

Title: Spoofing. What it takes to prove manipulation in the market.





Author: Leading_Metal8974



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ECONOMICS** 

July 16, 2021 | Article


Regulatory and enforcement agencies, market exchanges, and at least one private party have brought legal actions for alleged spoofing in futures markets. These actions have exposed a variety of spoofing strategies.

Those who bring actions against spoofers bear the burden of proving the defendant's intent to defraud. Establishing this requisite intent, without an admission from the trader, can be particularly challenging.

Satisfying the legal evidentiary standard is complicated by the fact that neither the statutory nor regulatory definition of spoofing provides an objective benchmark against which spoofing allegations may be measured and proved. To meet applicable standards of proof, attorneys are increasingly turning to expert testimony regarding statistics and econometrics to prove and refute spoofing allegations in litigation.

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Potential Avenues for Investigating Spoofing Behavior





NEWS & PUBLICATIONS

THE IMPORTANCE OF EXPERT ECONOMISTS IN SPOOFING LITIGATION

July 16, 2021 | Article

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the burden of proving the defendant's intent to





- **Servicing and Master Servicing of**

RMBS: The Vega team supported both the damages rebuttal expert and the servicing expert in the analysis and drafting of expert reports to address claims related to the obligations of the servicer and master servicer of RMBS in a half dozen cases.

- **Analysis of CDS Agreement on**

CDO: In *China Development Industrial Bank v. Morgan Stanley & Co. Incorporated, et al.* (N.Y. Sup. No. 650957/10), plaintiff entered into a \$275 million credit default swap with Morgan Stanley on the super senior tranche of a CDO. The Vega team supported Dr. Cohen-Cole in responding to plaintiff's experts regarding risk disclosed in the offering documents as well as the CDO ratings.

- **Damages Analysis regarding RMB**

Trustee's Alleg Chat with us In
Phoenix Light S. Ltd., et al. v. Wells Fargo Bank, N.A. No. 16-cv-10100-KDE-SN





This case demonstrates the value and importance of expert testimony in litigating spoofing claims. Given the essential element of intent in spoofing allegations and the difficulty in establishing such intent without clear admissions from the accused party, placed orders and trading patterns must be the focal point in expert testimony. Some of the factors that experts may consider include:

- *Cancellation and fill rates:* In many cases prosecuted to date, the rates at which transactions are filled or canceled have been used to establish intent. An expert who can demonstrate lower cancellation rates and/or higher fill rates can help undermine claims of spoofing.
- *Depth at which orders are placed:* Is there a statistically significant pattern in the levels at which orders are placed such that they are likely to generate price movements, avoid execution, and/or ensure fulfillment? Expert economists are uniquely qualified to analyze such questions and offer testimony regarding such p
- *Length of time or* trades remain active an inordinate amount of

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filled.

- *Market Price and Order Book:* Keeping track of the last trade price and the evolution of the order book over the course of a trading day provides insight into market conditions. Identifying where in the order book traders place their orders, at what times, and for what quantities, sheds light on borrower trading strategies.

Expert Testimony in Spoofing Litigation

At least one trader has been acquitted of spoofing charges. In 2018, a federal jury acquitted Andre Flotron on the charge of conspiracy to commit commodities fraud. Mr. Flotron had been accused of leading a five-year spoofing conspiracy using a strategy similar to that used by Michael Coscia. This case demonstrates the value of expert economist testimony in spoofing cases.

Mr. Flotron's former trainee, Mike Chan, agreed to testify against Mr. Flotron in exchange for the government not prosecuting him for his own spoofing activities. In a recent trial that he learned about Flotron's spoofing techniques when they worked

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contain anonymized trader/firm identifiers necessary for the prosecution or defense of manipulative and deceptive trading allegations. Those seeking to hold alleged market manipulators accountable for spoofing activities must navigate the data and develop evidence that proves the alleged spoofer entered spoof orders with the required intent to manipulate the market. Experts for the defense will use the same data to show that the client's trades were legitimate.

Important Considerations When Working with Historical Futures Data

Using historical futures data to investigate spoofing allegations can be challenging because of the size and granularity of the data. Experts should keep the following in mind when evaluating such data:

- **Data Cleaning:** Depending on the data format and the software used to process the data, various fields can have whitespace, missing decimal digits, or other anomalies. Careful cleaning and review of the data is

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loans backing these transactions.

- **Class Action Issues Regarding RMBS**

Trustees: In *Royal Park Investments SA/NV v. Wells Fargo Bank, N.A.* (S.D.N.Y. No. 1:14-cv-09764) and *BlackRock Allocation Target Shares: Series S Portfolio, et al. v. Wells Fargo Bank, N.A.* (S.D.N.Y. No. 1:14-cv-09764), Vega supported a damages expert in analyzing the complex payment structures of the at-issue RMBS and determining the extent of heterogeneity among class members to address whether a proposed damages methodology could be consistently applied on a class-wide basis.

- **Materiality Analysis of RMBS**

Misrepresentations: In *National Credit Union Administration Board v. Credit Suisse Securities (USA) LLC, et al.* (D. Kan. No. 2:12-cv-02648) and *National Credit Union Administration Board v. Credit Suisse Securities, LLC* (S.D.N.Y. No. 1:15-cv-02591), a Vega expert used economic

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Important Considerations When Working with Historical Futures Data

Using historical futures data to investigate spoofing allegations can be challenging because of the size and granularity of the data. Experts should keep the following in mind when evaluating such data:

- **Data Cleaning:** Depending on the data format and the software used to process the data, various fields can have whitespace and/or decimal digits that may hinder accurate order, trader, and/or instrument matching. Careful cleaning and review of the data is necessary to ensure each order present in the order book is accurate.
- **Unique Order IDs:** A unique, reliable ID for each order placed in the futures market is necessary to track orders throughout their lifecycle, from placement to fulfillment, cancellation, or expiry. Order IDs must be specific to trader, instrument, order type, and market side. Without a reliable unique identifier for each order, it is impossible to compare, for example, fill rates, and differentiate each trader.

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- **Intervention by the Federal Reserve in a**

Distressed Company: A Vega expert provided testimony in a case involving the Federal Reserve's intervention in a distressed corporation in connection with the 2008 financial crisis. The expert analyzed the Federal Reserve's credit facilities and lending practices to financial institutions and other firms and provided an overview of the market crisis and its effect on the corporation.

- **Spoofing in High Frequency Trading:** In

USA v Vorley and Chanu (1:18-cr-00035), Vega analyzed allegations of certain traders' spoofing conduct and evaluated calculations of alleged market harm associated with these spoofing activities.

- **Servicing and Master Servicing of**

RMBS: The Vega team supported both the damages rebuttal and the master servicing expert testimony and the drafting of expert reports to address

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applied on a class-wide basis.

- **Materiality Analysis of RMBS**

Misrepresentations: In *National Credit Union Administration Board v. Credit Suisse Securities (USA) LLC, et al.* (D. Kan. No. 2:12-cv-02648) and *National Credit Union Administration Board v. UBS Securities, LLC, et al.* (D. Kan. No. 12-cv-02591), a Vega expert used economic analysis to determine whether the allegedly misrepresented loan characteristics would have been material to the total mix of information available to an investor. This analysis withstood plaintiff's motion to exclude.

- **Market Maker Analysis:** A Vega expert was engaged on *In re: Goldman Sachs Group, Inc. Securities Litigation* (S.D.N.Y. No. 1:10-cv-03461) to analyze the alleged fraud and misrepresentation in the formation of CDOs and opine on the market making activities of the defendant.

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- **Syndicated Loan Transaction:** A Vega



- *End-of-Day*: All official closing information, including the open, high, low, close, open interest, total volume, volume breakdown by venue, settlement, delta, and implied volatilities.
- *Market Depth*: All market data messages required to recreate the order book: five to ten orders deep in futures markets and three orders deep in options markets, as well as trade data for all CME Globex-traded products.
- *Time and Sales*: Trade times, prices, and quantities for all trades and bids and offers that better the traded prices.

These data are helpful in analyzing market trends on previous trading days but they do not contain anonymized trader/firm identifiers necessary for the prosecution or defense of manipulative and deceptive trading allegations. Those seeking to hold alleged market manipulators accountable for spoofing activities must navigate the data and develop evidence that proves the alleged spoof entered spoof order to manipulate the market. The defense will use the same data to show that the

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the order book is accurate.

- *Unique Order IDs:* A unique, reliable ID for each order placed in the futures market is necessary to track orders throughout their lifecycle, from placement to fulfillment, cancellation, or expiry. Order IDs must be specific to trader, instrument, order type, and market side. Without a reliable unique identifier for each order, it is impossible to compare, for example, the cancellation rates, fill rates, and different trading patterns of each trader.
- *Order Types:* Understanding the types of orders traders use and adding appropriate order type controls in the analysis of market trades helps maintain the integrity of any conclusions drawn from those trends. Different order types include limit, stop, and market orders. They may be resting or aggressing, iceberg or fully visible, and they may remain active until the end of the trading day/session, until canceled, until a specified date, or until a minimum quantity is filled.
- *Market Price and Order Book:* Keeping track of the last trade price and the order book of the day provides insight into market conditions.

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allegations in litigation.

Potential Avenues for Investigating Spoofing Behavior

Attorneys can find valuable futures trading data that will help them develop the circumstances surrounding a client's trading activities. Expert economists can help develop the data and compare and contrast it with other available information to help establish or refute fraud.

The CME Group is the largest futures exchange operator in the United States. It sells historical futures trading data that can offer insight into historical trading patterns. Some of the data they offer include:

- *Top-of-Book*: All top bid, bid size, top ask, ask size, last trade, trade volume, and time-stamp data.
- *End-of-Day*: All official closing information, including the open, high, low, close, open interest, total volume, volume breakdown by venue, settlement delta, and implied volatilities.
- *Market Depth*: All market data messages required to recreate the order book: five to

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A trader's entire profile based on a host of criteria, including those just discussed, must be developed in the context of other market participants to develop a legitimate argument in support of or in defense against spoofing allegations. The mere fact that a trader cancels some orders cannot, alone, provide the intent required under Dodd-Frank to prove spoofing. Expert witnesses are essential in analyzing the patterns and practices traders use and are uniquely qualified to develop the full picture that shows whether a trader has been guilty of spoofing.

Vega Economics

Vega Economics is an economic consulting firm specializing in expert testimony and data analysis. We deliver exceptional quantitative solutions for both litigation and consulting engagements. Contact us to learn how our prior experience on spoofing cases, familiarity with large datasets, innovative problem-solving and comprehensive client service can help you win spoofing litigation.

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calculations done by plaintiff's expert.

- **Damages Analysis regarding RMBS**

Trustee's Alleged Misconduct: In *National Credit Union Administration Board v. Wells Fargo Bank, N.A.*, No. 14-cv-10067-KPF-SN (S.D.N.Y.), Vega supported damages expert Dr. Ethan Cohen-Cole in analyzing the premises and assumptions of repurchase damages calculations done by plaintiff's expert.

- **Master Servicing of RMBS:** The Vega team supported the damages rebuttal expert, servicing expert, and securitization expert in the analysis and drafting of expert reports to address claims related to the obligations of an RMBS master servicer.

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execution, and/or ensure fulfillment. Expert economists are uniquely qualified to analyze such questions and offer testimony regarding such patterns.

- *Length of time orders remain active:* Do the trades remain active an inordinate amount of time? Is there a pattern to the length of time that orders remain active? Again, expert economists can analyze the data and educate juries on such issues.
- *Movements in market price:* Can cancellations be explained by movements in the market price away from the order or by market depth movements? Just because a trader cancels an order doesn't mean the order was fraudulently entered. Many factors justify canceling such orders and an expert economist can analyze the surrounding market conditions, other than an intent to commit fraud, that might have led to these cancellations.
- *Order types:* Does a trader use a specific order type to spoof and/or execute a trade? An expert can develop patterns and practices to explain how a trader conducts business.

A trader's entire pro
criteria, including those just discussed, must

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- **Damages Analysis regarding RMBS**

Trustee's Alleged Misconduct: In *Phoenix Light SF Ltd., et al. v. Wells Fargo Bank, N.A.*, No. 14-cv-10102-KPF-SN (S.D.N.Y.), Vega supported the damages expert Dr. Ethan Cohen-Cole in analyzing the premises and assumptions of repurchase and servicing damages calculations done by plaintiffs' expert.

- **Damages Analysis regarding RMBS**

Trustee's Alleged Misconduct: In *Commerzbank AG v. Wells Fargo Bank, N.A.*, No. 15-cv-10033-KPF-SN (S.D.N.Y.), Vega supported the damages expert Dr. Ethan Cohen-Cole in analyzing the premises and assumptions of repurchase and tort damages calculations done by plaintiff's expert.

- **Damages Analysis regarding RMBS**

Trustee's Alleged Misconduct: In *National Credit Union Administrative Board v. Wells Fargo Bank, N.A.*, No. 15-cv-10067-KPF-SN (S.D.N.Y.), Vega supported damages expert Dr. Ethan

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both Mr. Flotron and Mr. Chan. Here was a witness who claimed he learned how to spoof from the defendant. If this was true, Chan's trading practices likely would look very similar to those of Mr. Flotron's. Accordingly, the expert, Mr. Carr, examined the practices of each and found that they were, in fact, significantly different. Such testimony tends to undercut allegations of a conspiracy.

In particular, Carr highlighted the fact that Mr. Chan's order cancellation rate for large orders was twice that of Mr. Flotron's. High cancellation rates are considered an indication of possible spoofing. Further, and importantly, he testified that Mr. Flotron filled more orders than someone with the intent to spoof would have filled.

This case demonstrates the value and importance of expert testimony in litigating spoofing claims. Given the essential element of intent in spoofing allegations and the difficulty in establishing such intent without clear admissions from the defendant, the defendant's orders and trading patterns must be the focal

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- **Market Maker Analysis:** A Vega expert was engaged on *In re: Goldman Sachs Group, Inc. Securities Litigation* (S.D.N.Y. No. 1:10-cv-03461) to analyze the alleged fraud and misrepresentation in the formation of CDOs and opine on the market making and hedging activities of the defendant.
- **Syndicated Loan Transaction:** A Vega expert testified regarding the due diligence obligations in a syndicated loan transaction. The engagement involved analysis of the relevant regulatory duties of the parties to the transaction.
- **Intervention by the Federal Reserve in a Distressed Company:** A Vega expert provided testimony in a case involving the Federal Reserve's intervention in a distressed corporation in connection with the 2008 financial crisis. The expert analyze credit facilities and lending practices of financial institutions and other firms and

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Testimony in spoofing cases.

Mr. Flotron's former trainee, Mike Chan, agreed to testify against Mr. Flotron in exchange for the government not prosecuting him for his own spoofing activities. Mr. Chan testified at trial that he learned about Mr. Flotron's spoofing techniques when they worked together and he employed those techniques in his own trading.

The defense pointed out Mr. Chan's motivation to testify the way the government wanted him to. The defense also called an expert witness, Emre Carr, a former Securities and Exchange Commission economist, who analyzed and compared the trading practices and patterns of both Mr. Flotron and Mr. Chan. Here was a witness who claimed he learned how to spoof from the defendant. If this was true, Chan's trading practices likely would look very similar to those of Mr. Flotron's. Accordingly, the expert, Mr. Carr, examined the practices of each and found that they were, in fact, significantly different. This testimony undercut allegations that Mr. Flotron was the only person who used spoofing techniques.

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