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The Financial Conduct Authority – Part 1 – Market Manipulation

The term 'market manipulation' is a broad one which can mean a number of things.

In this GT Advisory, we consider how market manipulation is approached in the U.K. in both a civil and criminal context, and how it has been enforced by the U.K.'s Financial Conduct Authority (FCA). We also discuss spoofing, a tactic used by traders to gain an unfair advantage.

The Civil Regime

The Market Abuse Regulation (MAR), an EU regulation, contains prohibitions on insider dealing and the unlawful disclosure of inside information (Article 14). Here, we focus only on the prohibition of market manipulation (Article 15). MAR came into force in the U.K. following the commencement of the Financial Services and Markets Act 200 (Market Abuse) Regulations 2016 on 3 July 2016.

Article 12 of MAR specifies that market manipulation includes the following activities:

1. Entering into a transaction which gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument, a related spot commodity contract or an auctions product based on emission allowance;

2. Entering into a transaction, placing an order to trade or any other activity or behaviour which affects or is likely to affect the price of one or several financial instruments, a related spot

commodity contract or an auctioned product based on emission allowances, which employs a fictitious device or any other form of deception or contrivance;

3. Transmitting false or misleading information or providing false or misleading inputs in relation to a benchmark where the person who made the transmission or provided the input knew or ought to have known that it was false or misleading, or any other behaviour which manipulates the calculation of a benchmark.

4. The placing of orders to a trading venue, including any cancellation or modification thereof, by any available means of trading, including by electronic means, such as algorithmic and high-frequency trading strategies, and which has one of the effects referred to in paragraph 1(a) or (b) (in MAR Article 12), by:

   (i) disrupting or delaying the functioning of the trading system of the trading venue or being likely to do so;

   (ii) making it more difficult for other persons to identify genuine orders on the trading system of the trading venue or being likely to do so, including by entering orders which result in the overloading or destabilisation of the order book; or

   (iii) creating or being likely to create a false or misleading signal about the supply of, or demand for, or price of, a financial instrument, in particular by entering orders to initiate or exacerbate a trend;

Section 123 of the Financial Services and Markets Act 2000 (FSMA) as amended, allows the FCA to impose a penalty on a person who it is satisfied has contravened the prohibition on market manipulation as defined in Article 15 of MAR. Alternatively, the FCA can choose to publish a public statement censuring the person.

Following an investigation, the FCA must first issue a warning notice to the person in question, stating the amount of the proposed penalty or the terms of the proposed public statement. It is also able to impose prohibitions and suspensions on individuals if satisfied that such a contravention has occurred. If this is the case, the warning notice must state the proposed terms of the prohibition or length of the proposed suspension.

Should the FCA decide to impose a penalty, prohibition, or suspension, or to issue a public statement, a ‘decision notice’, also known as a final notice, must be issued informing the individual of the decision and explaining that the matter may be referred to the Tax and Chancery Chamber of the Upper Tribunal.

In addition, FSMA allows the FCA to apply to the High Court for an injunction restraining actual or likely contravention of Article 15 of MAR by an individual, ordering the individual to remedy the contravention and/or restraining any assets which the individual is likely to dispose of, or otherwise deal with.

The Criminal Regime

The principal market manipulation criminal offences are contained within Part 7 of the Financial Services Act 2012. These are as follows:

1. Making misleading statements (section 89) – It is an offence for a person to make a statement or to conceal facts with the intention of inducing another person either to enter into or to refrain

from entering into a relevant agreement or to exercise, or refrain from exercising, any rights conferred by a relevant instrument.

The offence is committed if the person who makes the statement knows it to be false or misleading, if the person is reckless as to whether his conduct may so induce, or if the person dishonestly conceals the material facts.

2. Misleading impressions (section 90) – It is an offence for a person to act or engage in a course of conduct which creates a false or misleading impression as to the market in, or the price or value of, any relevant investments.

   The person must intend to make the impression and intend either to induce another person to acquire, dispose of, subscribe for the investments, or to make a gain for himself or cause loss to another or be aware that it is likely to have that result.

These offences carry a maximum punishment of 7 years imprisonment and/or an unlimited fine.

The Fraud Act

In addition to the above, Section 2 of the Fraud Act 2006 makes it an offence for a person to:

1. Dishonestly make a false representation, and
2. To intend, by making the representation, either
   a. To make a gain for himself or another, or
   b. To cause loss to another or to expose another to a risk of loss.

A representation is false if it is untrue or misleading and the person making it knows that it is, or might be, untrue or misleading.

These offences carry a maximum punishment of 10 years imprisonment and/or an unlimited fine.

As with all financial crime, any investigation also will focus on the way in which the proceeds of the criminal conduct are dealt with, which could lead to further allegations of money laundering under Part 7 of the Proceeds of Crime Act 2002. This could include the concealment, conversion, or acquisition of such criminal property, offences which carry a maximum punishment of 14 years imprisonment.

Spoofing

The above legislation is drafted broadly, and there is therefore a range of conduct which could be considered a violation or an offence.

In recent years however, 'spoofing' has risen to become a primary concern for financial markets.

What is it?

Spoofing is a tactic used by traders to gain an unfair advantage. It involves the trader placing a high number of orders which he/she does not intend to fulfil in order to create a false impression of the market before exploiting the change by fulfilling contrary orders.

The effectiveness of the technique to the trader is often, but not necessarily, reliant on the use of 'high frequency' trading platforms, which use sophisticated algorithms and powerful computers to analyse and anticipate trends, as well as placing high numbers of orders in rapid succession.

In the U.K., the following description was given during the *Swift Trade* case (the description below is of 'layering', although in practice there is little difference between layering and spoofing):

> "layering" consists of the practice of entering relatively large orders on one side of an exchange's…electronic order book…without a genuine intention that the orders will be executed: the orders are placed at prices which are…unlikely to attract counterparties, while they nevertheless achieve the objective of moving the price of the relevant share as the market adjusts to the fact that there has been an apparent shift in the balance of supply and demand. The movement is then followed by the execution of a trade on the opposite side of the order book which takes advantage of, and profits from, that movement. This trade is in turn followed by a rapid deletion of the large orders which had been entered for the purpose of causing the movement in price, and by repetition of the behaviours in reverse on the other side of the order book. In other words, a person engaged in layering attempts to move the price up in order to benefit from a sale at a high price, then attempts to move it down in order to buy it again, but at a lower price and typically repeats the process several times.

This description was not challenged in the High Court in the *Da Vinci* case and in its judgment when referring to it, the court elaborated:

> From that description it will be apparent that the term 'layering' refers to the placing of multiple orders that are designed not to trade on one side of the order book, and the term 'spoofing' refers to the fact that the placing of such orders creates a false impression as to the person's true trading intentions.

A straightforward example could be the following:

1. Trader A places a high number of orders to sell a stock – this creates a reduction in the price of the stock as other traders follow suit, driving the price down even further.

2. Trader A then cancels his orders to sell, which he never intended to follow through on.

3. As the price reaches a significant low, Trader A buys a large order of the stock, which creates a surge in the price, earning him a large profit.

<u>Prosecutions and Enforcements Actions</u>

There have been no prosecutions in the U.K. for spoofing. Broadly, this may be due to the difficulty of proving the requisite element of intent. Similar difficulties have been encountered in the United States.

Instead, the FCA has chosen to pursue those suspected of the practice primarily through the civil courts. Notable enforcement actions include the following:

1. Michael Coscia (2013) – The FCA took civil enforcement action against Michael Coscia, a U.S.-based trader, fining him £597,993 ($903,176) in July 2013 for 'deliberately engaging' in layering over a six-week period in 2011. The FCA concluded that Coscia's trading activities in relation to Brent Crude, Gas Oil and West Texas Intermediate Futures on the ICE Futures Europe Exchange

in the U.K. amounted to deliberate market manipulation under Section 118(5) of the Financial Services and Markets Act (section now repealed).

After being pursued in the U.K., Michael Coscia was also pursued in the United States, with the Commodity Futures Trading Commission (CFTC) ordering him and his company Panther Energy Trading LLC to pay $2.8 million in penalties and disgorgements and banned both the company and Coscia from trading on any CFTC registered entity for 12 months. In addition to the CFTC's action, the United States Attorney brought a criminal action, and following a jury trial, in 2016 Coscia was sentenced to prison for three years.

This case represented a first on both sides of the Atlantic – it was the first time the FCA had taken enforcement action against a high frequency trader and was the first criminal prosecution under the specific prohibition on spoofing in the United States.

2. Swift Trade (2014) – In 2011 the FCA imposed a financial penalty of £8,000,000, which was appealed twice by the company to the U.K.'s Upper Tribunal and the Court of Appeal. A final notice was eventually issued in 2014.

3. Da Vinci Invest Ltd, Mineworld Ltd, Szabolcs Banya, Gyorgy Szabolcs Brad, and Tamas Pornye (2015) – the FCA applied for and secured an injunction in the High Court against the defendants after the court concluded that they had engaged in market manipulation by layering, ordering them and the companies to pay £7,570,000 in penalties.

Unlike the U.K., the U.S. has chosen to expressly outlaw spoofing, which is described in Section 6c, Title 7 of the United States Code as 'bidding or offering with then intent to cancel the bid or offer before execution'.

The U.S. definition was incorporated into U.S. law by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was created in the wake of the 2008 financial crisis and aimed to 'promote the financial stability of the U.S. by improving accountability and transparency in the financial system'.

More recently, the United States, armed with its express ban on the practice of spoofing, opted to pursue individuals in the criminal courts *and* the civil courts. In January 2018, the Department of Justice announced that it had charged eight individuals across six cases with spoofing offences. The CFTC also pursued many of the same individuals in civil enforcement actions.

Challenges

Whilst the U.S. authorities take a direct, criminal-based approach to dealing with this activity, they are still required to prove that when the individual placed the so-called 'spoof bid', they did so with the *intention* of cancelling it before the order was executed.

Equally, to secure a conviction for offences under the U.K.'s Fraud Act, the prosecuting body must prove that when the trader placed the spoof bid/bids, that it was a false bid, placed with an element of dishonesty and with the *intention* that the trader would make a gain or cause loss. Similarly, offences under the Financial Services Act 2012 require proof of intent to induce/create the misleading impression, or alternatively that the individual was reckless, a difficult test to satisfy.

To prove intent, prosecutions often rely on what can be inferred from the undisputable facts and other circumstances surrounding the action in question. Many traders and others connected to the world's financial markets argue that bids are placed and then cancelled all the time without any dishonest intent.

These types of challenges proved too difficult for the U.S. to overcome when in 2018 they prosecuted Andre Flotron, a former precious metals trader, for spoofing. The Greenberg Traurig defence team, led by Shareholder Marc Mukasey, successfully argued that the government could not prove spoofing because it presented only a fraction of Flotron's trading activity in what amounted to a 'prosecution by statistics'. In addition, they argued that the prosecution failed to present any evidence of collaboration with others to prove the conspiracy element of the charge against Flotron. The resulting acquittal was the first following a trial for allegations of spoofing.

Prosecution of spoofing necessarily involves an in-depth analysis of bid cancellations, however; what *Flotron* shows and what has perhaps prevented any criminal prosecutions in the U.K. thus far, is that proving a number of cancellations alone will not be enough.

An additional challenge in some cases is the employment of complex and sophisticated high frequency algorithms, which may require extensive and specialist consideration by prosecuting authorities. Not only is this expensive, but any resulting evidence will have to be collated, produced, and presented in a clear and concise way so that juries can understand the evidence presented to them.

Although there may be an apparent lack of enforcement action, on 13 December 2018, the FCA published guidance on 'financial crime systems and controls: insider dealing and market manipulation' which adds an additional chapter to its handbook on these two interrelated topics. The additions to the handbook include what is recommended to and expected of firms to counter the risk of financial crime and will be considered in more detail in a later article.

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