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# HFT spoof that wasn't funny

*American and UK regulators were unamused by US-based Michael Coscia's super-fast layering spoof and together fined him over £2 million for market manipulation.* ***Alex Lincoln-Antoniou*** *and* ***Mauro Wolfe*** *discuss trans-Atlantic perspectives on the case and why a commissioner was left fuming.*

For the first time a High Frequency Trader (HFT) has been fined by the Financial Conduct Authority. Michael Coscia, a US-based HFT, has been fined over £2m by US and UK regulators, banned from trading for 12 months and heavily censured for orchestrating a form of market manipulation known as 'spoofing' or 'layering'.

The ground-breaking action consisted of a three-pronged attack from the US Commodities and Futures Trading Commission (CFTC), the Chicago Mercantile Exchange (CME) and the FCA.

The case is noteworthy for a number of reasons. First, from the US perspective, it is the first enforcement action by the CFTC pursuant to new powers granted under the Dodd-Frank Act that were specifically created to thwart spoofing. Second, it is yet another example of coordinated, cross border enforcement effort that has become more common at the US sister agency – the Securities and Exchange Commission. Not to be outdone, the CFTC and the FCA have joined the chorus of international regulators who have taken an aggressive and sophisticated approach to deal with a novel form of manipulation. Finally, the breadth and complexity of the spoof is a fascinating look at the future of electronic platform trading, the much criticised world of HFT, and the (possibly mixed) messages being sent to perpetrators and prospective-perpetrators of similar conduct.

## The spoof

### Overview

Spoofing or layering – a practice in which traders place and then cancel orders to give an artificial impression of an intention to buy or sell shares in order to move the market – is not a new phenomenon. However, the manner in which Coscia and his company, Panther Energy Trading LLC, created the spoof in question was new – if not for the workings of the scheme, then most certainly for the speed with which it was executed.

Coscia developed his own super-fast algorithm that allowed him to execute a series of large buy and sell orders designed to push down the market price of various commodities before then raising it so that he could sell out at a profit.

### Details of the spoof

The algorithm employed by Coscia consisted of two 'legs'. 'Leg one' was to place a small buy order on the order book of a commodity of around the level of the best bid or offer. Once the small buy offer was in place, or 'resting' to use the industry vernacular, several large sell orders were placed for the same commodity. The large sell orders were placed to create the impression of significant supply in the market. This seeming overabundance of supply moved the sell price towards the small resting buy order as market participants were induced to place orders in the same direction. This downward pressure on prices resulted in Coscia being able to buy more cheaply than he might otherwise have been able to do. As soon as the buy order was executed, the trading programme then cancelled all the large sell orders immediately. There was never any intention that these large sell orders would actually be traded.

'Leg two' operated the same sequence of events as 'leg one' but in reverse – on the opposite side of the order book. It allowed Coscia to trade out his position created in 'leg one'. This involved placing a small sell order along with several large buy orders, the latter of which were never to be executed. This time, the large buy orders created an impression of significant demand in the market and moved the buy price towards the small resting sell order. This upward pressure on prices resulted in Coscia being able to sell at a higher price than he might otherwise have been able to do.

Each leg was timed to last a total of approximately 300 milliseconds – roughly the time in which it takes the human eye to blink.

### Depth and breadth of the spoof

The depth and breadth of the spoof was remarkable. Coscia employed the strategy in Europe on Brent Crude Futures, Gas Oil Futures and Western Texas Intermediate Crude Futures, all of which were traded on the IntercontinentalExchange (or ICE). He also used US exchanges – utilising CME's Globex platform to trade energy, metals, interest rate, agricultural, stock index and foreign currency commodities, including futures contracts for light sweet crude oil, corn, soybeans and wheat.

The spoof was carried out hundreds of times a day during the relevant period (August – October 2008) and would typically involve over a thousand large orders being placed and cancelled.

### Impact of the spoof

Interestingly, the spoof was not fool proof. For example, the FCA found that Coscia's attempt to manipulate Gas Oil Futures on the ICE on a given day actually resulted in him making a loss of $9,350. However, through the entirety of the scheme, Coscia snared hundreds of thousands of pounds in illegitimate profits.

That said, it was the risk that Coscia posed to the stability of the markets in which the strategy was employed that was of chief concern to regulators. The misleading impressions created as to liquidity were, stated Tracey McDermott, the FCA's director of enforcement and financial crime, "deliberately designed to abuse the market, undermining its integrity". They resulted in at least one significant market participant withdrawing from the marketplace.

## Ground-breaking regulatory action

### FCA

The action brought against Coscia by the FCA represents the first UK regulatory outcome brought against an HFT.

HFTs are now an established part of the financial services industry and were described by McDermott as being "an important and commonplace part of the markets". They take advantage of legitimate computer algorithms to trade securities rapidly, moving in and out of positions within seconds. However, it is clear the regulators will only permit the use of these programmes if there is a justifiable commercial rationale for orders placed and trades executed.

The regulator has signalled that it will not only pursue individual traders that engage in spoofing the market, but will also target entities that facilitate access to the marketplace for those individuals – so-called DMA (Direct Market Access) firms. The FCA, or FSA as it then was, sounded this warning back in August 2009, and repeated it in its final notice with respect to Coscia.

The FCA has the bit between its teeth regarding this form of market manipulation and it is clear that it will take full advantage of the breadth of its regulatory reach. It is noteworthy that Coscia was not an FCA-approved person during the relevant period, nor a member of the ICE Features Europe exchange but executed his trades through an intermediary in the US.

### CFTC

As mentioned above, the action in the US brought by the CFTC also represents the first time the agency has utilised its powers under the Dodd-Frank prohibition of the disruptive practice of spoofing by bidding or offering with intent to cancel before execution. This means that, at least for now, the CFTC is enforcing the provision. The question remains whether the punishment fits the violation. The CFTC commissioner thinks the punishment may not be enough and made his feelings known in a highly public comment – a move that is very unusual in the US.

Specifically, CFTC commissioner Bart Chilton issued punchy rhetoric indicating that it too will clamp down on this form of manipulation with vigour. Chilton described Coscia's behaviour as an "egregious violation" of US trading laws and declared himself "dissatisfied" with the imposition of a 12-month trading ban – which he stated was far too lenient. Chilton stated that in years gone by a short-term ban would have caused such reputational damage that it could have almost been considered a lifetime prohibition. However, in the modern day marketplace, where identities can be cloaked behind technology, Chilton likened a year-long prohibition to "a nice sabbatical" for a trader to develop new algorithms to unleash on the market once the ban has expired. The point has merit. Under US criminal laws, for example, the maximum sentence for a single violation of wire or mail fraud is 20 years in prison. Perhaps Coscia should be more concerned about US prosecutors.

Chilton added that the CFTC would be "tenacious and tireless" in its efforts "to track down market predators that break the rules" and that regulators


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would be "harsh hard-hitters" to violators. Combine this determination with the considered and co-ordinated approach that the CFTC took with both the CME and the FCA, and it is clear that market manipulators are exposed on a number of fronts.

## Conclusion

The action against Coscia evinced an impressively holistic and detailed approach to what was a sophisticated attempt to manipulate the market. The FCA's final notice in particular, replete with animated diagrams of Coscia's trading, demonstrated how well the regulator had dissected the workings of the algorithm and unpicked its illegitimate objectives. Yet arguably it is the words of Chilton that give the greatest pause for thought. If, at the end of these global investigations, perpetrators face nothing more than limited penalties and light bans, will that provide any real disincentive to them or those that aspire to be them?

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