated that a trader must be shown to:

“act with some degree of intent, or *scienter*, beyond recklessness to engage in the ‘spoofing’ trading practices prohibited by CEA section 4c(a)(5)(C). Because CEA section 4c(a)(5)(C) requires that a person intend to cancel a bid or offer before execution, the Commission does not interpret reckless trading, practices, or conduct as constituting a spoofing violation. Additionally, the Commission interprets that a spoofing violation will not occur when the person’s intent when cancelling a bid or offer before execution was to cancel such bid or offer as part of a legitimate, good-faith attempt to consummate a trade.”<sup>74</sup>

This specific intent requirement will be difficult to meet.

The CFTC interpretive statement also stated that spoofing would occur where a party submitted or canceled bids or offers with the intent to create artificial price movements upwards or downwards.<sup>75</sup> This raises the issue of whether Defendants thought they were responding to market changes or whether they were seeking to create such price changes artificially.

This new spoofing authority has been attacked in

another criminal case, *United States v. Coscia*,<sup>76</sup> as being void for vagueness. Although the district court rejected that claim in that case, it may have some credence on appeal.<sup>77</sup> The word “spoofing” is certainly a vague term. It appears to have originated as the name of a card game invented by a comedian in the 1880s. It was also later used as a term to describe a harmless hoax or gentle mocking of another person.<sup>78</sup>

Spoofing appears to have been applied in the first instance in financial markets to a form of an Internet scam. The spoofer in those cases sent out mass emails with false originating addresses in an effort to manipulate the price of a stock. For example, a blast email would be sent out that falsely indicated that the officer of a public company was publishing information that would have market effect. The perpetrator would trade in advance of the email and profit from the market reaction.<sup>79</sup>

The new use of the term spoofing, *i.e.*, to prohibit orders not intended to be filled, is a far different creature than that originally attacked in the email cases. This suggests that the term can be given any meaning desired by regulators and provides little guidance on what is permitted and what is prohibited. In that regard, the use of the term spoofing in the context of cancelling orders conflicts with other permitted market practices.

Historically “flash” orders, *i.e.*, orders that are flashed and immediately canceled, have long been considered to be permissible because they can attract trading interest to a market.<sup>80</sup> “Pinging” is another permissible practice that involves the entry of an order that is immediately cancelled. These orders are used as a means to determine if there is a trader on the sidelines seeking a better than existing market price. The pinging order seeks to draw out that interest from dark pools or other venues. This is considered a permissible practice because the order may be executed before cancellation. This raises a vagueness issue because there is no clear line between pinging,

flash trades and spoofing.<sup>81</sup> As noted in the *New York Times*:

High-frequency traders often 'ping' different markets by sending orders to gauge interest in a stock, and more than 90 percent are estimated to be canceled. That is not spoofing because there is a chance the order will be filled but illustrates the fine line between accepted practices and illegal conduct.<sup>82</sup>

As the CFTC has also noted with respect to manipulation claims, "a clear line between lawful and unlawful activity is required in order to ensure that innocent trading not be regarded with the advantage of hindsight as unlawful manipulation."<sup>83</sup> That bright line may not exist in the *Sarao* case.

### Prior Cases

There is not a lot of helpful precedent through which to analyze the *Sarao* case under the old CEA manipulation provisions. Manipulation cases brought under that authority tend to be in one of three classes: (1) market power in which the trader has control of supply and a corresponding futures position; (2) false reports of trading activity at artificial price levels; and (3) rigged trades. The *Sarao* case does not fit well into any of those categories.

Presumably, the CFTC will argue that the Defendants' trading was some form of rigged trade, which was the basis for its only success in an adjudicated manipulation proceeding. In that case, *In the Matter of Diplacido*,<sup>84</sup> the Second Circuit in an unpublished opinion, upheld a CFTC administrative decision, which held that a trader engaged in manipulation by "banging the close" with orders that violated the bids and offers of other traders. There does not appear to be any such conduct in this case.

An earlier decision by a hearing officer in the Department of Agriculture, which predated the CFTC, found manipulation where a trader bought up all the orders posted on the close of trading in constant ascending prices and then offered and bought at even

higher prices.<sup>85</sup> This was found to be manipulation but it too does not seem to fit this case.

The CFTC also settled a pre-Dodd-Frank manipulation case by consent in which it charged that the respondent traded on the CME with the intent to "push" the prices of nonfat dry milk futures contracts higher.<sup>86</sup> The respondent was seeking to establish a large short position in those same futures contracts with the hope that the market would then sell off and allow a profit. The CFTC charged that the trader attempted to manipulate futures prices higher by (1) executing trades by 'lifting' offers, and then immediately bidding a higher price than just paid in the trade; (2) placing both bids and offers above prevailing market prices across multiple contract months in order to establish higher price ranges in the market; and (3) consistently placing bids above the opening price or the prevailing price across multiple contracts. This case was based on the premise that traders normally buy low and sell high, while here the trader was allegedly buying high rather than low. This too does not seem to fit the *Sarao* facts. In any event, that case was settled by consent and therefore, may have little precedential effect.

With respect to the "layering" charges under the new Dodd-Frank anti-manipulation authority, the SEC and FINRA have brought actions making such claims under the 34 Act.<sup>87</sup> In a case that was settled by consent, the SEC defined layering/spoofing as follows:

"Layering concerns the use of non-bona fide orders, or orders that the trader does not intend to have executed, to induce others to buy or sell the security at a price not representative of actual supply and demand. More specifically, a trader places a buy (or sell) order that is intended to be executed, and then immediately enters numerous non-bona fide sell (or buy) orders for the purpose of attracting interest to the bona fide order. These non-bona fide orders are not intended to be executed. The nature of these orders is to induce, or trick, other market participants to execute against the initial, bona fide order. Immediately after the execution against the bona fide order, the trader cancels the open, non-bona fide orders, and repeats this strategy on the opposite side of the market to close out the position."<sup>88</sup>

The CFTC brought an earlier layering/spoofing case, which was similar to those brought by the SEC. In *In the Matter of Panther Trading LLC*,<sup>89</sup> the CFTC charged that respondents placed small orders to sell futures that wanted executed, followed quickly by several large buy orders at successively higher prices that they intended to cancel before execution. The buy orders were intended to give the impression that there was significant buying interest that would lift prices. This increased the likelihood that the respondents' small sell order would be executed, raising the likelihood that other market participants would buy from the small order. This process would then be reversed with a small buy order and several sell orders that would be canceled. These cancellations were done very quickly, but the Defendants' order imbalance offers remained open for some time even as they were being adjusted for all the market to see. In any event, the *Panther* case was settled by consent and without any admission of wrongdoing.

Also of interest is CME Rule 575, which prohibits certain disruptive trading practices. Specifically, that rule states that "[n]o person shall enter or cause to be entered an order with the intent, at the time of order entry, to cancel the order before execution or to modify the order to avoid execution." The CFTC complaint states that Sarao is a member of the CME,<sup>90</sup> but that exchange has brought no action against him. Moreover that rule is premised on business principles, not on criminal or statutory manipulation.<sup>91</sup> In contrast, the government is seeking to criminalize such conduct through Sarao and other cases.

### Does the Government Have a Case?

The facts in the *Sarao* case appear to be, in at least some aspects, *sui generis*, which will require a review of those unique facts to determine if the conduct in question was manipulative or intended to be disruptive. The filing of the complaint in CFTC's case against Sarao was accompanied by a Declaration by a CFTC investigator,<sup>92</sup> the Declaration of Professor Ter-

rence Hendershott, a professor at the University of California at Berkeley Business School,<sup>93</sup> and emails from Sarao detailing his trading strategies and giving instructions on how to modify his trading system to accommodate his trading strategies.<sup>94</sup> This documentation allows an unusual opportunity for an analysis of the strength of each party's case before trial.

Sarao will likely argue that his trades were bona fide positions that put him at risk and that he did not have any manipulative intent. Indeed, Sarao so stated to the Financial Conduct Authority (FCA) in London, *i.e.*, "[m]y orders are 100% at risk, 100% of the time."<sup>95</sup> Also, according to the CFTC Complaint, Sarao was a very successful trader who netted profits totaling \$40 million from his trading strategies.<sup>96</sup> If so, this presumably reflects the fact that there was considerable risk in his trading. This is because the amount of risk in an investment or trade is usually commensurate with the possible reward. The CFTC's expert report also concedes that, *albeit* in small amounts, some of the away-from-the-market orders entered by Sarao were actually executed before they could be canceled.<sup>97</sup>

Sarao also documented the reason for his practice of entering and cancelling orders to keep them away from the best bid or offer, which is the crux of the government's case:

"The other orders I sometimes place during the day are slightly away from the market price and move up and down as the market moves with it. This is to catch any blips up/down in the market so that I can make a small profit as the market comes back into line (almost immediately). These orders are placed rarely and only when I believe the market is excessively weak or strong. Again, this was inspired by other traders I could see doing the exact same thing."<sup>98</sup>

This strategy might have had price effect, but all volume traders will affect the market price. Moreover, if taken at his word, Sarao seems to believe that market forces rather than his orders were causing the market correction. This could negate a claim of manipulative intent.

Another wrinkle in this case is the fact that its filing resulted in worldwide headlines because the government in April 2015 charged that Sarao's trading had contributed to the Flash Crash that occurred on May 6, 2010.<sup>99</sup> However, if his trading actually had such a massive destabilizing effect, why did it take the government so long to figure out his role? Instead, the government, after much investigation, initially concluded that its cause lay elsewhere. Further, as noted by the *New York Times*, if Sarao's trading was so destabilizing, and it is charged that he was trading often, why did it not crash the market on other occasions?<sup>100</sup>

Another gap in this case is a failure by the government or its expert to explain why the market dropped simply because Sarao's algorithm kept his order at a given distance from the best bid or offer. The Complaint makes numerous references to the fact that these orders created an imbalance on the sell side, but why did the market react to an order that was keeping a constant distance from better orders? Did the market react the same way for every order imbalance created in this manner? If not, why not? And why did not market participants just ignore the Defendants' orders, which could readily be observed displayed on the order book at always a constant distance from the best offer?

Another question lacking an answer is why did high-frequency-traders (HFTs) not adjust their algorithms to profit from any market effect caused by Sarao's orders? Sarao was a relatively unsophisticated, and very slow trader. In his words, he was "an old school point and click prop trader" who used a mouse for order entry and a limited algorithm to move the order imbalance as the market changed.<sup>101</sup> As the *New York Times* noted, HFTs in the market "could reasonably be expected to adjust their algorithms to recognize the type of orders he used and discount their likely effect on prices."<sup>102</sup>

Sarao also pointed out to the FCA that he was trad-

ing on a very popular U.S. market from London without a high speed trading line.<sup>103</sup> In contrast, his competition, the HFTs, have co-located servers in Chicago and have access to high-speed communication lines.<sup>104</sup> As Saro stated to the FCA, he was at a disadvantage to the HFTs:

"Certainly not for a guy like me who is trading from the UK and who's system is miles too slow compared to these people due to the fact that my orders have to travel further than everyone else's who are trading in the USA. No wonder they can manipulative (sic) on top of my orders without any risk, for even when I change my mind and decide to sell into my buy order, the manipulative orders disappear in the 4 milliseconds it takes for my buy order to be canceled and replaced with my sell order so that I do not trade with myself!!!!"<sup>105</sup>

Sarao further complained to the FCA that others were manipulating the market through fake orders and were taking advantage of his orders. Sarao asserts that 95 percent of HFT orders are not "genuine" or "possibly even tradable."<sup>106</sup> Saro seems to be claiming that he is defending himself from the HFTs, as opposed to manipulating the market. This seems to be confirmed by a newspaper report that Sarao made over 100 complaints to the CME over the course of several years about the trading activities of HFTs that he claimed were manipulative.<sup>107</sup>

Surely, the nimble HFT traders would have spotted this order imbalance phenomenon allegedly created by Sarao and took advantage of his relatively large latency in order entry. Surely, large institutional traders in the market would have spotted this strategy if it was really impacting the market and responded to rob Sarao of this opportunity. How then could Sarao defeat the HFTs except, as he claims, his "intuition" was the reason for his trading success?

It seems from Sarao's view that he discovered a market flaw, developed a trading strategy that allowed him to avoid the predations of the HFTs and which was successful. Sarao, it appears, does not understand

why is he prohibited from using a successful trading strategy, especially since he views the HFTs as the real villains in the market. Further, Sarao actually executed trades and made money. So, he must be providing liquidity to someone? In all events, it is difficult to understand how the Defendants' trading was a cause of the Flash Crash.<sup>108</sup>

## Conclusion

The case against Sarao raises many interesting issues, but it is an *ad hoc* approach to regulation that provides little guidance for traders. What is needed are exchange controls that limit cancellations of orders that continually create an order imbalance at a given distance from the market. In that case, there would be no need for doubtful criminal and civil charges against traders seeking to take advantage of market flaws, as traders have done since time immemorial.

### (c) Filler and Markham

## ENDNOTES:

<sup>1</sup>See "Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues," entitled "Findings Regarding the Market Events of May 6, 2010" (hereinafter referred to as the "Joint CFTC/SEC Report"), issued on September 30, 2010.

<sup>2</sup>*Id.* at pages 1-2.

<sup>3</sup>CME Group Statement on the Joint CFTC/SEC Report Regarding the Events of May 6, Oct. 1, 2010, available at <http://cmegroup.mediaroom.com/index.php?s=43&item=3068> (accessed on May 10, 2015).

<sup>4</sup>Gary Shorter & Rena S. Miller, *High Frequency Trading: Background, Concerns, and Regulatory Developments*, Congressional Research Service 29, n. 120 (June 19, 2014), available at <http://fas.org/sgp/crs/misc/R43608.pdf> (accessed on May 1, 2015).

<sup>5</sup>Andrei Kirilenko, Albert Kyle, Mehrdad Samadi, and Tugkan Tuzun, "The Flash Crash: The Impact of High Frequency Trading on an Electronic Market, January 12, 2011, available at <http://ssrn.com/abstract=1686004> (accessed on May 10, 2015).

<sup>6</sup>See Note 6, *supra*, at pages 34-36.

<sup>7</sup>Guy Adams, *Is the Hound of Hounslow Innocent*, Daily Mail, May 8, 2015, available at <http://www.dailymail.co.uk/news/article-3074206/Is-Hound-Hounslow-Innocent-s-Briton-accused-triggering-500billion-Wall-Street-crash-suburban-semi-Guy-Adams-poses-disturbing-question.html> (accessed on May 10, 2015).

<sup>8</sup>Dodd-Frank Wall Street Reform and Consumer Protection Act., Pub. L. No. 111-203 (hereinafter referred to as the "Dodd-Frank Act" or "Dodd-Frank").

<sup>9</sup>*U.S. Commodity Futures Trading Commission v. NAV Sarao Futures Limited PLC and Navinder Singh Sarao*, U.S. District Court for the Northern District of Illinois, 1:15-cv-03398, before Judge Andrea Wood and Magistrate Michael Mason (hereinafter referred to as the "CFTC Complaint"). The CFTC Complaint can be found on its website at: [www.cftc.gov](http://www.cftc.gov).

<sup>10</sup>Order Granting Plaintiff's Ex Parte Motion for Statutory Restraining Order and Other Relief, U.S. District Court for the Northern District of Illinois, Civil Action No. 15-cv-03398, April 17, 2015. The Order can be found on the CFTC website at: [www.cftc.gov](http://www.cftc.gov).

<sup>11</sup>*United States of America v. Navinder Singh Sarao*, for the U.S. District Court for the Northern District of Illinois, Eastern Division, 15 CR 75, before Magistrate Judge Martin.

<sup>12</sup>CFTC Press Release 7156-15, which can be found at: <http://www.cftc.gov/PressRoom/PressReleases/pr7156-15>.

<sup>13</sup>*Id.* For a detailed explanation of the Layering Algorithm, see pages 12-17 of the CFTC Complaint.

<sup>14</sup>See CFTC Complaint, Note 11 *supra*, at page 1.

<sup>15</sup>*Id.*, at page 2.

<sup>16</sup>*Id.* What is interesting here is that the Defendants' orders remained in the Order Book, and thus visible to other participants, even though the process was always a few ticks away from the best asking price. As will be discussed later, the CFTC Settlement in a previous spoofing case, Panther Energy, was based primarily on the fact that the orders were pulled almost instantaneously and not left open.

<sup>17</sup>*Id.*

<sup>18</sup>*Id.* at page 3. For a more detailed explanation of the Flash Spoofing allegation, see page 20 of the CFTC Complaint. The "spoofing" allegations took place throughout the five-year period, even before the enactment of the Dodd Frank Act.

<sup>19</sup>*Id.*

<sup>20</sup>*Id* at pages 20-21.

<sup>21</sup>7 U.S.C. § 8(c).

<sup>22</sup>7 U.S.C. § 11(a)(2).

<sup>23</sup>17 C.F.R. § 180.2.

<sup>24</sup>7 U.S.C. § 8(c)(3).

<sup>25</sup>7 U.S.C. § 13(a)(2).

<sup>26</sup>7 U.S.C. 15(a)(2).

<sup>27</sup>7 U.S.C. 6c(a)(5)(c).

<sup>28</sup>7 U.S.C. 8(c)(1).

<sup>29</sup>7 U.S.C. 11(c)(1).

<sup>30</sup>17 C.F.R.180.1.

<sup>31</sup>See CFTC Complaint, Note 11 *supra*, at page 30.

<sup>32</sup>*Id.*

<sup>33</sup>See *U.S. v. Sarao*, 15 CR 75 (N.D. Ill.), available at [http://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/21/sarao\\_criminal\\_al\\_complaint.pdf](http://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/21/sarao_criminal_al_complaint.pdf) (accessed on May 10, 2015).

<sup>34</sup>Pages 10-12 of LaBerta's Affidavit.

<sup>35</sup>*Id* at pages 16-17 of LaBerta's Affidavit. See Note 3 of LaBerta's Affidavit whereby LaBerta identified the expert as a professor and academic researcher. The CFTC attached to its Complaint an Appendix that included an Affidavit of Professor Terrence Hendershott, which one can only assume is the same expert used by the DOJ.

<sup>36</sup>*Id* at pages 21-24.

<sup>37</sup>*Id* at page 21.

<sup>38</sup>*U.S. v. Sarao*, 15 CR 75 (N.D. Ill.), available at [http://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/21/sarao\\_criminal\\_complaint.pdf](http://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/21/sarao_criminal_complaint.pdf) (accessed on May 10, 2015).

<sup>39</sup>Chiara Albanese, *U.K. 'Flash Crash' Trader Navinder Singh Sarao Says He Did Nothing Wrong*, Wall St. J., May 16, 2015, available at <http://www.wsj.com/articles/u-k-flash-crash-trader-cant-pay-bail-due-to-asset-freeze-lawyer-says-1430915094> (accessed on May 11, 2015).

<sup>40</sup>7 U.S.C. §§ 9(c)(3) & 13(a)(2). The complaint also charges violations of CFTC Rule 180.2 (17 C.F.R. § 180.2). That rule was adopted after Dodd-Frank but seeks to encapsulate the pre-Dodd Frank anti-manipulation provisions of the CEA. 76 Fed. Reg. 41398, 41406 (July 14, 2011).

<sup>41</sup>7 U.S.C. § 9(c)(1). The complaint also charges

violation of CFTC Rule 180.1 (17 C.F.R. § 180.1). That rule seeks to define the new Dodd Frank anti-manipulation provisions. 76 Fed. Reg. 41398 (July 14, 2011).

<sup>42</sup>7 U.S.C. § 6c(a)(5)(C).

<sup>43</sup>See, Jerry W. Markham, *The Manipulation of Commodity Futures Prices—The Unprosecutable Crime*, 8 Yale J. on Reg. 281 (1991) (describing the background for this legislation and the effects of a lack of definition). See also Chapter 9 (Manipulation and Trading Abuses) in *Regulation of Derivative Financial Instruments (Swaps, Options and Futures)*, by Professors Filler and Markham, West Academic (May 2014) (hereinafter referred to as "Filler & Markham")

<sup>44</sup>*In re Cox*, Comm. Fut. L. Rep. (CCH) ¶ 23,786 (CFTC 1982). See also *Filler & Markham*, at pages 519 - 529.

<sup>45</sup>*In the Matter of Hohenberg Bros.*, Comm. Fut. L. Rep. (CCH) ¶ 20,271, n. 39 (C.F.T.C. 1977).

<sup>46</sup>*In the Matter of DiPlacido*, COMM. FUT. L. Rep. ¶ 30,970 (C.F.T.C. 2008), *aff'd sub nom.*, *DiPlacido v. CFTC*, No. 08-5559-ag, 2009 U.S. App. LEXIS 22692 (2d Cir. 2009), *cert denied*, 2010 U.S. LEXIS 2461 (2010).

<sup>47</sup>Declaration of Terrence Hendershott submitted in Support of the CFTC's motion for a statutory restraining order in *CFTC v. Sarao* ¶ 13 (Apr. 14, 2015).

<sup>48</sup>Notably, the CFTC, in proposing rule 180.2, which defines its pre-Dodd Frank manipulation authority, sought to read out the requirement of proving an artificial price, but backed off that claim in adopting the rule. See, *Jerry W. Markham, Law Enforcement and The History of Financial Market Manipulation* 329, 331(2014) (describing that effort).

<sup>49</sup>*In re Indiana Farm Bureau Coop. Association*, 1982 CFTC LEXIS 25 (C.F.T.C.).

<sup>50</sup>2006 U.S. Dist. LEXIS 85068, at \*9-10 (D. Neb. 2006).

<sup>51</sup>15 U.S.C. § 78j(b).

<sup>52</sup>See, *Jerry W. Markham, Law Enforcement and The History of Financial Market Manipulation* § 8:1(2014) (describing the borrowing of this language and the canons of statutory construction that apply to borrowed language).

<sup>53</sup>425 U.S. 185 (1976).

<sup>54</sup>*Id* at 199.

<sup>55</sup>430 U.S. 462 (1977).



<sup>56</sup>*Id* at 476.

<sup>57</sup>938 F.2d 364 (2d Cir. 1991).

<sup>58</sup>*See*, Note 54, *supra*, Jerry W. Markham, *Law Enforcement and The History of Financial Market Manipulation* § 8:3 (2014) (describing that debate).

<sup>59</sup>493 F.3d 87 (2d Cir. 2007).

<sup>60</sup>*Id* at 100-101.

<sup>61</sup>*Id* at 100.

<sup>62</sup>*Id* at 101. *See also*, *FL Advantage Fund Ltd. v. Colkitt*, 272 F.3d 189 (3d Cir. 2001), *cert. denied*, 536 U.S. 923 (2002) (short selling scheme not manipulative unless defendant was trying to create a false appearance of market activity through wash sales, matched orders or other improper trades).

<sup>63</sup>274 F.3d 525 (D.C. Cir. 2001), *cert. denied*, 537 U.S. 819 (2002). *See also* Filler & Markham, at page 537.

<sup>64</sup>*Id.* at 528.

<sup>65</sup>*Id.*

<sup>66</sup>*See*, Note 54, *supra*, Jerry W. Markham, *Law Enforcement and The History of Financial Market Manipulation* § 8:1(2014) (describing the borrowing of this language and the canons of statutory construction that apply to borrowed language).

<sup>67</sup>*See* Note 55, *supra*.

<sup>68</sup>*See also*, *See, Tellabs Inc. v. Makor Issues & Rights*, 551 U.S. 308, 319 (2007) and *Herman & Maclean v. Huddleston*, 459 U.S. 375, 382 (1983).

<sup>69</sup>*Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977).

<sup>70</sup>*See*, Note 54, *supra*, Jerry W. Markham, *Law Enforcement and The History of Financial Market Manipulation* § 8:2 (2014) (further describing why the two standards may vary only slightly, if at all).

<sup>71</sup>7 U.S.C. § 6c(a)(5)(C). On May 5, 2015, the CFTC brought another spoofing case against Heet Khara and Nasim Salim, residents of the UAE, for engaging in spoofing in the gold and silver futures markets between February and April 2015 “by placing bids and offers with the intent to cancel them before execution.” The CME had previously investigated this trading activity and denied the Defendants access to its markets. *See* CFTC Press Release No. PR7171-15, accessed at <http://www.cftc.gov/PressRoom/PressReleases/pr7171-15>.

<sup>72</sup>*See*, e.g., CFTC Complaint ¶ 101, 1:15-cv-03398 (N.D. Ill.).

<sup>73</sup>CFTC, *Anti-disruptive Practices Authority*, 78 Fed. Reg. 31890 (May 28, 2013).

<sup>74</sup> 78 Fed. Reg. at 31896.

<sup>75</sup>*Id.*

<sup>76</sup>*U.S. v. Coscia*, 2015 U.S. Dist. LEXIS 50344 (N.D. Ill. 2015).

<sup>77</sup>The Sullivan & Cromwell brief in support of that motion is well worth reading., available at [http://www.bridgingtheweek.com/ckfinder/userfiles/files/Coscia-%20Memo%20to%20Dismiss%20Indictment\(2\).pdf](http://www.bridgingtheweek.com/ckfinder/userfiles/files/Coscia-%20Memo%20to%20Dismiss%20Indictment(2).pdf) (accessed on April 28, 2015).

<sup>78</sup>Dictionary.com, *Spoofing*, available at <http://dictionary.reference.com/browse/spoofing> (accessed on April 28, 2015).

<sup>79</sup>*See*, e.g., *Wendler & Erza P.C. v. American International Group*, 521 F.3d 790, 791 (7th Cir. 20) (“ ‘Spoofing’ means taking steps that make a message appear to originate from an address other than its actual source”).

<sup>80</sup>*See*, Note 54, *supra*, Jerry W. Markham, *Law Enforcement and The History of Financial Market Manipulation* 323-(M.E. Sharpe 2014) (describing the use of flash trades and SEC rules allowing such trading).

<sup>81</sup>Note that the CME recently suspended two gold and silver traders for “laddering.” Nick Baker, *CME suspends Traders for Alleged Sarao-Like Futures Manipulation*, Bloomberg Business, April 30, 2015, available at: <http://www.bloomberg.com/news/article/2015-05-01/cme-suspends-traders-for-alleged-sarao-like-futures-manipulation> (accessed on May 1, 2015).

<sup>82</sup> Peter J. Henning, *The Fine Line Between Smart and Illegal*, New York Times, April 27, 2015, available at <http://www.nytimes.com/2015/04/28/business/dealbook/the-fine-line-between-smart-and-illegal.html> (accessed on April 28, 2015). *But see*, Gregory Scopino, *The (Questionable Legality of High-Speed “Pinging” and “front Running” in the Futures Markets*, 47 Conn. L. Rev. 607 (2015) (noting that pinging is generally viewed to be legal but making arguments for violations for at least some forms of pinging).

<sup>83</sup>*In re Indiana Farm Bureau Cooperative Association*, Comm. Fut. L. Rep. (CCH) ¶ 21,796 (C.F.T.C. 1982).

<sup>84</sup>*See* Note 48, *supra*, *In the Matter of Diplacido*, COMM. FUT. L. Rep. ¶ 30,970 (C.F.T.C. 2008), *aff’d sub nom.*, *DiPlacido v. CFTC*, No. 08-5559-ag, 2009 U.S. App. LEXIS 22692 (2d Cir. 2009), *cert denied*,

2010 U.S. LEXIS 2461 (2010).

<sup>85</sup>*In re Henner*, 30 Agric. Dec. 1151 (1971).

<sup>86</sup>*In the Matter of Ecoval Dairy Trade Inc.*, 2011 CFTC LEXIS 44 (2011).

<sup>87</sup>*See, Jerry W. Markham, Law Enforcement and The History of Financial Market Manipulation* 335-336 (2014) (describing those cases).

<sup>88</sup>*In the Matter of Hold Brothers On-Line Investment Services, LLC*, 2012 SEC LEXIS 3029 (S.E.C.)

<sup>89</sup>CFTC Doc. No. 13-26 (2013) (hereinafter referred to as “Panther Energy”)

<sup>90</sup>CFTC Complaint at ¶ 18.

<sup>91</sup>*See, CME, Market Regulation Advisory Notice* (Aug. 29, 2014), available at <http://www.cmegroup.com/tools-information/lookups/advisories/market-regulation/files/RA1405-5.pdf> (accessed on April 30, 2015).

<sup>92</sup>Declaration of Jessica M. Harrison submitted in Support of the CFTC’s motion for a statutory restraining order against Sarao, (Apr. 14, 2015).

<sup>93</sup>Declaration of Terrence Hendershott submitted in Support of the CFTC’s motion for a statutory restraining order against Sarao, ¶ 13 (Apr. 14, 2015).

<sup>94</sup>*See* Note 94, *supra*, Declaration of Jessica M. Harrison submitted in Support of the CFTC’s motion for a statutory restraining order against Sarao, Exhibits 2-4 (Apr. 14, 2015).

<sup>95</sup>*Id.* at Exhibit 2 at p. 48 (Apr. 14, 2015).

<sup>96</sup>CFTC Complaint at ¶ 9.

<sup>97</sup>*See* Note 95, *supra*, Declaration of Terrence Hendershott submitted in Support of the CFTC’s motion for a statutory restraining order against Saraos, ¶ 13 (Apr. 14, 2015). In the Complaint, the CFTC acknowledged that Sarao did incur both trading gains and losses in connection with his trading activities.

<sup>98</sup>*See* Note 94, *supra*, Declaration of Jessica M. Harrison submitted in Support of the CFTC’s motion for a statutory restraining order against Sarao, Exhibit 2 at p. 48 (Apr. 14, 2015).

<sup>99</sup>Compare the Joint CFTC-SEC Study that did not acknowledge any such imbalances by Sarao or any other traders. This Study consisted of 104 pages of extensive data, refers primarily to a large fundamental trader as the primary case of the Flash Crash. *See also* Note 7, *supra*, “The Flash Crash: The Impact of High Frequency Trading on an Electronic Market,” written by Andrei Kirilenko (Former CFTCF Chief Economist), Albert Kyle, Mehrdad Samadi and Tugkan

Tuzun, on October 1, 2010 and updated as of May 5, 2014, in which the authors stated: “We show that High Frequency Traders (HFTs) did not cause the Flash Crash but contributed to it by demanding immediacy ahead of other market participants.” at page 1.

<sup>100</sup>Peter J. Henning, *The Fine Line Between Smart and Illegal*, New York Times, April 27, 2015, available at <http://www.nytimes.com/2015/04/28/business/dealbook/the-fine-line-between-smart-and-illegal.html> (accessed on April 28, 2015).

<sup>101</sup>*See* Note 94, *supra*, Declaration of Jessica M. Harrison submitted in Support of the CFTC’s motion for a statutory restraining order against Sarao, Exhibit 2 at p. 48 (Apr. 14, 2015).

<sup>102</sup>*See* Note 102, *supra*, Peter J. Henning, *The Fine Line Between Smart and Illegal*, New York Times, April 27, 2015, available at <http://www.nytimes.com/2015/04/28/business/dealbook/the-fine-line-between-smart-and-illegal.html> (accessed on April 28, 2015).

<sup>103</sup>*Id.*

<sup>104</sup>*See* Jerry W. Markham, *High Speed Trading on Stock and Commodity Markets—From Courier Pigeons to Computers*, 52 San Diego L. Rev. - - (Fall 2015) (describing the operations of HFTs).

<sup>105</sup>*See* Note 94, *supra*, Declaration of Jessica M. Harrison submitted in Support of the CFTC’s motion for a statutory restraining order against Sarao, Exhibit 2 at p. 48 (Apr. 14, 2015).

<sup>106</sup>*Id.*

<sup>107</sup>Aruna Viswanatha, Bradley Hope, & Chiara Albabese, *Trader Accused in ‘Flash Crash’ Accused Rivals of Misconduct*, Wall St. J., May 14, 2015, available at <http://www.wsj.com/articles/trader-accused-in-flash-crash-accused-rivals-of-misconduct-1431556193> (accessed on May 14, 2015).

<sup>108</sup>*See* article prepared by Blackrock on “Understanding the ‘Flash Crash,’ What Happened, Why ETFs Were Affected and How to Reduce the Risk of Another” (November 2010), in which the paper listed “The Four Factors That Converged on May 6: First, the sudden market freefall in U.S. equity prices caused market makers in ETFs that seek to track benchmarks heavy in the falling stocks to have difficulty valuating the ETF’s underlying assets. Second, anxiety over potential trade cancellations caused liquidity providers to fear that normal ETF hedging strategies would be interrupted, which caused them to pull back from bidding for ETF shares. Third, several other exchanges stopped routing orders to NYSE Arca because they believed the NYSE Arca was not reporting trade

executions back in a timely manner. And Fourth, there was additional selling because stop-loss orders were triggered, which increased the volume of sell orders on affected securities, including ETFs.”

## FROM THE EDITOR

### Congratulations Derivatives Law Graduates 2015

It is June, the month for graduations, parties and proms. Derivatives University Law School (DULS) had its commencement last week. The graduation speaker was Dr. Karla Marks, the Chairwoman of the new Bitcoin Swap Execution Facility (Bitcoin SEF). Dr. Marks congratulated the students on completing three years of grueling study. In her commencement speech, Dr. Marks told the DULS graduates they must never stop learning, they must always keep up with regulatory developments, and they should never stop asking the CFTC the hard questions. She told the students that with all the problems facing our country—threats in the Middle East, terrorism, economic stagnation, poverty, financial system instability, policing incidents, climate change - they should reflect on the following 8 crucial questions.

1. Were Bitcoins “commodities” before and/or after the CFTC approved of their being traded on the Bitcoin SEF?
2. Will requiring margin to be posted by commercial end-users for uncleared swap threaten the creation of jobs, or will it create more and innovative back-office jobs for margin professionals?
3. What is the correlation between the Second Circuit’s May 7, 2015 decision invalidating the National Security Agency’s telephone metadata

collection practices and the CFTC’s proposed exemption for commodity trading advisors’ recordkeeping obligations for text messages and recorded phone calls?

4. What is the basis for the CFTC’s jurisdiction over aluminum warehouses located in the United States that are owned by the London Metals Exchange, which is regulated by the United Kingdom’s Financial Conduct Authority?
5. What would the CFTC’s position be if Delaware commodity pools offered only to United States investors that have sleeves managed by European trading managers were characterized as “EMIR Persons” for EU regulatory compliance purposes?
6. Do trade options that have been transacted for centuries by commercial entities pose such a threat to the U.S. financial system that they need to be regulated by the CFTC?
7. Has the CFTC created legal certainty as to their regulatory status as swaps for commercial deliverable physical commodity forward contracts that have embedded volumetric optionality?
8. Is the LIBOR rate a “commodity” regulated by the CFTC and, if your answer is yes, why?

Dr. Marks went on to warn the DULS graduates to use sun screen, drink plenty of water, act ethically and read every law firm’s client alerts on the CFTC’s swaps rules that you can find on Google. Her parting words were: “May the retail forex be with you.”

MSS